ASPPA
WORKING FOR AMERICA'S RETIREMENT

RPF-2 Study Guide: Retirement Plan Fundamentals Part 2

2007 Edition

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Preface

The objective of the Retirement Plan Fundamentals Course is to give an individual beginning a career as a retirement plan professional a general background in qualified retirement plans as a “first step” toward meeting the challenges of the profession. It also is to provide those individuals who work for insurance companies, brokerage firms, or financial consulting firms a level of knowledge that will help them increase their ability to assist plan sponsors. The course is divided into two parts: each part is designed to build upon the groundwork established by its predecessor while not duplicating content or presupposing knowledge or experience level. **This manual contains Part 2 only.** Part 1 is available separately or within a set of manuals containing the entire course. The material covered in each part is described below.

Part 1 - Retirement Plan Fundamentals 1 (RPF-1)

- Introduction to Retirement Plan Fundamentals
- Who Sets up the Plan and Keeps it Running Smoothly
- Defined Contribution Plans
- Defined Benefit Plans
- First Steps to a New Plan
- Basic Plan Document Language
- Plan Qualification
- Enrolling Employees
- Disclosure and Communication
- Withdrawals While Actively Employed
- Participant Loans
- Distributions Tax Rules
- Updating Plans and Error Corrections
- Record Retention

Part 2 – Retirement Plan Fundamentals 2 (RPF-2)

- Retirement Plan Administration
- Allocations and Maximum Limitations on Benefits
- Annual Testing
- Living in an Electronic World: Daily Valuation
- Differences Between Balance Forward & Daily
- Fiduciary Considerations
- Appropriate Investments for Daily Valuation Plans
- Analyzing Investment Fees
- Daily Activities
- Mutual Fund Trading Practices
- Processing Transactions

- Ethics in Dealing With Trading Errors and Corrections
- Conversion Decisions & Issues
- Conversion Types & Methods
- Audits of Employee Benefit Plans
- Mergers and Terminations

Throughout the course, preference has been placed on using descriptive titles rather than numeric references to the sections of various laws that govern retirement plans. In addition, in an effort to enhance understanding, both the descriptive title and the Code Section number may be provided within the textual discussions.

Should it be necessary to make any corrections to the study manuals or exams or should any clarification of the material in the study manuals or exams be required, this information will be posted on the ASPPA website at http://www.asppa.org/edu/study-guide-references.htm. It is the candidate's responsibility to regularly check the ASPPA website in order to obtain this information.

Each part (RPF-1 and RPF-2) of the Retirement Plan Fundamentals Course has a separate exam covering the material in that part. The exams are graded separately and may be taken at different times.

Additional information, including online registration for the RPF exams, is available on the ASPPA website at http://www.asppa.org/education/ed_rpf_info.htm. Once you register, you will receive access to the online exam via the ASPPA website. There are no paper exams for RPF-1 or RPF-2. All exams must be completed online. The instructions that appear at the beginning of the exams should be read carefully to understand the rules that must be followed when completing the exams. A grade of 90% (68 out of 75 questions correctly answered) is required to pass each exam.

Time Period Covered by This Material: This course manual and exams will not cover any new legislation passed after August 1, 2006.

Sample Forms and Procedures: The Retirement Plan Fundamentals Course contains sample forms and procedures. These are not meant to be used by a firm without review by the firm and its attorney. The forms and procedures are samples to show some of the items that may be included and are meant to be used as a training tool. The forms and procedures should not limit what is acceptable or might be used in practice.

ASPPA is a nonprofit professional society. The materials contained herein are intended for instruction only and are not a substitute for professional advice.

ASPPA welcomes comments about the course and requests completion of the User Input Form provided. For additional questions, please write to the ASPPA Education Services department at 4245 North Fairfax Drive, Suite 750, Arlington, VA 22203-1606. Candidates may also contact ASPPA by calling the Education Services department at (703) 516-9300, faxing an information request to (703) 516-9308, or sending a message to the ASPPA office via e-mail at educasppa@asppa.org.

User Input Form

Retirement Plan Fundamentals Course – Part 2
2007 Edition

Please complete this form with any suggestions which could be incorporated into future course updates. Make a note of any areas found unclear or where additional information might have been helpful. Any comments or observations are appreciated.

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Chapter 1:
Retirement Plan Administration

§1.01 Learning Objectives

- List the client data collected to serve as the basis for plan administration.
- Detail the type of census data collected and the steps involved in evaluating its veracity.
- Identify key employees from a list of employees and census data.
- Identify HCEs from a list of employees and census data.

§1.02 Introduction

The phrase retirement plan administration covers a wide range of administrative and clerical functions associated with the operation of an employee benefit plan. Depending upon the nature of the services provided by the administrative firm or a retirement plan professional's role in a qualified plan's day-to-day activities, retirement plan administration means different things to different companies.

Retirement plan administration firms, especially those administering daily valuation plans, often gather census data periodically during the year. Employee census information is the foundation for retirement plan administration work. The firms use the data to perform interim quarterly or semiannual nondiscrimination testing, as well as year-end testing. Some of the other administration functions handled by the retirement plan administrator include the determination of employee status, vesting and eligibility, performing various tests, monitoring limits, determining the allocation of contributions and preparing governmental forms. In order to perform these functions an administrator must review the plan document, look at the financial activity and review the census information.

§1.03 Review of Plan Document Files

A first, critical step in retirement plan administration is the review of the plan documents for all rules by which the plan and its trust are to be operated. At this juncture, care is taken to confirm with the plan sponsor or its designated representative that the document file is current and complete.

Most retirement plan administration firms maintain the following records relating to the plan and trust agreements in a document file:

- An executed copy of the current plan/trust. Older plans may have any number of prior documents or amendments because of ERISA and subsequent legislation, regulations and interpretative rulings;
- An executed copy of all amendments to the current plan/trust;
- A copy of the IRS determination letter or opinion letter for the plan, if applicable;
- A copy of the Summary Plan Description (SPD) and any Summary of Material Modifications (SMM); and
- A copy of the Form 5500 (Annual Return/Report of Employee Benefit Plan).

While this listing of plan documents is not exhaustive, it represents the minimum documentation necessary to begin administrative work.

If the plan document is a volume submitter, master or prototype plan, a copy of the opinion letter issued to the sponsor of the prototype is retained in the retirement plan administration firm's files. Any opinion letter on file is reviewed to be certain that it relates to the current plan document.

If the retirement plan administration firm submitted the plan to the IRS for a determination letter, copies of the submission forms are part of the document file. If the client's attorney prepared the submission, a copy of the submission is kept on file for reference purposes.

§1.04 Review of Client Data and Workpapers from Prior Years

To perform the year-end administration, a retirement plan professional generally receives the following information from the plan sponsor (or its designated agents):

- Employee census and plan documents;
- Financial information (account activity); and
- Supplemental information about the plan sponsor.

In addition to thoroughly reading the plan documents, the retirement plan administration firm reviews its existing files related to the plan. This review includes any prior workpapers, informational source documents from the plan sponsor or trustee (as explained below) and all correspondence. The goal is for the administrators to become acquainted or reacquainted with the plan type and design, its provisions, the number of employees and participants and the relationships of any parties-in-interest to the plan.

Particularly useful are:

- General correspondence with the plan sponsor and its advisors;
- Valuation or allocation reports for prior year(s) and current year;
- Source documents including fidelity bond, census and financial information for prior year(s) and current year;
- Government filings for prior year(s);
- Nondiscrimination testing results for prior year(s); and
- Determinations of key employees and HCEs.

If any of these items are missing, the retirement plan administration firm may not have enough information to proceed with the year-end administration of the plan. Also, the census data, as discussed later in this chapter, is analyzed after a careful reading of the plan document to determine if all the facts are present to identify eligible employees.

§1.05 Unresolved Issues and Sample Request Forms

[A] Dealing with Unresolved Issues

Files are evaluated carefully, making note of any issues which may be unresolved. For instance, current correspondence may request or reference a plan amendment that is not present in the file, or there may be a dispute with a terminated participant regarding vesting or the benefits payable. Perhaps something has transpired since the end of the prior plan year that materially influences the administrative assignment such as the implementation of a new investment option or the initiation of a rollover plan provision.

A plan administration firm never makes assumptions regarding the disposition of an unresolved issue. Some issues may require further consultation with attorneys, the client or others involved in the operation of the plan. Other issues may require research into the Internal Revenue Code and ERISA regulations and rulings. Attention to such details ultimately serves the best interests of the client.

[B] Sample Request Forms and Documents

The following are sample request forms that a retirement plan administration firm may use to collect information about the plan and/or the plan sponsor.

- Periodic Information Request - general company and sponsor information;
- Professional Advisor Information - list of agents, brokers, attorneys or other professionals;
- Plan Information - summary of administrative activity during the plan year;
- Plan Sponsor Information - ownership, controlled group and officer information; and
- Union Employee Information - data summary for union employees.

Please refer to Appendix A for samples of these request forms.

§1.06 Employee Census

Most retirement plan administration firms ask clients for full and complete census information for all employees each reporting period. This information may be provided annually or along with each electronic contribution file.

The data collected should include:

- Names;
- Social Security Numbers for identification and tax reporting purposes;
- Dates of birth, hire, rehire and termination;
- Hours worked; and
- Compensation.

Where applicable, the data should provide additional information regarding elective deferrals, after-tax employee and employer matching contributions, employee numbers, division or union codes, as well as any available status indicators such as “on military leave of absence” or “terminated due to disability.”

The information serves as the basis for:

- Calculation of vesting, eligibility, participation and contributions;
- Completion of administrative reports for the plan, along with participant statements and other disclosures;
- Preparation of annual governmental filings and tax forms issued to the participants from the plan; and
- Nondiscrimination testing required by the Internal Revenue Code and ERISA.

[A] Full and Complete Data

Upon receipt of the data, ascertain whether the employer has furnished the complete census, not just those employees it has determined to be eligible (although if union employees are ineligible under the plan, the employer may simply advise that it is supplying employee detail for the nonunion employees and include a headcount total of the union population). Many retirement plan professionals request census information in different forms to ensure complete disclosure of employee data. For example, one request might be for actual individual data for the entire population while another would be for a summary count by category.

Depending upon the frequency of administrative services for a client, different information may be needed at various times of the year. While some data is electronically collected with each contribution file, other information is collected only at the end of the plan year. As an example, a plan sponsor who engages a retirement plan administration firm for daily valuation may identify the owners and officers of the business for performing the plan’s interim nondiscrimination testing quarterly or only at year-end.

Upon receipt of census information, the data is carefully checked for completeness and a list of missing data or discrepancies is created for resolution with the plan sponsor. A good understanding of the plan document provisions lends itself well to census data review and assists the vigilant retirement plan professional in determining what data is required. For example, if the plan document specifies use of the elapsed time method for measuring service, then the census data need not contain hours worked but should contain all dates of hire, rehire and termination. (Missing information is further discussed below.)

[B] Electronic Data Transmission

It is common for many employers to transmit their data electronically. In general, electronic transfer is preferred because it eliminates input error for the retirement plan administration firm and is usually more efficiently processed. When a plan sponsor agrees to submit data electronically, the retirement plan administration firm works with the employer to identify and verify the formats in which data can be accepted and to formulate procedures for assuring receipt of a complete transmission. For example, the electronic data transfer might be accompanied with a summary showing grand totals of the number of employees, compensation and elective deferrals for the transmission period. Additionally, grasping the limits on formatting and transfer capabilities, if any, from both the retirement plan administration firm and the plan sponsor’s aspect enables a smooth procedure for receipt of data.

§1.07 Is the Census Data Reasonable?

[A] Comparing the Information

An important administrative step involves comparing the current year-end census information against that provided in the prior year. The following questions always bear consideration during this comparison:

- Are there significantly more or less employees than last year? If so, is there an explanation for a significant change in the number of employees?
- Is compensation reasonable when compared with last year? For example, if the total number of employees is relatively unchanged, then total compensation should not be markedly lower or higher than the previous period without a suitable explanation.
- If there is a significant increase or decrease in compensation for any specific employee, what precipitated the change? Is it reasonable?
- Has there been a change in ownership of the sponsor?
- Are there types of data provided in the prior year that are not present in the current data? For example, last year's data might have included after-tax employee contribution information, while this year's does not. The answer may be that the plan was amended to eliminate after-tax employee contributions, and a copy of the amendment was inadvertently not sent to the retirement plan administration firm.
- The dates of birth and hire for employees should be consistent with the prior year's data. If there is a change to an employee's information, what substantiates the change?

Many daily valuation software systems can generate exception reports that will automatically compare census data and provide an exception report. For example, a date of birth such as 2/15/2025 that should be 2/15/1925 will automatically be shown as an error to be evaluated.

[B] What Is Reasonable?

Evaluating data to determine if it is reasonable may prove difficult as it is a somewhat elusive measure. Generally speaking, any plan level change in the overall data from that of the prior period should have an accompanying explanation that can be accepted as reasonable, given knowledge of the plan, the plan sponsor and the existing economic climate. There should not be any mystery or blind acceptance of data discrepancies or anomalies.

<u>1. Understanding the Client's Business</u>

It may be helpful to understand the nature of the client's business before undertaking an evaluation of the employee data. For example, an employer whose business is seasonal may report many employees with short employment periods, engendering an understandable fluctuation in population size from year-to-year. Employers in certain industries such as technology or travel services may have undergone a reduction in employee population as their industry experiences a downturn. Businesses emerging from newly-established status into stable profitability might double their hiring practices or raise salaries significantly in the current period. These and similar considerations assist the retirement plan administration firm to establish criteria that may be applied during data review and help to support the reasonable standard of data integrity.

2. Changes in Size of Employee Population

One reasonable comparison that can be made easily relates to the number of employees shown on the current census compared to the prior period's data. If there is more than a 10-20 percent variance in the number of employees, the increase might be explained by a planned business expansion through vigorous hiring practices or the acquisition of another business. An influx of employees with current dates of hire would support such a reasonable explanation. Alternately, perhaps the plan sponsor sold a division of employees or undertook layoffs due to an industry-related economic downturn, as evidenced by a significant number of dates of termination reported on the prior period's census. The resulting decrease in the employee population during the current period could then be understood, since participants terminated in a prior period would not typically appear on the current period's census.

3. Normal Progression of Compensation

Another area for consideration is compensation. Typically, the compensation reported for an employee shows a normal progression from year-to-year as the result of annual raises. The amount of this progression reflects industry standards, the plan sponsor's financial position, and external economic indicators. For example, a salary increase of 3-10 percent from the prior year within a good economy normally is considered a reasonable adjustment.

Significant reductions in a participant's compensation should be reviewed. To illustrate, if an employee with a past salary history of $40,000 yearly is reported with $2,000 in compensation for the plan year with no date of termination, the retirement plan administrator might question the validity of the blank date of termination or ask if the employee is on a leave of absence.

Other fluctuations in data may be understandable if employees receive promotions, bonuses, commissions, overtime or work on an hourly basis, since these compensation elements are usually tied to the state of the general economy. Employee position also may dictate salary changes. For example, compensation figures reported for owners of the business may be subject to greater fluctuations based upon the general success of the business during the year.

<u>4. Discuss Significant Changes</u>

Any significant changes in census data should be discussed with the plan sponsor. There may be issues related to plan design or nondiscrimination testing which are discussed with the plan sponsor before proceeding with the current period's administrative work. For example, a reduction in the plan's population of 10-20 percent may create a situation where the plan is considered partially terminated.

§1.08 Other Items Involving Census Data

As part of the evaluation of the census data, the following areas also warrant attention:

[A] Retirement and Termination Issues

- Is any participant working beyond his or her normal retirement date as defined in the plan document? Generally, benefit accruals and contribution allocations continue if the participant remains employed beyond retirement age.
- Have any participants terminated employment during the plan year? Are any participants entitled to a distribution of their vested benefits?

[B] Missing Information

- Are there any employees who were employed during the last year/period for whom no compensation was reported or have otherwise dropped off the census?
- If the plan sponsor has a cafeteria plan, have the salary reduction contributions to that plan been provided?
- Does the definition of compensation in the plan document exclude bonuses, commissions or other compensation? Are there multiple definitions of compensation for different purposes? If so, is the compensation data sufficient to support application of these definitions?
- Are there any newly-reported employees on the current census with dates of hire in a prior period? If so, prior employment history is requested.

§1.09 Census Data Involving Employee Status

[A] Identification of Key Employees

As part of the intrinsic census data evaluation, it is critical that sufficient information be available for determination of key employee status for any employee. As introduced in RPF-1, the Internal Revenue Code requires that every qualified plan document contain the definition of a key employee, an explanation of how to determine if a plan is top-heavy and the top-heavy requirements for minimum contributions and vesting.

1. Key Employee Determination Data

The primary census data used in key employee determination are: officer status, number of employees, compensation, ownership percentage and familial relationship to an owner.

The three classifications of **key employee** are:

- Includible officer;
- 1% owner; and
- 5% owner.

If an employee falls into any one of the three classifications of key employees, he or she is considered a key employee for the plan year. Each classification test is applied independently.

The **includible officer** classification begins with identification of officers whose annual compensation is $130,000 or more (as indexed) and ranking them in order of descending compensation. For 2006, the limit is $140,000. Please refer to Appendix B for a summary of various plan limits, including limits applicable to the includible officer test.

Next, determine the maximum number of employees who may be considered officers for purposes of key employee identification. This is done by calculating that number which equates to 10 percent of the employee population, increased to the next whole number. The result is subject to a minimum of three and a maximum of 50.

Example 1-1. Maximum number of officers. A population consists of 400 employees. The maximum number of officers to designate as key employee is 50, or, if less, the greater of 10% of the employees (40) or three. Therefore, the resulting maximum officer count is 40.

Example 1-2. Maximum number of officers. A population consists of 20 employees. The maximum number of officers to designate as key employee is 50, or, if less, the greater of 10% of the employees (2) or three. Therefore, the resulting maximum officer count is three.

Designate all officers in descending compensation order up to the required officer count as key employees. To illustrate, assuming an employee population of 600 and a listing of 75 officers earning $130,000 or more (as indexed) ranked from highest to lowest compensation, only the 50 most highly paid officers are key employees.

The remaining two classification tests require data on familial relationships between owners and other employees of the plan sponsor to determine indirect ownership. There are no minimum or maximum ownership counts for these tests. A **1% owner** is an employee owning either directly or indirectly more than 1 percent of the business and whose annual compensation exceeds $150,000. Note that the $150,000 level is not indexed.

A **5% owner** is an employee owning either directly or indirectly more than 5 percent of the business regardless of compensation. Quantifying indirect ownership for these classifications requires an understanding of constructive ownership.

2. Constructive Ownership

Ownership at any time during the plan year should be taken into account when determining constructive ownership via familial relationships. For purposes of top-heavy requirements, generally, an individual is considered as indirectly owning the stock of a spouse, child, grandchild and parent. This is often also referred to as attribution of ownership.

Under these rules, spouses own each other's stock; parents own their children's stock; children own their parent's stock; and grandparents own their grandchildren's stock. Note that siblings do not own each other's stock, and a grandchild does not own the stock of a grandparent.

Example 1-3. Stock attribution. Jeremiah owns 50% of ABC Company. His daughter, Mary, owns 25% of ABC Company and is married to Robert. Mary and Robert have a son, Joshua, who owns 25% of ABC Company. When considering attribution, Jeremiah is considered a 100% owner (his 50%, plus his daughter's 25%, plus his grandson's 25%). Mary is also considered a 100% owner (her 25%, plus her father's 50%, plus her son's 25%). Robert is considered a 50% owner (his wife's 25% plus his son's 25%). Joshua is considered a 50% owner (his own 25% plus his mother's 25%). Note Joshua does not get attributed his grandfather's 50%.

In familial relationships, double attribution of ownership is not permitted. Once a family member is an attributed owner of the stock of a family member, that stock is not attributed again to another family member.

Example 1-4. Double attribution. If an owner's child is an employee of the plan sponsor, the stock of the owner is attributed to the child. If the child's spouse also is an employee, the stock that was attributed from the owner to the child is not attributed to the child's spouse because of their marital relationship.

Constructive ownership can also occur due to organizational structures. For example, if Warren, an employee of Company B, owns 100 percent of Company A which in turn owns 25 percent of Company B, Warren is the attributed 25 percent owner of Company B. He is, therefore, a key employee under Company B's plan.

As illustrated, an understanding of the client's organizational and business structure is necessary for key employee determination, and disclosure of such business structures should be part of the annual information gathered from a client.

[B] Identification of Highly Compensated Employees (HCEs)

Employer census data also should be evaluated with **highly compensated employee (HCE)** status in mind, as introduced in RPF-1. Much of the data used in designating key employee status also is utilized for HCE determination. Again, the plan document should be consulted as a prerequisite for understanding which census data elements are required.

1. HCE Determination Data

The primary census data for HCE determination are: ownership percentage and familial relationship to an owner in both the current plan year and the **lookback year** (12-month period immediately preceding the year), compensation in the lookback year, and, if the top-paid group election has been made, date of birth, date of hire, date of termination and hours worked.

The two classifications of HCE are:

- 5% owner; and
- Compensation.

If an employee falls into either of the two classifications of HCEs, he or she is considered an HCE for the plan year. Each classification test is applied independently, just as the key employee classification tests are applied.

Under the ownership classification, an employee who is a 5% owner in either the current year or the lookback year is considered an HCE. Constructive ownership rules apply as they do in key employee ownership determination. Of note: an individual who is an HCE due to ownership classification is an HCE regardless of whether the plan uses the top-paid group election.

The **compensation test** includes as an HCE any employee who earns more than $80,000 (as indexed) during the lookback period. Hence, current year compensation is not required. For 2006, the compensation limit is $95,000. Please refer to Appendix B for a summary of the various plan limits, including those applicable to the compensation test.

This classification may be modified by use of the top-paid group election as set forth in the plan document. If the plan document includes the **top-paid group election**, an employee earning more than the applicable dollar limit during the lookback period also would have to be in the top 20 percent of employees when ranked by compensation in order to be an HCE. As discussed in RPF-1, certain employees may be disregarded in the calculation of the number representing the top 20 percent, and data representing dates and hours worked would then be needed for that calculation.

When assessing the data for the current period, the HCE compensation classification and top-paid group election if used would determine HCE status for the next plan year. Ownership at the applicable threshold during the current year would additionally be used to determine HCE status for the next plan year as well as the current year.

This determination of HCEs and nonhighly compensated employees (NHCEs), once completed, is used to demonstrate compliance with various nondiscrimination and coverage rules including:

- Minimum coverage;
- The ADP test for elective deferrals;
- The ACP test for after-tax employee and employer matching contributions;
- The compensation definition test; and
- The general nondiscrimination test for the level or amount of benefits provided under the plan.

In keeping with key employee determination and top-heavy testing, accurate and complete HCE determination cannot be overemphasized.

[C] Key Employees Versus Highly Compensated Employees

It is important to understand the difference between the definitions of key employee and HCE. While it is often true that all key employees of a small employer are HCEs, this is not always the case. Be careful when identifying each category, remembering that key employees are used to determine top-heavy status, while HCEs are used in all other nondiscrimination testing.

Consider the following census data for the 2005 calendar year to compare the key employees and the HCEs. Assume ownership and compensation have not changed in 2004 or 2005 and the top-paid group election is not made.

Employee	Ownership	Officer	Compensation
Claire	0%	Yes	$35,000
Jordan (1)	50%	Yes	$187,500
Marie (2)	0%	No	$82,000
William (3)	50%	Yes	$240,000
John	0%	No	$16,423
David	0%	No	$95,000
Larry	0%	No	$5,480
Sally	0%	No	$68,000
Nancy	0%	No	$48,450
Patricia	0%	No	$46,200
Cindy	0%	No	$16,800

(1) Jordan is married to Marie and is brother to Charles.
(2) Marie is married to Jordan.
(3) Charles is brother to Jordan.

In 2005 key employees are includible officers (earning $130,000 or more, 1% owners or 5% owners.

Key Employees:
Jordan – 1% owner, 5% owner, includible officer
Marie – 5% owner (by attribution)
William – 1% owner, 5% owner, includible officer

In 2005, HCEs are 5% owners in 2004 or 2005 or satisfy the compensation test (earn more than $90,000 in 2004).

HCEs
Jordan – 5% owner (2004 and 2005), compensation test
Marie – 5% owner (2004 and 2005 by attribution)
William – 5% owner (2004 and 2005), compensation test
David – compensation test

§1.10 Trust Accounting

The production and/or review of detailed and accurate statements of the funded status of the qualified plan is a key function of a retirement plan administration firm. While every step of the periodic administration process is critical to the accuracy of the final product, trust accounting frequently proves to be the task that consumes the most time. Sometimes it is likened to balancing the plan's checkbook against its bank account statements on a grand scale. A plan that is using daily valuation performs this reconciliation daily to balance the assets reported by the investment firm to those reported on the daily valuation recordkeeping system. At the plan year-end, trust accounting is used for another purpose.

[A] The Purpose of Year-End Trust Accounting

Trust accounting at year-end shows the big picture of financial activity for the overall plan, as opposed to the small picture illustrated by the allocation and valuation processes on a daily basis for the individual participants. To confirm that expected transactions have been processed properly for daily valuation, the plan's whole performance must be analyzed.

Trust accounting serves the following purposes in plan administration:

- Examination of trust fund activity to identify prohibited transactions and other unusual entries; and

- Preparation of year-end (unaudited) financial statements for use by the client, auditor and in governmental reporting.

The financial statements referenced above include the Summary of Cash Receipts and Disbursements, the Balance Sheet (or Statement of Net Assets Available for Benefits), and the Income Statement (or Statement of Changes in Asset Values).

The Summary of Cash Receipts and Disbursements tracks the flow of cash in and out of the plan. It reconciles the cash balance at the beginning of the period to the balance at the end of the period.

The Balance Sheet presents the financial position of a plan at the end of the accounting period. It shows the assets and liabilities by major category: for example, cash, investments (identified by type) and expenses due to be paid.

The Income Statement provides a summary of the financial activity of the plan. It details income and expenses to track the change in net assets during the period.

Trust accounting is said to be in balance or reconciled when:

- The net assets on the Balance Sheet and the net assets on the Income Statement are the same; and
- The cash balance on the Summary of Cash Receipts and Disbursements and the Balance Sheet are the same.

[B] Directed Investments

In a daily valuation plan one additional financial statement may be prepared. In effect, a mini-income and expense statement for each of the investment choices available to participants is completed to assist in reporting and disclosure to the participants, plan fiduciaries, plan auditors and on Form 5500. This statement summarizes the net change during the plan year for each investment computing the interest, dividends, realized gains and/or losses, unrealized gains and/or losses and any fees or expenses that may have been charged against the fund.

§1.11 Key Terms

1% Owner: An individual who owns more than 1 percent of a business and earns more than $150,000. Used when determining key employees.

5% Owner: An individual who owns more than 5 percent of a business. Used when determining key employees and HCEs.

Compensation Test: An individual earning more than the indexed amount in the lookback year satisfies the compensation test. Used when determining HCEs.

Highly Compensated Employee (HCE): An employee who, (1) during the current or preceding year, is or was a 5% owner, or (2) received compensation in excess of the specified dollar limit for the preceding year.

Includible Officer: Generally, an officer whose annual compensation is $130,000 or more (as indexed). Used when determining key employees. Note that the maximum number of officers (those includible) is 50, or, if less, the greater of 10 percent of the employees or three.

Key Employee: A participant who, at any time during the plan year is: (1) an includible officer who earns $130,000 or more, as indexed, (2) a 5% owner, or (3) a 1% owner.

Lookback Year: The 12-month period immediately preceding the current year. Used when determining HCEs.

Top-Paid Group Election: An election made when determining HCEs whereby in addition to satisfying the compensation test, the employee must be in the top 20 percent of employees when ranked by compensation to be considered an HCE.

§1.12 Review of Key Concepts

- Retirement plan administration refers to the periodic reporting, recordkeeping and governmental filing for a retirement plan.

- The plan documents, census, financial data and supplemental information about the plan sponsor are some of the documents needed to perform administrative functions.

- Employee census information (name, Social Security Number, date of birth, date of hire, date of termination, hours worked, compensation) is the foundation for determination of employee status, vesting and eligibility for plan benefits and contributions.

- It is important that census data be reviewed for accuracy, completeness and reasonableness.

- The determination of key employees is used in top-heavy testing.

- The determination of HCEs is used in nondiscrimination testing.

§1.13 Review Questions

[A] True or False

______ 1. Generally, hours worked is necessary to complete retirement plan administration for the year.

______ 2. Every officer earning $130,000 or more (as indexed) is included as a key employee.

[B] Multiple Choice

3. All of the following employee census data is applicable to 401(k) plan administration, **EXCEPT**:

   A. Date of birth
   B. Date of hire
   C. Elective deferral rate
   D. Number of children
   E. Compensation

4. All of the following are reasonable steps to evaluating employee census data, **EXCEPT**:

   A. Requiring participants to return personal data sheets with notary signatures
   B. Requesting employee census information in different forms
   C. Comparing current year census data with prior year data
   D. Reviewing plan correspondence
   E. Contacting a plan administrator regarding significant changes

5. Based on the following information, determine 2006 key employees in a company of 500 employees.

Name	Direct Ownership	Officer	Relationship	Compensation
A	4% owner	No	None	$100,000
B	50% owner	Yes	Married to C	$120,000
C	No	No	Married to B	$ 70,000
D	No	Yes	None	$155,000
E	No	No	None	$200,000

   A. Participants A, B and D only
   B. Participants B and C only
   C. Participants B, C and D only
   D. Participants D and E only
   E. Participants B, D and E only

6. Based on the following information, determine the 2006 HCEs.

- Ownership is the same for 2005 and 2006.
- The top-paid group election has not been made.

Name	Direct Ownership	Officer	Relationship	2005 & 2006 Compensation
A	4% owner	No	None	$100,000
B	50% owner	Yes	Married to C	$120,000
C	No	No	Married to B	$ 70,000
D	No	Yes	None	$155,000
E	No	No	None	$200,000

A. Participants A, B and D only
B. Participants B and C only
C. Participants B, C and D only
D. Participants A, B, D and E only
E. Participants A, B, C, D and E

§1.14 Answers

1. **True.** Hours worked is necessary to complete retirement plan administration for the year. §1.06

2. **False.** The number of officers included as key employees is limited to 10 percent of the employee population subject to a minimum of 3 and a maximum of 50. §1.09 [A]

3. The correct answer is **D.** §1.06

   A. Incorrect. The statement is true because dates of birth are applicable to 401(k) plan administration.
   B. Incorrect. This statement is true because dates of hire are applicable to 401(k) plan administration.
   C. Incorrect. This statement is true because the elective deferral rate is applicable to 401(k) plan administration.
   D. Correct. This statement is false because the number of children is not applicable to 401(k) plan administration.
   E. Incorrect. This statement is true because the amount of compensation is applicable to 401(k) plan administration.

4. The correct answer is **A.** §1.09 [A]

   A. Correct. This statement is false because requiring participants to return personal data sheets with notary signatures is not a reasonable step in evaluating employee census data.
   B. Incorrect. This statement is true because requesting employee census information in different forms is reasonable when evaluating employee census data.
   C. Incorrect. This statement is true because comparing current year census data with prior year data is reasonable when evaluating employee census data.
   D. Incorrect. This statement is true because reviewing plan correspondence is reasonable when evaluating employee census data.
   E. Incorrect. This statement is true because contacting a plan administrator regarding significant changes is reasonable when evaluation employee census data.

5. The correct answer is **C.** An employee who is an includible officer, a 1% owner or a 5% owner in 2006 is considered a key employee. Employee D is an includible officer (earning $140,000 or more in 2006). Employee B is a 1% owner (owns more than 1 percent and earns more than $150,000). Employees B and C are 5% owners (own more than 5 percent directly or via attribution). Therefore, employees B, C and D only are considered key employees in 2006. §1.09 [A]

6. The correct answer is **E.** An employee is an HCE in 2006 if he or she is a 5% owner in 2005 or 2006, or satisfies the compensation test. Employees B and C are 5% owners (own more than 5 percent directly or via attribution in 2005 or 2006). Employees A, B, D and E satisfy the compensation test (earned more than $95,000 in 2005). Therefore, employees A, B, C, D and E are HCE in 2006. §1.09 [A]

Chapter 2:
Allocations and Maximum Limitations on Benefits for Defined Contribution Plans

§2.01 Learning Objectives

- Discuss how earnings and dividends are determined and credited to participant accounts in daily recordkeeping.
- Explain the concept of forfeitures and how forfeitures may be allocated each year in a defined contribution plan.
- Calculate a basic contribution allocation in a given limitation year using a pro rata formula.
- Explain the concept of allocating contributions using permitted disparity.
- Explain the formula for determining a participant's annual additions limit.
- Identify the types of allocations counted as annual additions.
- Calculate the annual additions limit for a participant in a defined contribution plan.

§2.02 Introduction

One might be surprised initially to learn that a contribution may not necessarily be divided or allocated among eligible participants in the same manner as its total amount was determined. For example, a contribution might be defined as three percent of eligible compensation, but each participant does not always receive an allocation of three percent of his or her individual compensation. Instead, perhaps the plan document sets forth an allocation on the basis of service rendered to the employer.

There are likely as many allocation formulas as there are contribution formulas, limited only by tax-deductibility, employer affordability, ease of administration and nondiscrimination testing considerations. Consequently, this chapter highlights principles that govern allocations in the administration of defined contribution plans.

Just as there are minimum benefits and contributions requirements under the Internal Revenue Code and ERISA which must be met for qualified plan status, so too are there benefits and contributions limits for every qualified plan. Sometimes called 415 limits after the Internal Revenue Code section that contains them, these maximums operate quite differently for defined contribution plans than for defined benefit plans because of the intrinsic dissimilarity in how retirement benefits are calculated under each plan type. This chapter considers the maximum limitation on benefits that applies to defined contribution plans: the annual additions limit.

§2.03 Investment Earnings Allocations

Defined contribution plans, particularly 401(k) plans, may permit participants to direct the investment of their individual accounts among various investment funds. Accounts with individual direction of investments using daily valuation are tracked and reported to the participant based on the number of shares or units that the participant owns. The plan document states the method for allocating investment gains or losses to the individual accounts of the participants; therefore, the method should be strictly adhered to for operational compliance.

In this case, the change in share or unit price of the investments reflects the earnings and the change in value in each participant's account. Dividends, interest and other income (e.g., capital gain distributions) are paid by the investments throughout the plan year. The income is automatically reinvested in the investment that generated the income. This is a routine process handled by the mutual fund or other investment vehicle.

When a dividend or capital gain distribution is paid, the mutual fund notifies the plan that it will make the payment to shareholders on record as of a certain date (also known as the record date or ex-date), the amount of the distribution per share and the date it will be paid. This notice may be received several months in advance of the time the payment is made; however, the recordkeeper frequently receives the information after the distribution is paid and reinvested.

The details may be received in the form of a written communication, by mail or by fax, or an electronic file may have been sent. Upon receipt of the information, the recordkeeper posts the distribution on the daily system and allocates it pro rata based on shares held to the participants who own shares in the mutual fund or other investment vehicle that made the payment. There is no movement of money or trades to request in this process since the cash is automatically reinvested by the mutual fund.

What happens if a participant has transferred out of the fund after the record date but before the payment is posted? The participant is entitled to receive his or her share of the distribution. Some plans credit the participant's amount to the fund and leave it to the participant to request another transaction to transfer the funds. Other plans liquidate the participant's share of the distribution and move the cash to the fund the participant bought when he or she made the original transfer.

If the participant has terminated employment and received a full benefit payment before the dividend or capital gains are posted, most plans reallocate to the remaining participants the shares that would have been allocated to the terminated participant. This is done to avoid the expense incurred when making a second distribution to a terminated participant. While most daily valuation software systems are flexible to accommodate different dividend allocation methods, it is ultimately up to the recordkeeper to determine who shares in the dividend allocation.

§2.04 Forfeitures

[A] Forfeiture Allocation

The process of gradually accumulating ownership of one's retirement benefits, or vesting, creates the opposing situation of forfeiting the nonvested portion in the event of one's termination of service. That is, since vested percentages increase through performance of additional years of service, once termination of service occurs the opportunity to progress higher on the plan's vesting schedule comes to an end. If a participant is not 100 percent vested at date of termination, only part of that participant's benefit is owned by the participant. The portion that is not owned by the participant, the nonvested portion, cannot be distributed to the participant and is forfeited.

Example 2-1. Forfeiture. Evan is a participant in his employer's profit sharing plan and currently has an account balance of $10,000. The plan uses a six-year graded vesting schedule, and Evan terminates his employment with four years of service. Since he is 60% vested in his profit sharing account based on his years of service, Evan receives a distribution of $6,000 ($10,000 x .60). The $4,000 remaining in his account ($10,000 less $6,000 vested) eventually is forfeited: removed from his account in order to close it with a zero balance.

Under defined contribution plans, since these forfeited amounts represent monies held under the plan which do not belong to the terminated participant, employers may choose the manner in which forfeitures are utilized. There are several options available, and the plan document dictates which of the following may apply:

1. Use the forfeiture to reduce the employer's future contribution;
2. Use the forfeiture to pay plan expenses; or
3. Reallocate the forfeiture to the remaining plan participants.

[B] Determining Forfeiture Amount

A determination of the amount of forfeitures for the accounting period starts with a reading of the plan document provisions regarding when forfeiture may occur. These provisions can be contained in the definitions, vesting, allocations or distributions sections of the plan document. Generally, a forfeiture of a terminated participant's individual account occurs on the earlier of:

1. The end of the plan year in which a terminated participant receives a total distribution of his or her vested account balance; or
2. The end of the plan year in which the participant incurs five consecutive one-year breaks in service (generally, a break in service occurs when a participant is credited with 500 or fewer hours of service in a plan year).

In instances where a participant terminates without a vested benefit of any type under the plan, the account balance is usually considered forfeited at the end of the plan year in which the participant terminates employment.

Example 2-2. Forfeiture Timing. Jack, age 45, ends his employment in 2006 after completing 1,200 hours of service and receives a distribution of his entire vested balance in 2007. The plan document states that the nonvested portion is forfeited as of the earlier of the year in which the participant receives a distribution or in which the participant has attained five consecutive breaks in service. Therefore, the forfeiture will occur in 2007, the year that Jack receives his distribution.

Alternately, if Jack decides to retain his accounts under the plan until he reaches the plan's normal retirement age of 65, the forfeiture would occur in 2011, the year in which Jack incurs his fifth consecutive break-in-service year.

In the event that the employer has chosen to have forfeitures reallocated to participants, the plan document contains a formula for this forfeiture allocation. It does not have to be the same method or formula used to allocate other employer contributions, or be performed under the same eligibility requirements, so any differences in methodology should be duly noted.

§2.05 Allocation of Employer Contributions and Forfeitures

There are stated formulas for allocating employer contributions and forfeitures, as applicable, in a defined contribution plan. As always, the plan document is the first source of information and guidance in this regard.

The definition of participants eligible to receive contributions and forfeitures can vary from plan to plan; therefore, it is important to read the entire section of the plan document that deals with allocations to be certain participants are properly included or excluded for allocation purposes. This is particularly important when participants terminate during the plan year due to retirement, death, disability or other severance of employment since provisions may vary for each separate event.

[A] Pro Rata Allocation of Contributions

The formula for a pro rata allocation of contributions is:

Individual Compensation / Total Compensation x Contribution = Individual Allocation

Example 2-3. Pro Rata Allocation. The employer contribution is $5,000. There are three eligible participants. The allocation is determined as follows:

	Compensation	Allocation
Participant A	$ 40,000	$1,000
Participant B	$ 60,000	$1,500
Participant C	$100,000	$2,500
Total	$200,000	$5,000

The allocation is determined by dividing the individual's compensation by the total compensation and multiplying the result by the contribution amount as follows:

Participant A: ($40,000 / $200,000 x $5,000 = $1,000)
Participant B: ($60,000 / $200,000 x $5,000 = $1,500)
Participant C: ($100,000 / $200,000 x $5,000 = $2,500)

The attraction of a pro rata contribution allocation and its ease of use become enhanced upon consideration of its effect on nondiscrimination testing. Simply stated, a **pro rata allocation** results in each eligible participant receiving the same percentage of his or her eligible compensation as a contribution, regardless of HCE or NHCE status. This allocation formula is deemed automatically to be nondiscriminatory.

§2.06 Alternate Allocation Methods

There are a number of other methods of allocating employer contributions in defined contribution plans, not all of which automatically satisfy the nondiscrimination requirements. Advanced methodologies that require additional nondiscrimination testing are elaborated upon in more advanced ASPPA courses. This course introduces one alternate method that is automatically deemed nondiscriminatory: integration, also called use of **permitted disparity**.

Under the concept of integration, the plan's allocation formula takes into consideration the contributions that employers make on behalf of their employees to Social Security. Both employee and employer accomplish this by paying Federal Insurance Contributions Act (FICA) taxes on wages up to the stated, yearly **Social Security Taxable Wage Base**. The taxable wage base is $94,200 for 2006. Please refer to Appendix B for a listing of current limits.

Because part of these Social Security taxes are used to provide retirement benefits, in effect an employer is contributing actively toward its employees' retirement via the Social Security program. As such, by integrating the plan sponsor's retirement plan with Social Security, the plan sponsor can capture credit for these contributions made outside of the retirement plan.

For example, employees and employers each pay 6.2 percent of wages up to the taxable wage base toward Old-Age, Survivors and Disability Insurance under Social Security. (An additional payroll deduction often considered Social Security taxes is actually the contribution for Medicare.) For purposes of integrated allocation formulas, the Old-Age or retirement benefit portion of the employer's Social Security contribution is considered historically to be 5.7 percent, although in actuality it is lower. Thus, under the concept of integration, one might construe an employer as having already made a contribution for eligible participants of 5.7 percent of compensation up to the Social Security Taxable Wage Base. With this in mind, a defined contribution plan may construct its allocation formula to incorporate all or part of this 5.7 percent Social Security employer contribution.

Three key elements of the allocation are the integration level, the base contribution percentage and the excess contribution percentage. The plan's integrated formula states what dollar amount of compensation serves as the integration level, expresses what percentage of compensation up to that dollar amount is to be allocated as the **base contribution** and what percentage of the compensation above that dollar amount is to be allocated as the **excess contribution**.

An example of an integrated formula that fully incorporates the 5.7 percent Social Security employer contribution would be: a base contribution of 6 percent of compensation up to the taxable wage base (the integration level) plus an excess contribution of 11.7 percent of compensation in excess of the taxable wage base. In this manner, a participant whose compensation falls below the taxable wage base receives an allocation of 6 percent from the retirement plan and is considered to receive 5.7 percent from the employer via Social Security for a total contribution of 11.7 percent of compensation. A participant whose compensation reaches beyond the taxable wage base receives that same 11.7 percent combination from the plan and Social Security on compensation up to the taxable wage base, as well as the full 11.7 percent of compensation above the taxable wage base from the plan (since Social Security does not pay on compensation exceeding the taxable wage base). Although these two participants receive different allocations in the plan, this disparity in allocation amount is permitted because of the presence of Social Security, hence the term permitted disparity.

Employers are allowed to choose an integration level that is less than the taxable wage base, and they may set the base contribution percentage as something less than 5.7 percent. However, to enjoy the automatic fulfillment of nondiscrimination in the level or amount of benefits provided under the plan, the following requirements of the Internal Revenue Code and ERISA must be met:

The maximum excess contribution percentage is the lesser of

- Two times the base contribution percentage; or
- The base contribution percentage plus the maximum permitted disparity allowance.

The **maximum permitted disparity allowance** is determined by the relationship between the plan's integration level and the taxable wage base as set forth below:

Integration Level	Maximum Disparity Allowance
100% of the taxable wage base	5.7%
Less than 100% but greater than 80% of the taxable wage base	5.4%
Less than or equal to 80% but greater than 20% of the taxable wage base	4.3%
Less than or equal to 20% of the taxable wage base	5.7%

The taxable wage base used in the allocation is the taxable wage base in effect as of the beginning of the plan year. For example, for an October 1, 2005 to September 30, 2006 plan year the taxable wage base used is $90,000, the 2005 taxable wage base.

The sections of the plan document that contain the integrated allocation formula should be carefully read and understood, bearing in mind that the document language may differ from that employed here. For example, the integration level may be specified as a fixed dollar amount (e.g., $85,000) or as a percentage of the taxable wage base (e.g., 100 percent). If stated as a dollar amount, the integration level remains the same each year, pending a plan amendment. If stated as a percentage, the integration level changes each year as the taxable wage base increases.

Example 2-4. Integrated Formula. Employer Z maintains a profit sharing plan with a July 1 to June 30 plan year. The allocation formula is 4% of compensation up to the integration level and 8% of compensation in excess of the integration level. The integration level is the taxable wage base in effect for the plan year. Participant #1 earns $95,000, Participant #2 earns $50,000 and Participant #3 earns $25,000. Determine the allocation for the plan year ending June 30, 2006.

First, determine in the integration level. The plan year is July 1, 2005 to June 30, 2006. The taxable wage base in effect as of the beginning of the plan year (2005) is $90,000. Since the integration level is 100% of the taxable wage base, the maximum permitted disparity allowance is 5.7%.

Next determine the base contribution, the excess contribution and the total allocation.

Participant	Compensation	Base Compensation	Base Contribution (4%)	Excess Compensation	Excess Contribution (8%)	Total Allocation
1	$95,000	$90,000	$3,600	$5,000	$400	$4,000
2	$50,000	$50,000	$2,000	$ 0	$ 0	$2,000
3	$25,000	$25,000	$1,000	$ 0	$ 0	$1,000

Note that the total allocation for Participant #2 is 4% ($2,000 / $50,000) while the total allocation for Participant #1 is 4.21% ($4,000 / $95,000).

In order to satisfy the permitted disparity rules, the excess contribution percentage (8%) may not exceed the lesser of two times the base contribution percentage (4% x 2 = 8%), or the base contribution percentage plus the maximum permitted disparity allowance (4% + 5.7% = 9.7%). Therefore, the allocation satisfies the requirements.

Example 2-5. Integrated Formula. Employer Z maintains a profit sharing plan with a calendar plan year. The allocation formula is 5% of compensation up to the integration level and 9.3% of compensation in excess of the integration level. The integration level is $30,000. Participant #1 earns $95,000, Participant #2 earns $50,000 and Participant #3 earns $25,000. Determine the allocation for the plan year ending December 31, 2006.

The taxable wage base in effect as of the beginning of the plan year (2006) is $94,200. The integration level is 31.85% of the taxable wage base ($30,000 / $94,200) so the maximum permitted disparity allowance is 4.3%.

The base contribution, the excess contribution and the total allocation are determined as follows:

Participant	Compensation	Base Compensation	Base Contribution (5%)	Excess Compensation	Excess Contribution (9.3%)	Total Allocation
1	$95,000	$30,000	$1,500	$65,000	$6,045	$7,545
2	$50,000	$30,000	$1,500	$20,000	$1,860	$3,360
3	$25,000	$25,000	$1,250	$ 0	$ 0	$1,250

Note that the total allocation for Participant #3 is 5% ($1,250 / $25,000); the total allocation for Participant #2 is 6.72% ($3,360 / $50,000); and the total allocation for Participant 1 is 7.94% ($7,545 / $95,000).

In order to satisfy the permitted disparity rules, the excess contribution percentage (9.3%) may not exceed the lesser of two times the base contribution percentage (5% x 2 = 10%), or the base contribution percentage plus the maximum permitted disparity allowance (5% + 4.3% = 9.3%). Therefore, the allocation satisfies the requirements.

Note: permitted disparity formulas may alternately reference total compensation and excess compensation instead of base contribution and excess contribution. As an illustration, in the integrated formula above, a base contribution of 6 percent of compensation up to the taxable wage base plus an excess contribution of 11.7 percent of compensation in excess of the taxable wage base can be alternately expressed as 6 percent of total compensation and 5.7 percent of excess compensation (compensation in excess of the taxable wage base).

§2.07 Maximum Limitations on Benefits

The limitation on benefits is governed by IRC §415. Over the years, the statutes surrounding the annual additions limit have created changes in how this maximum limit was first calculated under the Internal Revenue Code and ERISA. Most recently, EGTRRA raised the annual additions limit beginning in 2002. Therefore, the plan document should contain provisions which address the limitation. In particular, the plan document must be consulted for instructions on how any corrective measures should be applied in the event the annual additions limit is exceeded.

As one might expect, compliance with the annual additions limit is mandatory, and it must be applied judiciously and accurately to keep the plan in qualified status. Since the annual additions limit is tested every year for each individual participant rather than applied at the overall plan level, the calculations demonstrating that the limit is met necessitate care and diligence in their performance and documentation of results.

[A] Limitation Year

Central to the concept of the annual additions limitation is the plan's **limitation year**: the 12-month period as defined by the plan document that dictates how the maximum benefit limit is calculated and over what annual period it is measured. If the plan document does not define the limitation year, which is usually the plan year, it defaults to the calendar year. A resolution by an employer can define the limitation year when the plan document does not specify it.

Any change in the limitation year results in a short limitation period. If, for example, the plan defines the limitation year to be the plan year, and the employer amends the plan to change the plan year, both a short plan year and a short limitation year result.

Example 2-6: Limitation Year. The GHI Corporation maintains a qualified plan with a September 30 year-end and a calendar limitation year. Effective January 1, 2006, the plan is amended to equate the limitation year with the plan year. This creates a short limitation year of January 1, 2006 through September 30, 2006.

As a consequence of a short limitation period or year, the maximum benefit limitation is applied separately to the short period and adjusted accordingly, as explained below.

It should be noted that the termination of a plan does not create a short limitation year ending on the date of the plan termination. A plan termination does not cause the limitation year to end. Also, the limitation year may begin before the establishment of the plan. For example, there may be a short first plan year because the plan is implemented in the middle of the year, but the limitation year is defined as the calendar year.

[B] Annual Additions Limit

The annual additions limit determines the maximum amount that can be added or allocated to a participant each year under a defined contribution plan. It has two components: a percentage of compensation limit and a dollar limit. The lesser of the two components functions as an individual's annual additions limit.

1. Compensation Limit – For limitation years beginning on or after January 1, 2002, the limit is 100 percent of IRC §415 compensation. Prior to January 1, 2002 and EGTRRA, the limit was 25 percent of compensation.

2. Dollar Limit – For limitation years beginning on or after January 1, 2002, EGTRRA set the dollar limit at $40,000 (as indexed). For 2006, the dollar limit is $44,000.

The dollar limit applicable for a given limitation year is the dollar limit that is in existence at the end of the limitation year. Please refer to Appendix B for a summary of various plan limits including the IRC §415 or annual additions limit.

Caution: Remember the 100 percent of compensation limit is an individual limit. This determines how much an individual can be allocated in plan. Don't confuse this with the employer's deduction limit (generally 25 percent of eligible compensation) that determines the amount of deductible contribution an employer may make to a plan.

For short limitation years, the dollar amount is prorated by multiplying the annual amount by a fraction whose numerator is the number of months including fractional months in the short period and whose denominator is 12. Thus, if the short limitation year is six months in length, the applicable dollar limit is one-half of the annual limit. The 100 percent of compensation limit automatically reflects the short period, since only compensation for that period is considered in the calculations.

1. What allocations are included as annual additions?

Contributions that are considered annual additions include employer contributions, elective deferrals, matching contributions, forfeiture allocations and after-tax employee contributions. Investment earnings, loan repayments, deferrals which exceed the maximum elective deferral limit, catch-up contributions and rollover contributions are not considered annual additions.

The computation for the annual additions limit takes into account all contributions and forfeitures allocated to a participant in all defined contribution plans of an employer. The Internal Revenue Code treats SEP (including SARSEP), SIMPLE-401(k), and 403(b) plans as defined contribution plans for purposes of applying the annual additions limits. If the employer also sponsors a defined benefit plan with mandatory employee contributions, those employee contributions are included in the annual additions calculation, despite having been made under a defined benefit plan. Plans that are excluded from the calculation are IRAs, SIMPLE-IRAs, nonqualified plans and cafeteria plans.

There are special rules for determining the annual additions limitation for ESOPs that are beyond the scope of this course. An ESOP with an exempt loan; that is, where the ESOP has borrowed money to purchase shares, is discussed in greater detail in more advanced ASPPA courses.

Generally, an employer contribution is credited as an annual addition for a given limitation year if the contribution is allocated to the participant's account during that limitation year. If an employer contribution is made no later than 30 days after the due date (including extensions) for filing the employer's tax return, an employer contribution made after the end of a year may be treated as an annual addition for the prior year.

<u>2. What compensation is used for annual additions calculations?</u>

Compensation for maximum benefit purposes is based on the participant's total compensation received from the employer for the entire limitation year, even if the plan uses a different definition of compensation for other purposes. In effect, this results in a participant's complete limitation year compensation being used for the annual additions compensation limit, even if that participant entered the plan after the first day of the limitation year.

The Internal Revenue Code defines compensation for annual additions purposes by including catch-up contributions and elective deferrals to cafeteria plans, 401(k) plans, 403(b) plans, qualified transportation fringe benefit arrangements, SARSEPs and SIMPLE plans. The amount of compensation is generally subject to the maximum compensation limit ($220,000 in 2006). As always, consulting the plan document for provisions regarding compensation should be a first step before performance of annual additions testing.

[C] Correction of Excess Annual Additions

Amounts in excess of the maximum limits must be corrected as provided under the plan document. Some plans allow amounts in excess of the annual additions limit to be held in a suspense account so they may be allocated in future years. Other plans state that after-tax employee contributions and elective deferrals should be returned to the participant before any employer-provided contributions are reduced to comply with the maximum limitation on annual additions. In this manner the participant's own contributions are distributed first with as much of the employer contribution and allocations being retained in the participant's account as possible.

There are timing and other nondiscrimination testing issues involved with correction of annual additions failures, as well as consequences from a taxation standpoint for the individual participant. Essentially, maximum benefit limitations must be met or the plan may face loss of its qualified status.

[D] Sample Annual Additions Limit Calculation

Sam is a participant in his employer's calendar year 401(k) plan, the only plan sponsored by the employer. The limitation year is defined as the plan year. During 2006, Sam receives IRC §415 compensation totaling $67,000.

For 2006, Sam makes elective deferrals of $11,000 and after-tax employee contributions of $500. His employer allocates $4,680 in matching contribution and $2,000 in employer discretionary contribution in addition to a forfeiture allocation of $570. His account had $520 of investment earnings during the year. Has Sam exceeded the annual addition for 2006?

<u>Step 1: Determine annual additions</u>

Annual additions include the sum of the following items:

- Employer contributions (including elective deferrals, matching contributions and discretionary contributions);
- After-tax employee contributions; and
- Forfeitures allocated to the participant's account.

Therefore, Sam's 2006 annual addition is $18,750 ($11,000 + $500 + $4,680 + $2,000 + $570). Note the earnings of $520 are not included as an annual addition. Also, if Sam were catch-up eligible, any elective deferrals that are categorized as catch-up would not be included in the limit.

<u>Step 2: Calculate compensation used to determine the limit</u>

The IRC §415 compensation for 2006 is applied using gross compensation, unreduced by elective deferrals under a 401(k) plan or a cafeteria plan. Therefore, Sam's IRC §415 compensation is $67,000. Remember, this compensation would be limited to the 2006 maximum of $220,000.

<u>Step 3: Determine the annual additions limit</u>

Under a defined contribution plan, a participant's maximum annual additions are limited to the lesser of the compensation limit (100 percent of IRC §415 compensation) or the dollar limit ($44,000 for 2006). Therefore, Sam's annual additions limit is $44,000.

Again, if Sam were catch-up eligible he could have a total annual addition of $49,000 ($44,000 + $5,000 catch-up).

<u>Step 4: Determine whether the maximum limitation on benefits has been exceeded</u>

Sam's annual additions limit is $44,000. His annual additions are $18,750. Therefore, his maximum limitation on benefits has not been exceeded.

§2.08 Key Terms

Base Contribution: The percentage of contribution allocated on compensation up to the integration level.

Excess Contribution: The percentage of contribution allocated on compensation above the integration level.

Limitation Year: The 12-month period used to determine annual addition limitations under IRC §415.

Maximum Permitted Disparity Allowance: The percentage of disparity allowed based on the plan's integration level and the taxable wage base.

Permitted Disparity: Disparity in a retirement plan that is considered nondiscriminatory because it takes into account Social Security benefits.

Pro Rata Allocation: Each eligible participant receives the same percentage of his or her eligible compensation as a contribution.

Social Security Taxable Wage Base: The amount of compensation above which a person does not receive Social Security benefits.

§2.09 Review of Key Concepts

- There are many methods for allocating investment earnings to a participant's account. The method used must follow the plan document.

- Generally, a forfeiture of a terminated participant's individual account occurs on the earlier of the end of the plan year in which a terminated participant receives a total distribution of his or her vested account balance or the end of the plan year in which the participant incurs five consecutive one-year breaks in service.

- The method for allocating the forfeiture is stated in the plan document and may be different than the method for allocating the contribution.

- The plan document must state the method for determining the contribution and the method for allocating the contribution.

- Under the concept of permitted disparity, a plan allows higher contribution allocations to employees whose compensation exceeds certain thresholds by recognizing that employer contributions to Social Security cease above these thresholds.

- Three key elements of an allocation using permitted disparity are the integration level, the base contribution percentage and the excess contribution percentage.

- The annual additions limit is the lesser of 100% of IRC §415 compensation or $40,000 (as indexed).

- The maximum benefit limit for defined contribution plans restricts the total annual additions that may be allocated to a participant's account in a limitation year. Allocations of employer contributions, employee contributions and forfeitures are considered annual additions.

§2.10 Review Questions

[A] True or False

______ 1. A forfeiture may be used to pay plan expenses.

______ 2. Forfeitures occur at the end of the plan year in which the participant terminates.

______ 3. The annual addition limit under IRC §415 for limitation years ending in 2006 is the lesser of 100% of IRC §415 compensation or $44,000.

______ 4. The method for allocating investment gains or losses to a participant-directed individual account is stated in the plan document.

[B] Multiple Choice

5. Based on the following information, determine Participant A's allocation of the employer's discretionary contribution for the 2006 calendar year.

   - The allocated is made pro rata based on compensation.
   - The employer contribution is $7,000.
   - The IRC §401(a)(17) compensation limit is $220,000 in 2006.
   - Total compensation for all eligible participants is $500,000.
   - No eligible participant's compensation is above the maximum limit.
   - Participant A's compensation is $80,000.

   A. $232
   B. $600
   C. $1,120
   D. $2,940
   E. $3,230

6. All of the following statements regarding permitted disparity are **TRUE, EXCEPT**:

   A. It satisfies the nondiscrimination requirements.
   B. It considers employer contributions made to Social Security.
   C. Employers can choose an integration level less than the Social Security taxable wage base.
   D. The integration level can be a fixed dollar amount up to the Social Security taxable wage base.
   E. The maximum permitted disparity allowance is the relationship between the plan's integration level and the year's maximum compensation level.

7. All of the following are types of allocations included when calculating the maximum annual addition that can be provided to a participant in a defined contribution plan, **EXCEPT:**

   A. Elective deferrals not including catch-up contributions
   B. Rollover contributions
   C. Forfeiture allocations
   D. After-tax employee contributions
   E. Matching contributions

8. Based on the following information, determine the participant's annual addition for 2006.

   - Gross compensation - $50,000
   - Elective deferral, not including catch-up contribution - $15,000
   - Catch-up contribution - $5,000
   - Matching contribution - $5,000
   - Profit sharing contribution - $10,000
   - Forfeiture allocation - $1,500
   - Loan repayment - $2,000
   - Rollover - $1,500
   - Earnings - $3,500

   A. $12,500
   B. $31,500
   C. $36,500
   D. $44,000
   E. $50,000

§2.11 Answers

1. **True.** Forfeitures may be used to pay plan expenses. §2.04

2. **False.** Forfeitures generally occur on the earlier of the end of the plan year in which a terminated participant receives a total distribution of his or her account balance or at the end of the plan year in which the participant incurs five consecutive one-year breaks in service. §2.04 [B]

3. **True.** The annual addition limit under IRC §415 for limitation years ending in 2006 is the lesser of 100% of IRC §415 compensation or $44,000. §2.07 [B]

4. **True.** The method for allocating investment gains or losses to a participant-directed individual account is stated in the plan document. §2.03

5. The correct answer is **C.** The pro rata allocation formula is the individual's compensation divided by the total compensation times the contribution. $80,000 / $500,000 x $7,000 = $1,120. §2.05

6. The correct answer is **E.** §2.06

   A. Incorrect. This statement is true because permitted disparity satisfies nondiscrimination requirements.
   B. Incorrect. This statement is true because permitted disparity considers employer contributions made to Social Security.
   C. Incorrect. This statement is true because the integration level may be less than the Social Security taxable wage base.
   D. Incorrect. This statement is true because the integration level can be a fixed dollar amount up to the Social Security taxable wage base.
   E. Correct. This statement is false because the maximum permitted disparity allowance is the relationship between the plan's integration level and the Social Security taxable wage base.

7. The correct answer is **B.** §2.07 [B]

   A. Incorrect. This statement is true because elective deferrals, not including catch-up contributions, are considered when determining the annual addition.
   B. Correct. This statement is false because rollover contributions are not considered when determining the annual addition.
   C. Incorrect. This statement is true because forfeiture allocations are considered when determining the annual addition.
   D. Incorrect. This statement is true because after-tax employee contributions are considered when determining the annual addition.
   E. Incorrect. This statement is true because matching contributions are considered when determining the annual addition.

8. The correct answer is **B.** Annual additions do not include catch-up contributions, loan repayments, rollovers or earnings. In this question, annual additions do include elective deferrals of $15,000, matching contributions of $5,000, profit sharing contributions of $10,000 and forfeiture allocations of $1,500 for a total of $31,500. §2.07 [D]

Chapter 3:
Annual Testing

§3.01 Learning Objectives

- Determine if a plan is top-heavy.
- List the contribution requirements that may apply to top-heavy plans.
- Explain top-heavy vesting requirements.
- Explain the basic concept of minimum coverage testing for qualified plans.
- Define the term benefiting under a qualified plan as a function of coverage testing.

- Identify the employees who may be excluded in coverage testing.
- Calculate the ratio percentage test to determine if a plan satisfies minimum coverage requirements.
- Review the ADP and/or ACP test results and determine if contributions are nondiscriminatory.
- List methods of correcting a failed ADP and/or ACP test.
- Explain and contrast the two types of safe harbor 401(k) plan contributions.
- Explain the concept of a safe harbor 401(k) plan, including the vesting rules, notice requirements, withdrawal restrictions and top-heavy rules.

§3.02 Introduction

An integral part of the census data for a qualified plan is the determination of key employee and HCE status. Both definitions were introduced in RPF-1 and discussed in more detail in the census section of Chapter 1 of this course. Key employee status is important for determining whether a plan is top-heavy, and HCE status is used for performing the annual nondiscrimination testing for the plan.

This chapter begins with calculating a plan's top-heavy status and continues with an explanation of the top-heavy minimum benefit and vesting requirements for a top-heavy plan. Both defined benefit and defined contribution plans determine whether a plan is top-heavy on an annual basis. The top-heavy calculation is usually performed at the time a retirement plan administrator is completing the year-end reports for a plan.

IRC §410(b) governs the minimum coverage requirements of qualified plans. Plans must set their eligibility and participation criteria such that they allow a nondiscriminatory cross-section of HCEs and NHCEs to receive benefits from the plans. Qualified plans cannot skew the method by which they determine eligibility for benefits so that HCEs benefit under the plans in disproportionately greater numbers when compared to the numbers of NHCEs who benefit. Any such result would jeopardize the plan's qualified status. In fact, if minimum coverage were not satisfied, it would not matter how large a benefit is provided to those covered; the plan would face disqualification under the Internal Revenue Code.

While these coverage rules apply to both defined benefit and defined contribution plans, defined benefit plans also are subject to an additional minimum participation requirement (under IRC §401(a)(26)). Coverage testing should not be confused with nondiscrimination testing. The coverage test looks at how many employees receive allocations or accrue a benefit, and not at whether the amounts allocated or accrued are nondiscriminatory.

Under the Internal Revenue Code, qualified plans may not discriminate in favor of the highly compensated in the level or amount of benefits provided to plan participants. Each year, to demonstrate compliance with these statutes, a qualified 401(k) plan must show that HCEs are not contributing either pre-tax or after-tax more than an allowable percentage of their compensation to the plan, and similarly are not receiving more than an allowable percentage as a matching contribution. The Internal Revenue Code's requirements may be satisfied through yearly performance of the special tests for 401(k) plans, or by designing the plan to satisfy the rules automatically such as in a safe harbor 401(k) plan.

§3.03 Top-Heavy Status

[A] Top-Heavy Definition

After the key employees have been identified, the task at hand becomes determination of the plan's top-heavy status. The plan document introduces the top-heavy rules and how they are to be applied to the plan.

A plan is **top-heavy** if the account balances (in a defined contribution plan) or the present value of accrued benefits (in a defined benefit plan) for key employees exceed 60 percent of the total account balances or present value of accrued benefits of all participants.

Generally, all plans of the plan sponsor must be aggregated, or combined, and tested together for purposes of determining top-heavy status, including terminated plans and safe harbor 401(k) plans, as applicable. Safe harbor 401(k) plans are examined later in this chapter; they are plans designed to be exempt from nondiscrimination testing by providing a minimum employer contribution in the form of a qualified nonelective contribution or a matching contribution, along with compliance with certain vesting, employee notification and restrictions on withdrawal standards. Certain safe harbor plans are granted non-top-heavy status regardless of their amount of benefits for key employees.

While typically every plan that has been tested with other plans for top-heavy status becomes top-heavy if the group is top-heavy, a safe harbor 401(k) plan that has been granted non-top-heavy status is not top-heavy despite the outcome of the testing. Instead, its matching contribution may count toward fulfillment of top-heavy minimum contribution requirements for the group, again, discussed later in this chapter.

[B] Determination Date

The calculations to quantify the key employees' portion of plan benefits are performed as of the determination date. The top-heavy **determination date** is defined by statute as the last day of the preceding plan year for an existing plan or the last day of the first plan year for a new plan. For example, to determine if an existing calendar year plan is treated as top-heavy for the 2006 plan year, the determination is made as of December 31, 2005.

In this manner the key employee determination and top-heavy status calculations undertaken with the current year's census and accounting data determines whether the next plan year is top-heavy and must satisfy top-heavy requirements. For new plans, the last day of the first plan year serves as the determination date for top-heavy status in both the first and the second plan years.

[C] Performing the Top-Heavy Calculation

Most administration firms have software or spreadsheets for top-heavy calculations. The procedure begins with the account balances or present value of benefits as of the determination date and progresses by adding in distributed amounts or contributions that must be included and subtracting amounts, such as certain rollover contributions, that are required to be excluded. A review of that software or spreadsheet illustrates the following rules:

- For the first plan year, the determination date is the last day of that year, and the calculation determines whether the plan is top-heavy for that first plan year. The first year calculation includes any receivable contributions.
- Except for the first plan year, contributions to profit sharing plans that have not been deposited into the plan by the end of the plan year (a receivable contribution) may be excluded from the calculation, as the cash accounting method generally is used.
- Contributions for money purchase and target benefit plans are always included, whether or not they are receivable as of the end of the plan year, as they use the accrual accounting method.
- All distributions that occurred during the plan year ending on the determination date for participants who completed at least one hour of service in that plan year are included in the calculation, including distributions from a terminated plan of the same employer.
- Distributions during the year to participants who terminated employment in prior years are excluded in the calculation.
- Any in-service distributions (distributions made for a reason other than death, disability or severance of employment) for the plan year ending on the determination date and the prior four years are included in the calculation. Thus, in-service distributions over a five-year period are included.
- Unrelated rollover contributions are not included in the calculation. An **unrelated rollover** is a rollover contribution or transfer that is elected by the participant and made between plans that are maintained by unrelated employers with no ownership connection. A rollover contribution from an individual IRA is also considered an unrelated rollover.

The top-heavy calculation is usually made at the time a retirement plan administrator is completing the year-end reports for a plan. The timing permits the employer to prepare for the following year, particularly when the top-heavy ratio is at or near 60 percent.

[D] Minimum Benefits or Contributions to Non-Key Employees

Plans that are top-heavy must provide minimum benefits or contributions to all non-key employees who are participants. In a defined contribution plan, all non-key participants who are employed at the end of the plan year must receive the top-heavy minimum contribution. This is true even when the participant has not completed the minimum hours required to share in the annual allocation.

1. Defined Contribution Plans

The top-heavy minimum contribution in a defined contribution plan is the lesser of:

1. Three percent of compensation for the entire plan year; or
2. The contribution percentage of the key employee who receives the largest contribution as a percent of compensation.

It should be noted that for purposes of top-heavy minimum calculations, compensation includes all compensation earned during the plan year even if the plan otherwise defines compensation as compensation only while a participant. Also, catch-up contributions for key employees are disregarded in determining the highest contribution rate of a key employee although elective deferrals are included. No contribution is required if key employees did not receive any contribution or allocation during the year, as in the case of a profit sharing plan for which the plan sponsor declares no contribution for the year.

2. Defined Benefit Plans

The top-heavy minimum benefit in a defined benefit plan must not be less than the employee's average compensation multiplied by the lesser of:

1. Two percent times the number of years of service or participation for benefit accrual during top-heavy years; or
2. 20 percent.

These defined benefit terms such as average compensation and years for benefit accrual along with other details on how to calculate a top-heavy minimum benefit for a defined benefit plan are discussed more fully in RPF-1.

[E] Minimum Vesting

When a plan becomes top-heavy, the Internal Revenue Code requires the use of a vesting schedule at least as generous as a three-year cliff or a six-year graded vesting schedule (these schedules are discussed in RPF-1). The schedule may accelerate the participant's current vesting in the plan and need not be applied during non-top-heavy years if the plan document so allows.

Although not typically seen due to the additional administrative issues created, a plan can switch between top-heavy vesting and the regular vesting schedule under the plan as its top-heavy status changes from year to year. However, there are detailed rules about how vesting table changes can apply to each individual participant.

Given the consequences of top-heavy status, documented and accurate performance of top-heavy testing remains critical to qualification and proper administration of the plan.

§3.04 Minimum Coverage Testing Requirements

[A] Benefiting under a Qualified Plan

The first step toward assessing whether minimum coverage has been achieved is to determine who is benefiting under the plan. The Internal Revenue Code defines benefiting as:

- Accruing an additional benefit during the year in a defined benefit plan;
- Receiving an allocation of contributions or forfeitures in a defined contribution plan;
- Being eligible to make an elective deferral under a 401(k) plan, whether or not the participant chooses to defer;
- Being eligible to make an elective deferral and as a consequence receive an employer matching contribution, whether or not the participant chooses to defer; and
- Under certain circumstances, failing to receive a benefit because of the imposition of an applicable benefit limit. For example, if a participant fails to receive a profit sharing contribution allocation because he or she has reached the annual additions limit, he or she is still treated as benefiting for purposes of testing coverage for the profit sharing contribution.

[B] Coverage Groups

In general, all types of contributions and benefits provided under all plans of the employer must satisfy coverage requirements. While the regulations allow specific types of plans to be combined for testing, called permissive aggregation, certain components of a plan or plans are required to be tested separately, called required or mandatory disaggregation.

For example, elective deferrals must satisfy coverage rules without considering employer matching contributions. After-tax employee and employer matching contributions are combined into one coverage test and tested separately from other types of contributions. Profit sharing and forfeiture allocations also are combined under the separate coverage test for employer nonelective contributions. Similarly, ESOPs must be separated from non-ESOPs and union components from non-union components.

An extension of the coverage rules explain permissive disaggregation, where a plan sponsor may choose to segregate part of a plan for coverage testing on its own. The concept of required aggregation also exists, such as when one plan must rely on another plan in order to satisfy minimum coverage.

In whatever manner the coverage groups are established after application of aggregation and disaggregation rules, a few precepts govern:

- Where a plan or plan component contains no HCEs, coverage testing ends in an automatic or deemed pass, as there is no one to discriminate in favor of within the test group.
- Where a plan or plan component contains only HCEs, coverage testing again ends with a deemed pass, as there is no one to discriminate against.
- The basis upon which a plan or plan component passes coverage is generally the basis used for further nondiscrimination testing; that is, once it is established that a nondiscriminatory mix of HCEs and NHCEs receives benefits, the level or amount of those benefits is subjected to additional testing.

[C] Minimum Coverage—In General

Under the coverage rules, a plan or separately tested plan component satisfies qualification requirements if it satisfies either one of two available tests:

1. The ratio percentage test; or
2. The average benefit test.

Details of these two options are found in the next section.

[D] Ratio Percentage Test

Under the **ratio percentage test**, the percentage of NHCEs who benefit under the plan must be at least 70 percent of the percentage of HCEs who benefit under the plan.

Certain employees may be excluded (**excludable employees**) for coverage testing. They are:

- Active employees not satisfying the plan's minimum age and service requirements for entry into the plan;
- Union employees if not more than 50 percent are owners, officers or executives of employers covered under the plan; if not more than 2 percent are highly-compensated persons who perform professional services for the employers under the plan; and retirement benefits were the subject of good faith bargaining;
- Nonresident alien employees who receive no U.S. source income; and
- Terminated employees who satisfied the eligibility requirements (terminated participants) but worked 500 or fewer hours in the plan year and did not benefit in the plan during the plan year.

In determining the NHCE and HCE benefiting percentages, the following employees must be included (**nonexcludable employees**):

- Employees actively at work on the last day of the plan year who met the eligibility requirements (active employees);
- Terminated employees who benefited during the year; and
- Terminated employees who satisfied the eligibility requirements (terminated participants) and worked more than 500 hours in the plan year (whether or not they benefited).

Once the employees and participants who constitute the coverage testing groups are identified, they are divided into HCEs and NHCEs. The numbers of benefiting HCEs and benefiting NHCEs are determined, and the ratio percentage calculated using the following fractions:

Number of nonexcludable NHCEs benefiting / Total nonexcludable NHCEs

Number of nonexcludable HCEs benefiting / Total nonexcludable HCEs

If the percentage of NHCEs benefiting is at least 70 percent of the percentage of HCEs benefiting, the ratio percentage test is satisfied.

As an example, if there are ten nonexcludable HCEs and all receive a profit sharing allocation, what number out of 100 nonexcludable NHCEs must be given a profit sharing allocation in order for the plan to pass the ratio percentage test? The answer is 70. Since 100 percent of the HCEs are benefiting, 70 percent of the NHCE population must benefit in order for the NHCE percentage to be at least 70 percent of the HCE percentage (70%/100% = 70%). Thus, at least 70 NHCEs must benefit (70/100 = 70%). If the same ten HCEs receive an allocation but the NHCE population were 90 instead of 100, then to fulfill the ratio percentage test at least 63 out of the 90 NHCEs must receive an allocation (63/90 = 70% compared to 10/10 = 100%)

Example 3-1. Ratio Percentage Test. The ABC Company sponsors a profit sharing plan and has 250 employees during 2006. Two hundred employees are actively employed at the end of the year. Of the 50 terminated employees, 30 worked more than 500 hours in the plan year and had satisfied the eligibility requirements. Eighty employees still employed at the end of the year did not satisfy the minimum age and service requirements. All eligible employees still employed on the last day of the plan year benefited. No terminated employees benefited.

When the employees are divided between the highly compensated and non-highly compensated, the test looks like this:

		HCE	NHCE	TOTAL
(1)	Total employees during 2006	80	170	250
(2)	Terminated employees who worked less than 500 hours	-5	-15	-20
(3)	Excludable employees – not satisfying age and service requirements	-25	-55	-80
(4)	Total nonexcludable employees	50	100	150
(5)	Terminated employees who worked more than 500 hours and did not benefit	-5	-25	-30
(6)	Employees benefiting under the plan	45	75	120
(7)	Employee Benefiting Percentage (Divide Line (6) by Line (4)	.90	.75	
(8)	Ratio Percentage = .75/.9 = .8333			

Since .8333 ≥ .7 (83.33% > 70%), ABC Company's plan has passed the ratio percentage test for 2006.

[E] Average Benefit Test—In General

If the ratio percentage test is failed, and the plan document does not specify that minimum coverage is satisfied by correction of a failed ratio percentage test, the average benefit test exists as an alternative. The **average benefit test** contains two parts, both of which must be satisfied:

1. the nondiscriminatory classification test; and
2. the average benefit percentage test.

In broad terms, a plan passes the **nondiscriminatory classification test** if the classification of employees who benefit under the plan is both 1) reasonable, that is the classification is based on objective business criteria such as location, and 2) nondiscriminatory.

Nondiscrimination here is established in much the same way as the ratio percentage test. It is in fact the same test, except the 70 percent required threshold is lower. The amount by which the 70 percent requirement is lowered is based on the percentage of employees of the employer that are NHCEs (the NHCE concentration percentage).

Essentially, the higher the concentration of NHCEs in the employee population, the lower the 70 percent threshold moves. This acknowledges the potential difficulty in having an NHCE ratio percentage set to a minimum of 70 percent of the HCE ratio percentage, as required by the ratio percentage test, when NHCEs make up an exceedingly greater part of the employee population.

The second part of the average benefit test is the **average benefit percentage test**. Generally, this test looks at all of the benefits provided under all of the plans of the employer and combines the benefits for testing. To pass the average benefit percentage test, the average benefit provided for NHCEs must be at least 70 percent of the average benefit of the HCEs.

The average benefit test alternative to the ratio percentage test can quickly become very complex in its calculations and issues. Consequently, a detailed discussion of this test is an advanced subject of ASPPA Courses.

§3.05 Nondiscrimination Testing

Under the Internal Revenue Code, qualified plans may not discriminate in favor of the highly compensated in the level or amount of benefits provided to plan participants. Each year, to demonstrate compliance with these statutes, a qualified 401(k) plan must show that HCE's are not contributing either pre-tax or after-tax more than an allowable percentage of their compensation to the plan, and similarly are not receiving more than an allowable percentage as a matching contribution. Passing the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test demonstrates compliance. Alternately, a plan can be designed to satisfy the rules automatically with a safe harbor 401(k) plan design.

[A] 401(k) Testing Definitions

There are a number of definitions and terms that generally appear only in defined contribution plans that allow for elective deferrals, after-tax employee contributions or matching contributions.

1. Deferred Compensation

With respect to any participant, **deferred compensation** means the portion of the participant's total compensation that has been contributed to the plan in accordance with the participant's deferral election.

2. Elective Deferrals

The employer's contributions to the plan that are made pursuant to the participant's deferral election are **elective deferrals**. As such, the terms elective deferrals and deferred compensation are equivalent. Note that while the participant determines how much of his or her compensation is deferred into the plan, these elective deferrals are considered employer contributions. As of 2006, if the plan document allows, elective deferrals may be pre-tax or after-tax (designated Roth contributions) or a combination of the two.

3. Nonelective Contribution

This type of contribution is made by the employer on the participant's behalf to the plan. No election by the participant is required; hence the adjective nonelective. A profit sharing allocation is an example of a nonelective contribution for the participant.

4. Participant's Elective Account

Established and maintained by the plan administrator for each participant, the elective deferral account reflects the total interest in the plan and trust resulting from the employee's elective deferrals. A separate accounting is maintained with respect to the portion of the participant's account that is attributable to any designated Roth contribution, after-tax employee contribution, employer matching contribution and nonelective contribution.

5. Excess Deferrals

Elective deferrals that exceed the annual individual deferral limit ($15,000 for 2006) are **excess deferrals** under the Internal Revenue Code.

6. Excess Contributions

Failure of an ADP test results in **excess contributions** under the Internal Revenue Code: amounts by which the ADP test has failed, requiring the plan to take corrective measures.

7. Excess Aggregate Contributions

Failure of an ACP test results in **excess aggregate contributions** under the Internal Revenue Code: amounts by which the ACP test has failed, requiring the plan to take corrective measures.

[B] Actual Deferral Percentage (ADP) Test

The **actual deferral percentage (ADP) test** determines whether or not HCEs are contributing more than an allowable percentage of their compensation into the plan. Typically these elective deferrals are made on a pre-tax basis, but beginning January 1, 2006, participants may make designated Roth contributions which are elective deferrals made on an after-tax basis.

The combination of pre-tax and after-tax elective deferrals is subject to the IRC §402(g) dollar limit of $15,000 for 2006 (with an additional catch-up contribution of $5,000 for those age 50 and older anytime during the calendar year.) Therefore, the ADP test may include both pre-tax and after-tax elective deferrals.

1. Performing the ADP test

First, each participant's **actual deferral ratio (ADR)** is calculated by dividing the individual's total elective deferrals for the plan year by the individual's compensation. The plan document defines compensation for ADP testing. Note that this definition does not have to be the same as that employed for other plan purposes. Ratios are calculated to two decimal places (the nearest 1/100th of a percent) and then averaged by HCE or NHCE status. Those eligible participants who chose not to defer have ADRs of zero when deriving the overall averages.

In order to pass ADP testing, the HCE group's average (the ADP of the HCEs) must not exceed the ADP of the NHCEs by more than a specified amount. The Internal Revenue Code states that the HCEs' ADP must not exceed the greater of:

1) 1.25 times the ADP for NHCEs; or

2) the lesser of:

   (a) Two times the ADP for NHCEs; or
   (b) the ADP for NHCEs plus two percent.

The effect of these dual limits, the "1.25 times" and the alternative "two times and two percent plus," is set forth in the following table:

If NHCEs Defer	HCEs Cannot Defer More Than
0 – 2%	2 times more
2 – 8%	2% more
Over 8%	1.25 times more

In this manner, HCE elective deferrals are set in proportion to what NHCEs defer. To facilitate compliance with ADP rules and minimize the potential for failed tests, the Internal Revenue Code provides that unless the plan document states otherwise, the current year's HCE deferrals are measured against the prior year's NHCE deferrals.

As an example, in a calendar year plan, the level at which HCEs may defer during 2006 has been determined by the NHCEs' ADP from 2005. This is called the **prior year testing method**, and it allows the plan sponsor and HCEs to know at the beginning of a new plan year what the HCEs' ADP limit is for that year, enabling them to make their financial decisions accordingly.

Alternately, the plan sponsor can choose to use a **current year testing method** as elected within the plan document. Under this methodology, the current year HCEs' ADP is measured against the current year NHCEs' ADP, and as such the HCEs' ADP limit remains unknown until the end of the plan year. Consequently, plans that undertake current year testing often perform mid-year or projected ADP testing during the plan year to get an estimate of the year's testing results.

Each method has its merits, and under certain circumstances plans may change methods. Consequently, the plan documents should be carefully consulted to determine whether ADP testing is calculated on a current or prior year basis.

Example 3-2. Prior Year ADP Test.

Name	**Current Year Compensation (2006)**	**Current Year Elective Deferrals (2006)**	**Current Year ADR (2006)**
HCE 1	$150,000	$7,000	4.67%
HCE 2	150,000	6,000	4.00%
HCE 3	95,000	5,000	5.26%
Total			13.93%

2006 ADP for HCEs = 13.93% / 3 = **4.64%**

Name	**Prior Year Compensation (2005)**	**Prior Year Elective Deferrals (2005)**	**Prior Year ADR (2005)**
NHCE 1	$45,000	$2,000	4.44%
NHCE 2	32,500	0	0.00%
NHCE 3	30,000	1,500	5.00%
NHCE 4	28,000	840	3.00%
NHCE 5	25,000	1,250	5.00%
NHCE 6	24,000	1,500	6.25%
NHCE 7	16,500	0	0.00%
Total			23.69%

2005 ADP for NHCEs = 23.69% / 7 = **3.38%**

In the example, the prior year ADP of the NHCE group is 3.38%; the current year ADP for the HCE group is 4.64%. Since the ACP for the HCEs is less than 5.38% (3.38% + 2), the test is satisfied.

§3.06 Actual Contribution Percentage (ACP) Test

The **actual contribution percentage (ACP) test** measures the extent to which HCE after-tax employee contributions and employer matching contributions provided to the HCEs exceed similar contributions for the NHCEs. The ACP test applies to any plan or portion of a plan that accepts employer matching or after-tax employee contributions.

Remember, designated Roth contributions are elective deferrals made on an after-tax basis and are tested in the ADP test. Designated Roth contributions are not the same as after-tax employee contributions.

[A] Qualified Matching Contributions (QMACs)

Matching contributions may be subject to a vesting schedule and must satisfy the ACP test to satisfy nondiscrimination requirements in the level or amount of benefits provided under the plan.

Alternately, an employer can provide matching contributions that are qualified by requiring the matching contributions to satisfy rules that normally apply to elective deferrals. **Qualified matching contributions (QMACs)** must be 100 percent vested and subject to the same withdrawal restrictions that apply to elective deferrals. QMACs may then be tested with elective deferrals under the ADP test instead of the ACP test. Thus, if the plan does not allow after-tax employee contributions, the need for an ACP test may be eliminated. Alternately, in pursuit of the most beneficial testing results, the plan administrator may choose to include some of the QMACs in the ADP test and subject the remaining contributions to the ACP test.

[B] Calculating the ACP Test

The ACP test is conducted in a similar fashion as the ADP test using **actual contribution ratios (ACR)** instead of actual deferral ratios. First, each participant's ACR is calculated by dividing the sum of the individual's after-tax employee and matching contributions by the individual's ACP testing compensation as defined by the plan document. Ratios are calculated to two decimal places (the nearest 1/100th of a percent) and are then averaged by HCE or NHCE status.

Eligible participants who chose not to make after-tax employee contributions or received no matching contribution have ACRs of zero when deriving the overall averages. The HCEs' ACP may not exceed the NHCEs' ACP by the same "1.25 times" and alternative "two times and two percent plus" limits used in the ADP test. Also, either the prior year or current year testing method is specified by the plan.

Example 3-3. Prior Year ACP Test.

The example uses the same data as the ADP test example and assumes a matching contribution of 50% of deferrals.

Name	Current Year Compensation (2006)	Current Year Employer Match (2006)	Current Year ACR (2006)
HCE 1	$150,000	$3,500	2.33%
HCE 2	150,000	3,000	2.00%
HCE 3	95,000	2,500	2.63%
Total			6.96%

2006 ACP for HCEs = 6.96% / 3 = **2.32%**

Name	Prior Year Compensation (2005)	Prior Year Employer Match (2005)	Prior Year ACR (2005)
NHCE 1	$45,000	$1,000	2.22%
NHCE 2	32,500	0	0.00%
NHCE 3	30,000	750	2.50%
NHCE 4	28,000	420	1.50%
NHCE 5	25,000	625	2.50%
NHCE 6	24,000	750	3.13%
NHCE 7	16,500	0	0.00%
Total			11.85%

2005 ACP for NHCEs = 11.85% / 7 = **1.69%**

In the example, the prior year ACP of the NHCE group is 1.69%; the current year ACP for the HCE group is 2.32%. Since the ACP for the HCEs is less than 3.38% (1.69% x 2), the test is satisfied.

§3.07 What if the ADP or ACP Test Fails?

The ADP and ACP tests must be satisfied if the plan is to remain qualified and eligible for favorable tax treatment. If either of the tests fails, corrective action must be taken. There are a number of advanced testing options which may minimize or eliminate failing margins; these are discussed at length in advanced ASPPA Courses. For purposes of this course, two of these correction options are addressed: raising the NHCE averages to achieve passing results or distributing sufficient excess contributions and excess aggregate contributions to affected HCEs such that the HCE averages are lowered to acceptable levels.

[A] Qualified Nonelective Contributions (QNECs)

One means of ensuring the plan passes ADP and ACP tests is to raise the NHCE averages to the level necessary to support the HCE averages. Let's assume we are using current year testing. In the example above, the HCEs' ADP is 4.64%, requiring the ADP of the NHCEs to be at least 2.64% to satisfy ADP test standards. If the NHCEs' ADP were 2.38% after averaging the individual ADRs, the plan would need to raise the NHCEs' ADP by 0.26% to achieve passing results. Consequently, if the plan document so allowed, the plan sponsor could choose to make a **qualified nonelective contribution (QNEC)** for NHCEs that can be taken into consideration for ADP test purposes in an amount sufficient to boost the NHCEs' ADP by 0.26%.

Like QMACs, QNECs must be 100 percent vested when made, be subject to the same withdrawal restrictions as elective deferrals and comply with various deposit timing restrictions. While currently there are various methods of determining which NHCEs receive a QNEC and in what amounts, the simplest QNEC allocation provides the same percentage of compensation to each NHCE regardless of whether that NHCE deferred into the plan. In the example employed here, the plan sponsor would contribute 0.26% of compensation to each NHCE, thereby raising the NHCEs' ADP by 0.26%. Under the same logic and methodology, a QNEC may be used to correct a failing ACP test.

[B] Corrective Distributions

An alternative to raising the NHCE averages by contributing QNECs would be lowering the HCE averages through corrective distributions. In the previous example, the NHCEs' ADP of 2.38% set the HCEs' ADP maximum at 4.38%, or 0.26% lower than the 4.64% the HCEs actually averaged.

Lowering the HCE average is accomplished in two steps. First, the dollar amount of the correction is calculated by lowering the individual ADRs in turn beginning with the HCE who deferred the highest percentage of compensation until the HCEs' ADP reaches the required level. In this first step, no HCE actually receives a distribution. Second, the dollar amount of the correction is apportioned beginning with the HCE who deferred the highest dollar amount into the plan. Thus, the HCEs who receive corrective distributions are those who deferred the highest dollar amounts into the plan, and these may not necessarily be the same HCEs who deferred the highest percentage of compensation.

For example, an HCE with compensation of $100,000 and elective deferrals of $8,000 might have the highest ADR at 8%, while one HCE with the highest maximum compensation for plan purposes during 2006 ($220,000) defers the maximum amount ($15,000) for an ADR of 6.82%. The next highest dollar amount of deferral is $12,000. If the highest individual ADR must be limited to 7% in order for the HCEs' ADP to pass testing, the HCE at 8% would have deferrals limited to $7,000 in step one of the calculation ($100,000 x 7%). This would add $1,000 to the dollar amount of the correction ($8,000 less $7,000 maximum). In step two of the calculation, the HCE deferring $14,000 would receive a corrective distribution of $1,000 with affiliated earnings since that HCE deferred the highest dollar amount into the plan, exceeding the next highest dollar contribution by more than the total amount of correction.

It should be noted that if the plan allows catch-up contributions, reaching an ADP test limit would trigger catch-up contribution eligibility for HCEs at least age 50 by the end of the calendar year, and to the extent possible, a corrective distribution may be reclassified as a catch-up contribution and thereby retained in the plan.

Under the same logic and methodology, excess aggregate contributions under a failed ACP test are calculated and either distributed from the plan or, in the case of nonvested employer matching contributions, forfeited as necessary.

Example 3-4. ADP Test Correction.

Name	**Current Year Compensation (2006)**	**Current Year Elective Deferrals (2006)**	**Current Year ADR (2006)**
HCE 1	$150,000	$ 7,000.00	4.67%
HCE 2	150,000	6,000.00	4.00%
HCE 3	95,000	5,000.00	5.26%
Total		$18,000.00	13.93%

2006 ADP for HCEs = 13.93% / 3 = **4.64%**
If the maximum ADP was 4.38%, the HCEs' ADP must be lowered by .26%

Step One		**Maximum Deferral**	**Limited ADRs**
HCE 3	$ 95,000	$ 4,341.50	4.57%
HCE 1	150,000	6,855.00	4.57%
HCE 2	150,000	6,000.00	4.00%
Total		$17,196.50	13.14%

Maximum ADP for HCEs = 13.14% / 3 = **4.38%**
Dollar Amount of Correction = $18,000 - $17,196.50 = **$803.50**

Step Two	**Elective Deferrals**	**Corrective Distribution**	**Deferrals Remaining**
HCE 1	$ 7,000.00	$ 803.50	$ 6,196.50
HCE 2	6,000.00	0.00	6,000.00
HCE 3	5,000.00	0.00	5,000.00
Total	$18,000.00	$ 803.50	$17,196.50

§3.08 Safe Harbor 401(k) Plans

For employers who wish to avoid the annual nondiscrimination ADP and ACP testing, the need to satisfy these testing requirements may be eliminated by using a safe harbor 401(k) plan design. In general, the ADP test is the nondiscrimination test for elective deferral contributions, while the ACP test is the nondiscrimination test for employer match and after-tax employee contributions.

[A] Safe Harbor ADP

Under the safe harbor alternative to the ADP test, employers can elect to make one of the following safe harbor contributions to a 401(k) plan:

1. A QNEC equal to at least 3% of compensation for all eligible NHCEs. The plan may, but is not required to, provide the safe harbor contribution to the HCEs.

   For example, an NHCE whose annual compensation is $20,000 would receive an allocation of $600 ($20,000 x 3%) without regard to any elective deferrals under the plan.

2. A matching contribution equal to either the basic formula or the enhanced formula:

   i) Basic Formula: A matching contribution on behalf of each NHCE equal to 100% of the employee's elective deferrals up to 3% of the employee's compensation, plus 50% of the next 2% of the employee's elective deferrals.

      For example, an NHCE with compensation of $20,000 makes elective deferrals totaling $2,000 (10% of compensation). The safe harbor matching contribution under the basic formula would be $800 calculated as follows:

      100% of the first 3% of compensation deferred ($20,000 x 3% = $600)

      plus

      50% of the next 2% of compensation deferred ($20,000 x 2% x .5 = $200).

   ii) Enhanced Formula: An alternate rate of matching contribution that at each level of elective deferral contribution is no less than the matching contribution determined under the basic formula. This formula may not provide a higher level of matching contributions for HCEs than is provided for NHCEs who contribute at the same level.

For example, and enhanced matching formula of 125% of the first 3% of compensation deferred plus 25% of the next 1% deferred satisfies the safe harbor requirements.

Deferral	Basic Match	Enhanced Match
1%	1.00%	1.25%
2%	2.00%	2.50%
3%	3.00%	3.75%
4%	3.50%	4.00%
5%	4.00%	4.00%
6% or more	4.00%	4.00%

[B] Safe Harbor ACP

Under the safe harbor alternative to the ACP test, the following restrictions apply to the employer matching formula:

- Elective deferrals and after-tax employee contributions above 6 percent of compensation may not be matched;
- The rate of match cannot increase as the rate of deferral increases;
- HCEs cannot receive a greater rate of match than NHCEs deferring at the same rate;
- If the rate of any non-safe harbor matching contributions is determined at the discretion of the plan sponsor, these matching contributions are limited to 4 percent of compensation; and
- If the matching contribution is used to satisfy the safe harbor for ADP testing, it may not be discretionary, and no allocation restrictions such as requiring 1,000 hours of service may be imposed.

After-tax employee contributions are not eligible for ACP safe harbor treatment and must still fulfill ACP testing requirements.

[C] Additional Safe Harbor Requirements

In addition, the 401(k) plan must satisfy vesting, notice and withdrawal conditions.

1. Vesting Requirements

Contributions that satisfy the ADP safe harbor requirements must be fully vested. Contributions made in excess of the safe harbor amounts may be subject to a vesting schedule.

2. Annual Notice to Participants

Each employee who is eligible to participate must receive, within a reasonable period of time prior to the start of the plan year, a written annual notice describing the safe harbor options the employer will use for the plan year. This notice must be written in a manner designed to be understood by the average employee.

3. Use of Safe Harbors on a Continued Annual Basis

Employers are not required to use the safe harbor for any minimum number of years. This could result in the employer utilizing the safe harbor alternative in one year and not the next.

4. Withdrawal Restrictions

The safe harbor contributions may not be withdrawn. This is in accordance with the distribution restrictions that apply to elective deferrals under the Internal Revenue Code. In addition, unlike elective deferrals, safe harbor contributions are not allowed to be withdrawn for reasons of financial hardship. If the plan provides for employer contributions other than the ADP safe harbor contribution, such contribution may be subject to hardship or any other distribution event that is permitted.

5. Top-heavy 401(k) Safe Harbor Plans

Effective January 1, 2002, a safe harbor 401(k) plan is deemed to be a non-top-heavy plan if there are no nonelective contributions allocated other than those used to satisfy the ADP safe harbor, and if there are matching contributions allocated, all of those matching contributions are used to satisfy the ACP safe harbor.

In the event that a safe harbor 401(k) plan includes other nonelective contributions or an additional discretionary employer match that are not safe harbor related, top-heavy requirements will apply. In these instances, a top-heavy safe harbor 401(k) plan may use the safe harbor nonelective contribution or the safe harbor matching contribution to satisfy the required top-heavy minimum contributions. However, care must be taken to ensure that all of the top-heavy minimum contribution requirements are met.

For example, if the safe harbor nonelective contribution is determined based on compensation from a participant's entry date, it will not completely satisfy the top-heavy rules, for top-heavy minimum contributions must always be calculated on a participant's compensation for the entire plan year.

Bear in mind that a plan document can contain provisions that allow for non-safe harbor related nonelective and matching contributions, and as long as these provisions are not utilized during a plan year and no non-safe harbor related allocations are actually made, the plan will be deemed to be a non-top heavy plan for that year.

§3.09 Cross-Tested Plans

A qualified retirement plan may not discriminate in favor of HCEs with respect to the amount of contributions or benefits. Whether a defined contribution plan satisfies this requirement is usually determined with respect to the amount of contributions as tested in the ADP and ACP tests discussed above. Alternately, a defined contribution plan may be tested with respect to the equivalent amount of benefits. Likewise, a defined benefit plan generally is tested with respect to the amount of benefits; however, it can be tested with respect to the equivalent amount of contributions.

The cross-tested defined contribution plan, sometimes called new comparability profit sharing plans in reference to the allocation method, allows for discretionary contributions that are more beneficial to the older and more highly compensated owners. Nondiscrimination testing of cross-tested plans is beyond the scope of this course. Consult more advanced ASPPA courses regarding tax-shelter plans favoring owners and key employees for more details on nondiscrimination testing for cross-tested plans.

§3.10 Key Terms

Actual Contribution Percentage (ACP) Test: The test performed to show that employer matching and after-tax employee contributions are nondiscriminatory.

Actual Contribution Ratio (ACR): Used to perform the ACP test it is a calculation of the individual's total contributions included in the ACP test divided by the individual's compensation.

Actual Deferral Percentage (ADP) Test: The test performed to show that elective deferrals are nondiscriminatory.

Actual Deferral Ratio (ADR): Used to perform the ADP test it is a calculation of the individual's total contributions used in the ADP test divided by the individual's compensation.

Average Benefit Test: One of the minimum coverage tests under IRC §410(b) used as an alternative to the ratio percentage test.

Average Benefit Percentage Test: One of the two tests under the average benefit test used to satisfy minimum coverage testing under IRC §410(b).

Current Year Testing Method: In ADP and/or ACP testing a methodology used whereby the NHCE averages in the current year are compared to the HCE averages in the current year.

Deferred Compensation: The portion of a participant's compensation that has been contributed to the plan in accordance with a deferral election.

Determination Date: For top-heavy purposes, the last day of the preceding plan year for an existing plan or the last day of the first plan year for a new plan.

Elective Deferral: A contribution to a cash or deferred arrangement made pursuant to an employee's election to have such contribution made in lieu of receiving cash. Alternately referred to as elective contributions, salary deferrals or salary reduction contributions.

Excess Aggregate Contribution: Contributions attributed to a failure of the ACP test.

Excess Contribution: Contributions attributed to a failure of the ADP test.

Excess Deferral: Elective deferrals that exceed the IRC §402(g) limit.

Excludable Employee: Employees who may be excluded from minimum coverage testing.

Nondiscriminatory Classification Test: One of the two tests under the average benefit test used to satisfy minimum coverage testing under IRC §410(b).

Nonexcludable Employee: Employees who must be included in the minimum coverage testing whether or not they are considered benefiting.

Prior Year Testing Method: In ADP and/or ACP testing a methodology used whereby the NHCE averages in the prior year are compared to the HCE averages in the current year.

Qualified Matching Contribution (QMAC): A matching contribution that is 100 percent vested and subject to withdrawal restrictions. It may be used in the ADP and/or ACP tests.

Qualified Nonelective Contribution (QNEC): An employer contribution that is 100 percent vested and subject to withdrawal restrictions. It may be used in the ADP and/or ACP tests.

Ratio Percentage Test: One of the minimum coverage tests under IRC §410(b) whereby the percentage of NHCEs who benefit under a plan is compared to the percentage of HCEs who benefit under a plan.

Top-Heavy: For plan years beginning in 1984, a plan that primarily benefits key employees is considered top-heavy and qualifies for favorable tax treatment only if, in addition to the regular qualification requirements, it meets several special requirements.

Unrelated Rollover: A rollover contribution or transfer that is elected by the participant and made between unrelated plans or IRAs.

§3.11 Review of Key Concepts

- A plan is top-heavy if the present value of accrued benefits or account balances of all key employees exceeds 60 percent of the present value of accrued benefits or account balances of all employees.

- A top-heavy plan is subject to minimum contribution requirements.

- A top-heavy plan must include a vesting schedule at least as favorable as a three-year cliff or a six-year graded schedule.

- A nondiscriminatory group of employees must benefit under one or more of an employer's qualified plans.

- For defined benefit plans, benefiting means accruing an additional benefit during the year; for defined contribution plans, benefiting means receiving an allocation of contributions or forfeitures.

- Certain employees may be excluded from coverage testing, such as employees who have not satisfied the plan's age and service requirements, union employees, nonresident aliens and nonbenefiting terminated employees with 500 or fewer hours of service during the plan year.

- To prove that a nondiscriminatory group of employees benefits under a plan, the plan must pass either the ratio percentage test or the average benefit test.

- Under the ratio percentage test, the percentage of NHCEs who benefit must be at least 70 percent of the percentage of HCEs who benefit.

- The ADP test is used to show that the elective deferrals (including designated Roth contributions) made to a plan are nondiscriminatory.

- The ACP test applies to any plan, or portion of a plan, that accepts after-tax employee contributions and/or matching contributions.

- Two ways to correct a failed ADP and/or ACP test include allocating a QNEC and making corrective distributions to HCEs.

- An employer may eliminate the need for ADP and ACP testing by adopting a safe harbor 401(k) plan.

- In a safe harbor 401(k) plan, a QNEC of 3 percent of compensation or a minimum matching contribution that satisfies either the basic or enhanced formula must be made.

- Safe harbor 401(k) plans are subject to additional vesting, notice and withdrawal requirements.

§3.12 Review Questions

[A] True or False

______ 1. A participant who receives a forfeiture allocation during the year is considered benefiting for minimum coverage testing.

______ 2. Corrective distributions due to a failed ADP test are made to the HCEs who deferred the highest percentage of compensation.

______ 3. A top-heavy plan is must have a vesting schedule at least as favorable as the three-year cliff or the six-year graded schedules.

______ 4. The basic safe harbor matching contribution is 100% on the first 3% of compensation deferred and 50% on the next 2% of compensation deferred.

______ 5. A matching contribution of 100% on the first 5% of compensation deferred will satisfy the enhanced formula for safe harbor 401(k) plans.

[B] Multiple Choice

6. Based on the following information, determine the top-heavy ratio for the 2006 calendar plan year.

   - The plan is an existing profit sharing plan and the only plan of the employer.
   - The key employee balances total $200,015 as of December 31, 2005.
   - The non-key employee balances total $410,856 as of December 31, 2005.
   - A non-key employee had in-service withdrawal in 2004 totaling $12,400.

   A. 20.18%
   B. 32.09%
   C. 47.30%
   D. 48.68%
   E. 60.01%

7. All of the following statements regarding 401(k) safe harbor plans are **TRUE, EXCEPT**:

   A. Safe harbor contributions are not allowed to be withdrawn for reasons of financial hardship.
   B. An employer can utilize the safe harbor alternative in some years and not others.
   C. Every employee who is eligible to participate must receive a written notice before the end of the plan year describing the safe harbor options being utilized for that year.
   D. Contributions in excess of the safe harbor amount may be subject to a vesting schedule.
   E. The safe harbor notice must be written in a manner designed to be understood by the average employee.

8. Based on the following information, determine the minimum percentage of nonexcludable NHCEs that must benefit under the plan in order to satisfy the ratio percentage test under IRC §410(b).

   - 65% of the nonexcludable HCEs benefit.
   - The employer only has a profit sharing plan.

   A. 20.05%
   B. 45.50%
   C. 70.00%
   D. 92.86%
   E. 100.00%

9. All of the following employees are excludable for coverage testing, **EXCEPT**:

   A. Terminated participants who did not work more than 500 hours and who did not benefit in the plan
   B. Active employees who did not meet age and service requirements
   C. Eligible employees who elect not to defer
   D. Union employees whose retirement benefits were the subject of good faith bargaining
   E. Nonresident alien employees who receive no U.S. source income

10. All of the following statements regarding contributions for a top-heavy profit sharing plan are **TRUE, EXCEPT**:

    A. Catch-up contributions for key employees are disregarded when determining the highest contribution rate of a key employee.
    B. Elective deferrals for key employees are considered contributions to key employees when determining the highest contribution rate.
    C. Compensation considered can be only that compensation earned while the employee was a participant in the plan.
    D. The top-heavy minimum contribution is the lesser of 3% of compensation for the year or the contribution rate of the key employee who receives the largest contribution as a percent of compensation.
    E. All non-key participants who are employed at the end of the plan year must receive the top-heavy minimum contribution.

11. All of the following contribution types must satisfy minimum coverage testing under IRC §410(b), **EXCEPT**:

    A. Elective deferrals
    B. Employer matching contributions
    C. Employer profit sharing contributions
    D. Rollover contributions
    E. Forfeiture contributions

12. Based on the following information, determine the maximum HCE ADP for the plan to pass the ADP test.

    - The NHCE ADP = 5%

    A. 2.50%
    B. 4.00%
    C. 6.25%
    D. 7.00%
    E. 10.00%

13. Based on the following information, determine the maximum HCE ACP for the plan to satisfy the ACP test.

    - The NHCE ACP = 1.75%

    A. 0.88%
    B. 1.23%
    C. 2.19%
    D. 3.50%
    E. 3.75%

§3.13 Answers

1. **True.** A participant who receives a forfeiture allocation during the year is considered benefiting for minimum coverage testing. §3.04 [A]

2. **False.** Corrective distributions due to a failed ADP test are determined based on the HCEs who deferred the highest percentage of compensation but distributed based on the HCEs who deferred the highest dollar amounts. §3.07 [B]

3. **True.** A top-heavy plan is must have a vesting schedule at least as favorable as the three-year cliff or the six-year graded schedules. §3.04 [E]

4. **True.** The basic safe harbor matching contribution is 100% on the first 3% of compensation deferred and 50% on the next 2% of compensation deferred. §3.08 [A]

5. **True.** A matching contribution of 100% on the first 5% of compensation deferred will satisfy the enhanced formula for safe harbor 401(k) plans. §3.08 [A]

6. The correct answer is **B.** The top-heavy ratio for the 2006 calendar year is based on account balances as of December 31, 2005. The key employee balances are divided by the total balances in the plan, including in-service distributions made in the last five years. The top-heavy ratio is 32.09% ($200,015 / ($200,015 + $410,856 + $12,400)). §3.03 [C]

7. The correct answer is **C.** §3.08 [C]

   A. Incorrect. This statement is true because safe harbor contributions are ineligible for financial hardship distribution.
   B. Incorrect. This statement is true because an employer can utilize the safe harbor alternative in some years and not others.
   C. Correct. This statement is false because the annual notice must be provided to employees before the plan year begins.
   D. Incorrect. This statement is true because contributions in excess of the safe harbor amount may be subject to a vesting schedule.
   E. Incorrect. This statement is true because the safe harbor notice must be written in a manner designed to be understood by the average employee.

8. The correct answer is **B.** The ratio percentage test is satisfied if the benefiting NHCEs constitute 70% of the HCEs benefiting. If 65% of the HCEs benefit, 45.50% of the NHCEs must benefit (45.50 / 65.00 = 70%). §3.04 [D]

9. The correct answer is **C.** §3.04 [D]

   A. Incorrect. This statement is true because nonbenefiting terminated participants who did not work more than 500 hours are excludable.
   B. Incorrect. This statement is true because active employees who did not satisfy age and service requirements are excludable.
   C. Correct. This statement is false because eligible employees are not excludable simply because they choose not to defer.
   D. Incorrect. This statement is true because union employees are excludable.
   E. Incorrect. This statement is true because nonresident aliens are excludable.

10. The correct answer is **C.** §3.03

   A. Incorrect. This statement is true because catch-up contributions for key employees are disregarded when determining the highest contribution rate of a key employee.
   B. Incorrect. This statement is true because elective deferrals for key employees are considered contributions to key employees when determining the highest contribution rate.
   C. Correct. This statement is false because top-heavy contributions are based on full year compensation, not date of participation.
   D. Incorrect. This statement is true because the top-heavy minimum contribution is the lesser of 3% of compensation for the year or the contribution rate of the key employee who receives the largest contribution as a percent of compensation.
   E. Incorrect. This statement is true because all non-key participants who are employed at the end of the plan year must receive the top-heavy minimum contribution.

11. The correct answer is **D.** §3.04

   A. Incorrect. This statement is true because elective deferrals must satisfy minimum coverage testing.
   B. Incorrect. This statement is true because employer matching contributions must satisfy minimum coverage testing.
   C. Incorrect. This statement is true because employer profit sharing contributions must satisfy minimum coverage testing.
   D. Correct. This statement is false because rollover contributions do not need to satisfy minimum coverage testing.
   E. Incorrect. This statement is true because forfeiture contributions must satisfy minimum coverage testing.

12. The correct answer is **D.** The maximum HCE ADP must not exceed the greater of 1.25 times the NHCE ADP (5.00 x 1.25 = 6.25) or the lesser of 2 times the NHCE ADP (5.00 x 2 = 10.00) or 2 plus the NHCE ADP (5.00 + 2 = 7.00). Therefore, the maximum HCE ADP is 7.00%. §3.05 [B]

13. The correct answer is **D.** The maximum HCE ACP must not exceed the greater of 1.25 times the NHCE ACP (1.75 x 1.25 = 2.19) or the lesser of 2 times the NHCE ACP (1.75 x 2 = 3.50) or 2 plus the NHCE ACP (1.75 + 2 = 3.75). Therefore, the maximum HCE ACP is 3.50%. §3.06

Chapter 4:
Living in an Electronic World—Daily Valuation

§4.01 Learning Objectives

- Explain what is meant by the term daily valuation as it relates to plan administration.
- Differentiate between the role of the recordkeeper and the administrator.
- State the advantages and disadvantages of the bundled and unbundled approach to plan administration.

§4.02 Introduction

The phrase retirement plan administration covers a wide range of administrative and clerical functions associated with the operation of an employee benefit plan. Depending upon the nature of the services provided by the retirement administrative firm or a retirement plan professional's role in a qualified plan's day-to-day activities, retirement plan administration means different things to different companies.

This course considers retirement plan administration from the perspective of processing daily valued, participant-directed defined contribution plans. Participants are demanding access to and information about their retirement plan accounts on a 24-hour basis. Plan sponsors have responded by choosing daily valuation recordkeeping services for their plans.

Technology makes daily valuation possible, but it is not the only force shaping the industry. This chapter presents the many factors affecting daily valuation services today and explains why the recordkeeper's work is key to a successful daily practice.

This chapter also discusses the development of the daily valuation environment and the effect it has had on administration of 401(k) plans by revising the job functions and changing the departmental organization. It also discusses how daily valuation 401(k) plans are marketed to the plan sponsor.

§4.03 Balance-Forward Valuation Versus Daily Valuation

Acronyms and buzzwords - our lives are filled with them. They move us more quickly through a conversation; keep us thinking, trying to figure out what each vanity license plate might mean. They are creative and colorful. What's more, we have become so attached to some of these expressions that we refuse to let them go even when the original use or meaning for the term has ceased to exist.

The Keogh plan is a good example for retirement plan professionals. Keogh plans, established in 1963 for the self-employed, became obsolete with new legislation, but the term continues to be used by many to refer to retirement plans for the self-employed. Unfortunately, each industry has its own series of acronyms without regard to any other industry. A blackout to some is a power outage. To retirement plan professionals it involves a trading moratorium when converting a plan.

Daily valuation, otherwise known as "daily val" or "daily," doesn't really mean everyday, but it lets a person say only one or two words to describe something very complex. Daily valuation is a valuation process used in the administration of defined contribution plans. This course focuses on this unique process used mainly by participant-directed 401(k) plans.

Before we expand your knowledge on daily valuation, let's discuss the history of valuation processes over the years since retirement plans began.

[A] Balance-Forward Valuation

Historically, most plans operated with only an annual valuation, and all plan assets were invested at the direction of the trustee. Defined benefit plans continue to operate in this fashion.

In 1978, Section 401(k) was added to the Internal Revenue Code. This allowed participants to contribute to a retirement plan on a pre-tax basis. In the mid-80s this concept began gaining popularity, and participant account balances started to build. In 1988, the IRS issued proposed 401(k) regulations that were finalized in 1991, causing 401(k) plans to gain more popularity. In July 2003, IRS issued a new set of proposed 401(k) regulations that were finalized in December 2004. In these finalized regulations, the IRS compiled all the statutory changes made since 1978 and incorporated them into the old regulations with a few changes and additions.

As participant account balances increased, participants began requesting control over how their money was invested. Plan sponsors began to offer investment options for participants to choose how to invest their account balances.

As the concept of investment options evolved and participants were able to make investment choices, plan sponsors adopted semiannual or quarterly valuation cycles in order to provide more frequent account balance and investment information to participants. The recordkeeping method in these situations is known as **balance-forward**. Loosely translated, this means the participant's account balance as of the last valuation date is updated for the activity (i.e., withdrawals, contributions, and investment earnings) as of each subsequent valuation date. The manner in which the account activity is treated in creating the basis for income allocation varies from plan to plan, although some common methods are used.

For example, some plans determine the basis for allocation of a plan's investment income by using the following formula:

- Account value as of last valuation date;
- Less withdrawals for loans and benefit payments;
- Plus one-half of the participant and employer contributions during the period.

In essence, this method treats all contributions as being made ratably over the month, quarter or semiannual valuation period without regard to the actual cash flow to the plan. Other methods time-weight the value of contributions differently, according to the terms of the plan document.

Surveys indicate that the majority of defined contribution plans today offer investment choice for participants; however, plans that do not allow participants to direct the investment of their account balances generally continue to use some form of this balance-forward approach to recordkeeping. Many balance-forward plans continue to provide only an annual valuation date, but for those situations where the employer decided to permit participant direction, daily valuation has become the industry standard.

[B] Daily Valuation

Daily valuation is a valuation process substituted for balance-forward methodologies in defined contribution plans where the value of plan investments is determined each day. Daily valuation responds to participant demands for immediate access to information through interactive voice response systems, call centers and the Internet. Daily valuation accommodates faster processing of benefit payments and fund transfer requests than balance-forward.

Calling the process daily valuation is as honest as any other description one would attach to this method. The truth is that any investment can only be valued as frequently as that particular investment permits. A current market value for many securities can be determined for any day the New York Stock Exchange (or some similar exchange) is open for business. So, it is not 365 days of the year that current market value can change or the investment can be bought and sold, but actually any business day. The price at the close of the business day is treated as the current market value.

Of course, there are investments that cannot be, or are not, valued as frequently. For example, certain types of insurance contracts or employer stock (not publicly-traded) may be valued only on a specified date each year. The types of investments that are typically used in defined contribution plans and that are most suitable for a plan that is valued daily are discussed in detail in Chapter 7. The accounting for plans using daily valuation may be identical to that used for a balance-forward plan; however, the "last valuation date" for the plan may be yesterday!

It is this continuous processing of transactions that brought about three major changes in how participant-directed defined contributions plans are administered:

1. It redefined the role of recordkeeper and differentiated it from administrator on the plan.
2. It changed the structure of the administration department due to the functionalizing of many tasks.
3. It caused organizations to begin to partner with each other to provide a complete daily package.

§4.04 Who Is an Administrator or Recordkeeper?

It is important to distinguish between an administrator and a recordkeeper. Prior to the mid-90s, the persons performing the administrative, recordkeeping and compliance functions for a qualified plan were all called administrators. The number of participants covered by the plan, as well as the complexity of the plan's provisions, usually determined the amount of time that was expected to be spent servicing a plan. Other factors, such as controlled group situations, added time to compliance activities. Retirement plan administration firms, providing the traditional, balance-forward type of service, generally assigned the client's plan to a single administrator. Some firms, however, used a team approach, whereby more than one person did the servicing of a client's plan.

Today, the functions of an administrator remain the same. Retirement plan administration includes compliance and initiating and processing distributions, loans and other withdrawals. Compliance involves the performance of the various nondiscrimination tests and preparation of governmental filings, including Form 5500 series reports and the Form 1099-R distribution reporting. The recordkeeping function describes the tracking of activity within the participant accounts.

The introduction of daily valuation prompted the segregation of previously defined administrator functions to create what has quickly become considered the standard role of the recordkeeper. A retirement plan administration firm that offers daily valuation services to its customers employs both administrators and recordkeepers. This arrangement allows the firm to have employees who focus on particular aspects of each plan's operation to efficiently provide the total package of services.

[A] Administrator

The **administrator** in a daily valuation unit typically handles the following functions:

- Determining eligibility;
- Performing nondiscrimination testing, including IRC §410(b) minimum coverage, IRC §401(k) actual deferral percentage (ADP) testing, IRC §401(m) actual contribution percentage (ACP) testing, IRC §414(s) compensation testing and top-heavy testing required under IRC §416;
- Monitoring limits such as those under IRC §402(g) deferral limit, IRC §415 annual additions testing and catch-up contributions;
- Preparing governmental forms such as the Form 5500 series reports;
- Responding to client calls and handle special situations that are raised by the plan sponsor; and
- Managing the process associated with participant withdrawals and distributions, including loan and withdrawal eligibility.

For the average plan, this work involves spending time occasionally on the plan as needed, with the bulk of the administrator's time spent on the annual testing and compliance activities.

[B] Recordkeeper

The **recordkeeper**, however, deals with the processes that make daily valuation what it is. Typically, the recordkeeper handles the following functions:

- money in (contributions, loan repayments, transfers or rollovers);
- money out (transfers, distributions, loans or other withdrawals);
- balancing fund positions;
- updating systems with daily investment pricing; and
- reporting to both participants and plan sponsors.

These functions occur every day for every plan. The ideal administrator or recordkeeper is a detail person, but comfort with technology is especially important to the recordkeeper. Every aspect of the recordkeeper's work deals with computers.

§4.05 Structuring a Daily Valuation Unit

A specific recordkeeper's role within a daily valuation unit varies depending on how the unit operates. All of the following factors affect how the daily valuation unit operates:

- The number of participants in a plan;
- The sophistication of the automated systems;
- Whether paper transactions are accepted; and
- The overall size and maturity of the unit.

All of these factors play a part in how work is assigned within a daily valuation unit or operation. In some daily valuation operations separate recordkeepers manage one type of function for the entire unit, while others might assign all transaction processing and reporting for a single plan to a single recordkeeper.

As retirement plan administration firms wrestled with decisions about how to provide daily valuation services to their clients, it quickly became obvious that the staffing model and department structures of the balance-forward environment no longer worked. This is because participant records are maintained on a share basis and cash accounting (rather than accrual accounting methods) is used in daily valuation. Daily valuation requires a very different thought process. Thus, staff expected to work on balance-forward plans generally are not also assigned daily valuation recordkeeping.

Retirement plan administration firms have recreated themselves in various ways to provide daily valuation services. This section reflects on how functionalizing a daily valuation unit causes the unit structure to change as the unit increases the number of daily plans that it administers. It also illustrates how a 401(k) department is restructured as it moves from balance-forward to daily valuation, transitioning from a nonfunctionalized department to a functionalized department.

Functionalizing a daily valuation department has several advantages:

- It takes less time, knowledge and training to learn a specific function than it does to learn all aspects of administration that is typical in balance–forward administration;
- The cost to employ a recordkeeper is minimized due to functionalizing of the recordkeepers role;
- The many deadlines in daily valuation processing are easier for a recordkeeper to manage; and
- It allows the process to become efficient by focusing on a narrow task.

However, there are also disadvantages to functionalizing:

- It creates tunnel vision. Recordkeepers become proficient at their function but without cross-training, tend to see only a very narrow view of the total daily valuation process.

- It can create a slower response time to plan sponsor inquiries. In a balance-forward unit one person tends to handle most functions for a plan, and therefore knows the status of processes and can respond immediately. In a daily, functionalized unit many different recordkeepers work on one plan. Thus, an administrator who takes the call from the plan sponsor may not know the status of all aspects of the plan and needs to check with the recordkeepers on the issue and call the plan sponsor back.

Therefore, how a daily valuation unit is structured plays a big part in how clients are serviced.

§4.06 Evolution of the Daily Valuation Market—Bundled Versus Unbundled

Daily valuation has redefined the role of the recordkeeper and changed the structure of the daily unit causing most to become functionalized. It has also caused new ways to market the daily valuation product to the plan sponsor. Insurance companies through annuity products, and banks through collective trusts, were probably the first institutions to bundle retirement plan services for their customers. **Bundled** arrangements combine money management (trading and custody), paying agent (distributions, loans, payroll processing) and accounting/compliance services for one-stop shopping for the plan sponsor.

In contrast, an **unbundled** arrangement requires a plan sponsor to have services set up with a money manager, an accounting firm and, perhaps, a consulting firm for compliance work or to prepare nondiscrimination testing.

Although mutual fund companies were the first to offer the new daily valuation product/services completely in-house, mutual funds as an investment vehicle allowed a wider variety of providers the ability to offer the same daily valuation services through the bundling of products and services. The very nature of mutual funds – wide availability and easy access to daily pricing - makes daily valuation easy. The recordkeeping system maintains the number of mutual fund shares held by each shareholder (participant), and every morning an operator enters the current price of each mutual fund within the plan.

Many retirement plan administration firms, investment houses and insurance companies raced to enter the daily valuation business. Insurance companies built daily valuation into the annuities they offered. Mutual fund companies created plan administration departments to complement the investment services they already offered. Developing these in-house, proprietary systems allows the company to specifically match the product offering to services provided to and required by its customers. New features can be tested before implementation, and the business maintains complete control over these systems. The cost for this flexibility and control can be enormous.

While some of these institutions were building special retirement plan departments and services, others decided to combine resources, realizing they either did not have the time or the money to effectively enter the daily valuation business. The retirement plan business began to take on a new look.

The easiest and quickest way for retirement plan administration firms to enter the daily valuation market was to combine resources in some way with another vendor/provider. This created several defined daily-marketing models as shown below.

Marketing Models

Bundled	**Unbundled**
In-house	Wrap Plans
Strategic Alliance	Strategic Alliance

[A] Bundled Model

The bundled models include all marketing packages where the plan sponsor engages one entity to provide the total package of services for the retirement plan. This one entity, under the bundled in-house model, has the capability to provide the investment services, recordkeeping, compliance, trading, custody, paying agent and employee communications services. Generally, this is a very large bank, insurance company or mutual fund company. They have built and maintained all of the systems (including proprietary daily valuation recordkeeping software) and services in-house. They offer "one-stop shopping" or "turnkey" services to plan sponsors.

The bundled strategic alliance model also allows plan sponsors to obtain all of the services under one vendor's umbrella, even though some of the products and services actually are not their own. The plan sponsor is not aware of the other entities involved in providing the services. This could be a mutual fund company who has contracted with a retirement plan administration firm to do the recordkeeping and compliance. All communication regarding the plan goes through the mutual fund company. All materials sent to the plan sponsor also go through the mutual fund company.

[B] Unbundled Model

The unbundled models include all marketing packages where the plan sponsor has engaged more than one entity to provide services for the retirement plan. Thus, the plan sponsor can pick and choose service providers for various aspects of the total package. For example, the plan sponsor could be happy with the investment choices but change the recordkeeper.

The unbundled **wrap plans** model has been a popular model for small retirement plan administration firms because it allows them to enter the daily valuation market without having to invest significant resources in daily valuation software and interactive systems. This model allows the retirement plan administration firm to provide governmental reporting, compliance testing and maintenance of census data. The insurance company or mutual fund company provides the recordkeeping, voice and web systems, investment services, trading custody, paying agent and employee communications. Under this model the plan sponsor is aware that there are two entities performing important and distinctively different roles.

The unbundled strategic alliance is similar to the bundled strategic alliance except that in this model the client is aware that there are two or more entities providing the various services needed to perform daily valuation. Due to the importance of strategic alliances in the daily valuation market the next section discusses them in further detail.

[C] Strategic Alliances

A **strategic alliance** is a group of two or more service providers that have entered into written agreements enabling them to offer a complete package of daily valuation services to plan sponsors. Most alliances include investment products, administrative and recordkeeping services. Within strategic alliances, all parties work together for the mutual benefit of each other. They may create exclusive arrangements that more closely tie the companies together.

Many firms in different lines of business have found that it is cheaper to purchase a product or service from another company than to manufacture the product or offer the service with their own staff. Some banks and mutual fund companies with proprietary systems are falling behind in the technology race and realizing that it is too costly to maintain the service in-house. They choose instead to outsource certain services to a retirement plan administration firm. In this case, the bank or mutual fund company continues to provide the sales force, develop and offer investment products and provide employee education but uses another company to provide recordkeeping and compliance services.

The bundler of services can be any entity within the product offering. Mutual fund companies sometimes contract with retirement plan administration firms, banks and brokers. Banks can contract with retirement plan administration firms. Some insurance companies contract with banks and compliance/testing providers. Brokers can contract with mutual fund companies and retirement plan administration firms to provide services. Several models are explained in more detail in the following examples.

Example 4-1. Strategic Alliance.

Partner	Description of Services Provided
Mutual Fund Co. (Bundler)	Investment products Trading Custody Sales Employee education
Bank	Paying agent services (loans, distributions, payroll processing, lockbox) and/or trustee
Retirement Plan Administration Firm	Recordkeeping and compliance testing

Example 4-2. Strategic Alliance.

Partner	Description of Services Provided
Broker (Bundler)	Sales Employee education
Mutual Fund Co.	Investment products Trading Custody
Bank	Paying agent services (loans, distributions, payroll processing, lockbox) and/or trustee
Retirement Plan Administration Firm	Recordkeeping and compliance testing

Example 4-3. Strategic Alliance.

Partner	Description of Services Provided
Insurance Company (Bundler)	Sales support Employee education support Investment Products—Annuities or mutual funds Trading Custody Paying agent services (loans, distributions, payroll processing)
Broker	Sales Employee education
Retirement Plan Administration Firm	Recordkeeping and/or compliance testing

Example 4-4. Strategic Alliance.

Partner	Description of Services Provided
Insurance Company (Bundler)	Sales support Employee education Investment products – Annuities or mutual funds Trading Custody Paying agent services (loans, distributions, payroll processing) Recordkeeper Employee statements Service center – live operators
Broker	Sales
Retirement Plan Administration Firm	Governmental reporting Compliance testing Maintain census

Example 4-5. Strategic Alliance.

Partner	Description of Services Provided
Retirement Plan Administration Firm (Bundler)	Recordkeeping Compliance testing Employee education Sales
Mutual Fund Co.	Investment products
Brokerage House	Trading Custody
Bank	Paying agent services (loans, distributions, payroll processing, lockbox) and/or trustee

These examples illustrate the various combinations of relationships that can be developed to provide daily valuation services.

[D] Application Service Provider (ASP)

Over the past few years another methodology has been developed to provide the participant level daily valuation recordkeeping services. The firm responsible for doing the recordkeeping enters into a service agreement with an **Application Service Provider (ASP)**. Instead of creating the daily software under the in-house bundled marketing model, or licensing the software and installing it on the recordkeeper's hardware under the bundled and unbundled strategic alliance marketing models, the ASP hosts and manages web-based software applications. The recordkeeper performs various functions on this software through the Internet.

The ASP is responsible for:

- upkeep and development of the software,
- testing new releases,
- providing disaster recovery,
- data security,
- backup systems and power generators,
- technical support,
- servers and networks monitored around the clock, and
- licenses or upgrades of software or hardware.

There are several advantages to this methodology:

- The applications can be run from any computer, any time of day and from anywhere, allowing staff to work from home or telecommute;
- The recordkeeper no longer needs servers to run the daily valuation software, freeing up memory, routers, server hardware and IT staff;
- The recordkeeper no longer needs to maintain voice response systems, freeing up phone lines and servers; and

This methodology is a way to cut costs and improve efficiency for the entity providing the participant level daily valuation recordkeeping services to a smaller number of plans. However, much like time-sharing arrangements of the past, it can become costly with increased volume of plans, participants and transactional activity.

[E] Strengths and Weaknesses of Marketing Models

There are certain advantages and disadvantages inherent in each of the bundled versus unbundled models.

<u>1. Bundled In-House</u>

A firm that is self-contained and has built all of its systems in-house relies on no other company to sell, provide or support its services. Timeliness and quality of services, as well as meeting strategic business goals, is under the total control of that self-contained firm. Those using alliances or subcontractors or who have purchased software or products from other firms must rely on each other's capabilities in providing overall high quality service and meeting business goals.

<u>2. Bundled Strategic Alliances or Unbundled Strategic Alliances</u>

Arrangements utilizing strategic alliances are generally more closely reliant on the other parties within the alliance. They may have written exclusive arrangements into a contract. Both parties make every effort to make sure the alliance works because systems and products are intertwined. It is critical to fully define the responsibilities and duties of each party so that if problems develop, they can be more easily resolved. If one of the providers begins having problems in service quality or production, it is much tougher for the other party to find a replacement for the alliance. Because of this, it is critical to fully evaluate a possible strategic partner before initiating an alliance.

It is important to recognize that a plan sponsor may perceive any given strength or weakness differently. For example, self-contained providers may view their fully bundled approach as a strength because it provides control over quality and timeliness. A sponsor who desires simplicity with a single relationship may agree. A sponsor who desires the flexibility of replacing one partner while retaining another may view this structure as a weakness. Thus, strengths and weaknesses of any given structure may differ, and it is important to understand the plan sponsor's perspective as well as the provider's perspective.

A retirement plan administration firm's decision to choose one structure over another usually can be traced to one of the following reasons:

- Increased revenue and profitability. Some firms believe that providing some form of daily valuation services is vital to their survival. Other firms choose to outsource daily valuation services to a third party because they find that another firm can do it more efficiently.

- Comfort with potential liability. Some firms find that they can no longer provide a high quality product using the systems and personnel they currently have and choose to find a solution elsewhere. Other firms feel that their current business practices expose them to unacceptable liability from the DOL, IRS, SEC or the NASD rules and regulations and choose to become allied with another company to provide those services.
- Availability of high quality marketing or employee education material. Smaller providers generally do not have the resources to create glossy, high-tech materials. Aligning with another company may provide access to the same materials as the larger, more established providers.
- Trouble keeping up with advancing technology. Over the last five to seven years, daily valuation technology has outpaced most firms' ability to integrate it. Only the most well-financed companies can afford to integrate the latest technologies into their own systems. Other providers play leapfrog by choosing this software, or that vendor, or incorporating this feature or that capability. At every enhancement, well-documented internal procedures must be established and monitored to ensure continuing high quality use of these systems.
- Other factors may include the availability of quality partners, the segment of the market being pursued (large plans, small plans and their expectations) and access to financial and/or human resources.

§4.07 Key Terms

Administrator: An administrator typically handles eligibility, nondiscrimination testing and preparation of government filings.

Application Service Provider (ASP): The ASP hosts and manages web-based software applications allowing the recordkeeper to perform various functions through the Internet.

Balance-Forward Valuation: A recordkeeping method of allocating plan earnings and expenses to the accounts of participants, while periodically determining the value of participant accounts.

Bundled: A package of complete administrative, recordkeeping and investment services provided by a single firm.

Daily Valuation: A recordkeeping method whereby participant accounts are valued every business day. This facilitates fund transfers, contributions, and distributions in a timely manner and results in up-to-date and current participant account balances. Participant accounts are held in shares or units.

Recordkeeper: A recordkeeper typically handles processes such as money in, money out, balancing fund positions, updating daily systems and reporting to participants.

Strategic Alliance: A group of two or more service providers that have entered into written agreements offering a complete package of daily valuation services to plan sponsors.

Unbundled: Plan sponsors set up services with different parties including a money manager, an accountant and/or a consulting firm.

Wrap Plans: In this model the retirement plan administration firm provides governmental reporting, compliance testing and maintains census data but an insurance company or mutual fund provides recordkeeping and investment services.

§4.08 Review of Key Concepts

- Daily valuation is a valuation process used in participant-directed defined contribution plans where the value of plan investments is determined each day.

- Daily valuation brought about three major changes in the administration of defined contribution plans: (1) Differentiated recordkeeper versus administrator, (2) changed how the administration department was structured and (3) changed the marketing of the products to support daily valuation.

- The recordkeeper's job function is to track the activity within the participant's account such as processing money in, money out (i.e. contributions, loan repayments, rollovers, transfers, distributions or loans), balance fund positions and price investments.

- The administrator's job function is to perform compliance testing, prepare governmental forms, respond to client inquiries and manage the process associated with participant activity.

- Marketing daily products is done through the use of a bundled or an unbundled arrangement. Under the bundled arrangement the plan sponsor engages one entity to provide the total package of daily valuation services. Under the unbundled arrangement the plan sponsor engages more than one entity to provide daily valuation services.

- An in-house bundled marketing approach is self-contained and relies on no other company to sell, provide or support its system.

- A strategic alliance approach must rely on other firms to provide high quality service. The strategic alliance unbundled marketing approach allows the plan sponsor flexibility to replace one partner while retaining another.

§4.09 Review Questions

[A] True or False

______ 1. Daily valuation allows for processing of transactions any business day.

______ 2. A plan sponsor who wishes to deal with the least number of companies as possible in a daily valuation arrangement would choose an unbundled strategic alliance.

[B] Multiple Choice

3. All of the following are roles of the recordkeeper, **EXCEPT**:

   A. Balancing fund positions
   B. Updating investment prices on the system
   C. Processing transfers
   D. Preparing Form 5500
   E. Reporting to plan participants

4. All of the following are characteristics of the bundled in-house approach for daily valuation, **EXCEPT**:

   A. The plan sponsor has several companies to consult.
   B. All retirement plan services are under one roof.
   C. All of the systems are maintained in-house.
   D. All communication goes through one company.
   E. The approach provides control over timeliness of services.

§4.10 Answers

1. **True.** Daily valuation allows for processing of transactions any business day. §4.03 [B]

2. **False.** A plan sponsor who wishes to deal with the least number of companies as possible in a daily valuation arrangement would choose a bundled in-house approach. §4.06

3. The correct answer is **D.** §4.04 [B]

   A. Incorrect. This statement is true because a recordkeeper balances fund positions.
   B. Incorrect. This statement is true because a recordkeeper updates investment prices on the system.
   C. Incorrect. This statement is true because a recordkeeper processes transfers.
   D. Correct. This statement is false because an administrator prepares Form 5500 not a recordkeeper.
   E. Incorrect. This statement is true because a recordkeeper prepares participant reports.

4. The correct answer is **A.** §4.06

   A. Correct. This statement is false because a bundled approach does not give the plan sponsor several companies to consult.
   B. Incorrect. This statement is true because all retirement plan services are under one roof in a bundled in-house approach.
   C. Incorrect. This statement is true because all of the systems are maintained in-house in the bundled in-house approach.
   D. Incorrect. This statement is true because all communication goes through one company in the bundled in-house approach.
   E. Incorrect. This statement is true because the bundled in-house approach provides control over timeliness of services.

Chapter 5:
Differences Between Balance-Forward and Daily Valuation

§5.01 Learning Objectives

- Compare and contrast balance-forward and daily valuation accounting, reconciliation and earnings allocation methods.
- Discuss distribution and transfer processing in a balance-forward versus daily valuation environment.
- List the characteristics of an efficient investment offered in a daily valuation environment.

§5.02 Introduction

Daily valuation and balance-forward recordkeeping methods deliver plan services in very different ways. The shift to daily valuation requires a fundamental change in the way retirement plan professionals approach their work.

This chapter addresses the differences in the administration between balance-forward plans and daily valuation plans.

§5.03 Accounting Methods

Daily valuation introduced a new way to think about valuing participant accounts. The shift from balance-forward recordkeeping methods to the use of daily valuation requires a corresponding change in the way plan sponsors, participants and administrators think about various plan activities, such as transfers or withdrawals from accounts. In addition, it is important to understand the differences between the two methods in order to design or modify a defined contribution plan so that it meets the needs of the plan sponsor and the participants.

The two methods deliver plan services in very different ways. In some sense, the plan sponsor gives up control of many plan activities when a plan transitions to the daily environment. Electronic systems take over and dictate the accounting methods, how earnings are allocated, the calculation and timing of distributions and transfers and the number of investment options available to participants. The daily world is extremely time-sensitive, particularly when it comes to reporting to participants.

The retirement plan administration firms offering traditional balance-forward services that decide to add daily valuation services find that they must adopt entirely new methods for maintaining participant records on a daily basis. It not only involves a significant investment in systems and equipment, but a substantial disruption to the normal workflow during the learning curve. New employees hired for the daily valuation unit quickly learn there is no down time and the firm must be able to fully support on-the-job training.

[A] Balance-Forward Accounting

Balance-forward plans track investment information based on dollars bought or sold and the dollars that resulted from the realized and unrealized gain or loss on the investment as of a specific date. Some practitioners refer to this as **dollar accounting**. The administrator must receive the investment statements showing all of the transaction activity for the accounting period in order to perform the periodic accounting.

These investment statements typically are received from the trustee or investment manager between three and 15 business days after the close of the accounting period. The investment activity is then reflected in dollars on the recordkeeping system. In contrast to daily accounting, balance-forward accounting reports transactions in an after-the-fact fashion, with some transactions being many months old before they appear in the participant's record.

[B] Daily Valuation Accounting

Accounting for plans in daily valuation requires investment information to be based on shares bought or sold. This is called **share accounting**. The unrealized gain or loss is calculated based on the number of shares held, multiplied by the price per share at the valuation date, with that value being compared to the cost of the shares at the time they were purchased.

For example, as illustrated below, if separate blocks of 10 shares are purchased at $10, $12 and $14, respectively, each block has a different amount of unrealized gain or loss if the current net asset value (NAV) is $13. This daily determination of unrealized gain or loss is computed separately for each block of shares purchased. The recordkeeper receives trade results daily and immediately posts this information to the daily valuation system used to track each participant's balance.

Example 5-1. Unrealized Gain/(Loss)

Number Of Shares	Purchase Price	Cost	NAV @ $13.00	Unrealized Gain/(Loss)
10	$10.00	$100.00	$130.00	$30.00
10	$12.00	$120.00	$130.00	$10.00
10	$14.00	$140.00	$130.00	($10.00)

[C] Differences Between Methods

One way to view the differences between the two accounting methods is to think about the pitcher and catcher in a baseball game. The catcher is receiving the ball after it has been thrown and is unsure of exactly when the ball will be thrown. The catcher has to react after the pitch is made.

The catcher's reaction is similar to that of the administrator in the balance-forward environment. The accounting is done after the transactions occur and the administrator generally has no control over when a transaction occurs. The activity is reported after-the-fact.

The accounting in plans using daily valuation is more representative of the pitcher's role because the pitcher knows when the ball will be thrown and has control of it. In daily valuation, each transaction is reported as it occurs, and the recordkeeper has control over when trades are processed. Thus, the daily valuation recordkeeper can immediately take steps to correct an error that may have occurred or prevent it from ever happening in the first place.

In balance-forward, the administrator waits until the end of the valuation period to receive the investment information and hopes that all transactions were processed correctly. If an error is found in a plan that has quarterly valuation dates, the correction is made as many as 30 to 90 days after the problem occurred.

Balance-forward accounting reports the value of the accounts as of a specific date. Daily valuation plans can report the value of the accounts every day. This is possible because the daily system tracks the number of shares held, rather than the number of dollars invested. The number of shares recorded in the recordkeeping system is simply multiplied by the price per share for any specific day to determine that day's current value.

Another difference is that balance-forward accounting reflects accruals. Accounting using an accrual method reports transactions that occur after the end of the valuation period that are attributable to that accounting period as if they occurred during the valuation period. For example, elective deferrals that are withheld on the last payroll for the period but not invested until several days after the end of the period are normally reported as accrued - that is, as if they were invested by the end of the period. In addition, money market income that is paid on the first day of the new period but earned because of investments in the prior period is reflected as receivable at the end of the prior period.

Daily valuation accounting reports all transactions in the period they actually occur, reflecting a cash basis accounting.

The types of activities that transpire in either a balance-forward plan or one using daily valuation are identical. Both plans process participant and employer contributions, withdrawals for loans, hardships, in-service withdrawals or benefit payments for terminated participants, as well as transfers between funds when there is some level of participant direction of investments. The difference is the precision with which the transaction activity is tracked on the recordkeeping system. Balance-forward environments can be more forgiving when adjustments are required, since tracking is in dollars in pooled accounts, and certain types of corrections can merely be adjusted or netted against a future transaction. Activity tracked in daily valuation reports shares bought or sold on an individual participant basis, so adjustments are more complicated.

For example, a participant defers $25 per pay period to the 401(k) plan. The employer mistakenly reports the participant's deferral in the amount of $250 instead of $25. On a subsequent payroll, the employer reduces the current contribution by the $225 error and reports a negative contribution for the employee of $200 ($225-$25).

On the balance-forward system, the negative contribution is absorbed without any interruption to the normal processing; however, correcting the posting on the daily system is not so simple. Shares were bought with the $225 at a specific share price. By the time the error is reported to the daily recordkeeper, any number of events might have transpired. The share price has almost certainly changed; the participant may have taken a loan or otherwise transferred out of the original investment, and so forth.

§5.04 Reconciliation of Assets

Both balance-forward and daily valuation plans reconcile the assets reported on the recordkeeping software to the assets reported by the institutional trustee or brokerage firm trading the assets. Balance-forward plans do this as of the periodic valuation date. When the accounting is performed the assets are reconciled to the recordkeeping system. Daily valuation plans reconcile daily. The shares reported by the trustee or brokerage firms for each asset in the plan are compared to the shares reported on the daily system. Uninvested cash is also reconciled daily. Any differences reported are researched.

§5.05 Allocating Investment Earnings

Whether the plan is using the balance-forward or daily valuation method, certain common elements make up the investment income (or loss) that must be allocated among the accounts of participants. Such as:

- Interest income;
- Dividend income;
- Capital gains distributions from mutual funds;
- Realized gains or losses from the sale of investments;
- Fees and expenses paid by the plan; and
- Unrealized gain or loss on investments held at the end of the accounting period.

Reminder! Mutual funds may have income in the form of dividends, but also receive capital gain distributions from the trading of individual securities that are purchased and sold within the mutual fund by the portfolio. These dividend and capital gain distributions made to shareholders are sometimes referred to as distributions in the investment industry. Occasionally, confusion arises because the retirement plan industry uses the term distribution to refer to benefit payments made to participants.

[A] Balance-Forward Earnings Allocation

Balance-forward plans calculate the net income (income less expenses) as of the end of the valuation period. The net income is then allocated to the participants' accounts based on the method prescribed in the plan document.

For example, some plans allocate the net income based on a formula that prorates the income or loss based on the sum of the account balances at the beginning of the valuation period, less any distributions or withdrawals during the period, plus one-half the elective deferrals for the period. Other balance-forward plans use a variety of time-weighted allocation methods. The weighting gives dollars that have been invested in the account longer a higher weighting than funds that are deposited sometime after the period begins or that are distributed during the period.

If the plan has participant-directed accounts, this methodology is applied to each sub-account within the plan by isolating the net income for each investment option, rather than simply for the plan as a whole.

[B] Daily Valuation Earnings Allocation

Daily valuation plans use more exact methods to allocate the realized gains or losses, dividends, interest or other income and capital gains distributions. The type of asset determines the allocation method used. Dollar par value assets that accrue income on a daily basis, such as money market accounts, GICs or other stable value funds frequently use a daily accrual allocation method or a weighted allocation method similar to that used by the balance-forward plans; however, the income is not actually allocated until the date it is paid. **Par value** is also called the face value of a share. Dollar par value shares always trade at $1 per share. Money market funds always trade at dollar par value. Other funds may be tracked on daily recordkeeping systems at dollar par value to facilitate income accruals throughout the month.

Assets with values that fluctuate frequently (e.g., mutual funds) normally allocate dividend and capital gain distributions using a prorated method. This technique allocates a dividend to the participant's account if he or she owned shares of the asset on the date the dividend was declared (the record date or ex-date) by the mutual fund. The allocation is made in proportion to the number of shares held by each participant invested in the mutual fund on the record date.

The mutual fund identifies the number of shares of record for the dividend (which should tie to the number of shares reflected in the recordkeeping system for the related record date), the date it is to be paid, the dollars being paid and the corresponding number of shares purchased with the dollars. The allocation, however, is not posted to the daily system until the date the dividend is actually paid.

[C] Accruing Versus Posting

The terms accruing and posting merit further explanation. **Posting** is a term used to describe the task of crediting or debiting a participant's account to reflect activity affecting the balance. For example, contributions are posted to the participant's account when they are invested after each pay period.

Accruing income, as it is described below, also involves posting of income to the participant's account; however, the accrued amount is money the trust expects to receive from the investment at the end of the accrual period. When the income is actually paid to the trust, the recordkeeper must verify that the accruals posted to the participants' accounts during the period are not more or less than the amount actually received. Any difference must be reconciled and the appropriate adjustment posted.

Income that is being accrued generally is not included in account balance information that is accessible through an automated response system. At the end of the accrual period, the income is released, or posted, permanently to the participant's account and is disclosed on the automated response systems.

Some fluctuating value assets, such as bond mutual funds, accrue income daily but pay it over to the shareholders only once a month. Daily valuation plans use one of two methods to allocate the income in these situations. Both methods provide a very similar result.

The first method is the weighted allocation method similar to that described above as used by balance-forward plans. Under this method the income is allocated upon receipt and requires no reconciliation. A second method is the accrual allocation method, which frequently is used with accounts invested in dollar par assets, such as money market accounts.

The accrual allocation method is based on daily accrual factors provided to the recordkeeper by the mutual fund or investment company. The factor is multiplied by the number of dollars (which is equal to the number of shares in a dollar par value fund) held in the fund for the day. The result is the amount of income accrued for the day. It is then accrued to the accounts of participants who own a share on that day. This process is repeated each day of the month. At the end of the month, when the income is paid by the fund, all the daily accrual amounts are totaled to determine the participant's portion of the amount paid. The income is released, or posted, to the accounts on the date the income is actually received.

The earnings allocation methods used in daily valuation are considered to be fairer to participants and much more precise than the balance-forward methods. Income is allocated at the end of the period for the balance-forward plan, and in some instances, participants who withdraw their funds before the end of the period do not benefit (or suffer) from investment experience during the period such transactions take place. A daily plan allocates any income, dividends and so forth on the date actually received.

§5.06 Distribution Processing

Balance-forward plans often require that distributions due terminated participants be processed only after the valuation work is completed for the valuation date following such termination. The amount of the benefit payment is based on the value determined for that same period. It often takes 45 to 135 days after terminating employment for the participant to receive the distribution if quarterly valuations are performed.

Example 5-2. Balance-Forward Distribution. A participant terminates employment on March 15, 2006. The next quarterly accounting is performed as of March 31, 2006. The allocations are completed and reported to the plan sponsor on or about May 15, 2006. The participant is paid out after May 15, 2006, based on the value of his or her vested account balance as of March 31, 2006.

Daily valuation plans perform valuations every business day; therefore, distributions can be processed at any time. Daily valuation plans track shares in each fund that are held on behalf of a participant. When a benefit payment is processed, shares are sold to make the payment. The value of the shares sold is the value the participant receives. Thus, the participant benefits (or suffers) from any market changes through the date the shares are sold.

Example 5-3. Daily Valuation Distribution. A participant terminates employment on March 15, 2006, and the recordkeeper receives instructions on April 5, 2006, to make the benefit payment. On April 6, 2006, shares are sold to cover the distribution to the participant. The value of the participant's vested benefit is the value on April 6, 2006. The check is cut and sent to the participant. This distribution process sometimes takes five to ten days after the notice is received, depending on the funds held and the marketing model used.

Daily valuation allows benefit payments to be processed very quickly. Some recordkeepers, however, delay processing benefit payments to ensure that the participant's final payroll contribution has been processed and to be sure any accrued earnings have been posted. The delay in processing distributions is usually a function of the frequency with which the payroll is processed. For example, a plan that submits payroll on a monthly basis may have a longer delay in processing distributions on account of termination of employment than a plan that submits payroll data each week. It is more efficient to include the amount of any deferral and loan repayment the participant made from his final payroll in the (original) benefit payment; otherwise, the recordkeeper may need to process a subsequent distribution, make manual adjustments to post loan payments on loans already reflected as disbursed and may charge the plan sponsor for the additional processing.

§5.07 Processing Transfers

[A] Balance-Forward Transfer Processing

A balance-forward plan that permits some participant direction of investments must, by its very nature, restrict the timing of transfers between funds. Typically, transfers may only be made coincident with a valuation date; however, many plans further limit transfers to the first day of the plan year.

Quarterly valuation is common for balance-forward plans with participant direction, although some of these plans can be valued monthly, semiannually and annually. If quarterly transfers are permitted, the participant must complete a transfer request form and submit it to the appropriate party before the beginning of the new quarter. After the quarterly valuation is performed and the value of the participant's account is known, the transfer is processed.

The transfer normally occurs as much as 45 to 60 days after the valuation period based on the value of assets on the valuation date. Some administrators recommend calculating estimated transfer amounts based on current balances to avoid a delay in processing transfers. This method requires a true-up calculation after the actual balance is known.

Example 5-4. Balance-Forward Transfer. A calendar year balance-forward plan accepts transfer requests effective as of the first day of each quarter. Participant Z submits a properly completed transfer form on June 28, 2006. The transfer is effective July 1, 2006; however, the administrator does not complete the June 30, 2006, valuation until July 28, 2006. In this instance, the recordkeeping system shows the transfer occurring as of July 1 even though at least 28 days elapses between the date the transaction is effective and the date it actually occurs.

[B] Daily Valuation Transfer Processing

Participants may request an initial transfer as often as each business day in a daily valuation environment. The participant completes a transfer request form, or more typically, connects with an automated response system to initiate the transfer. The transactions to affect the transfer are launched no later than the next business day.

The plan sponsor may impose some restrictions on how quickly a second transfer can be requested after placing of the first transfer due to the length of time it takes to settle the sell and make the buy side of the first transfer. In addition, the plan sponsor may impose some restrictions to avoid excessive numbers of transfers by the participants, *e.g.,* by limiting transfers to one per quarter processed at any time during the quarter. Other common restrictions limit transfers to one per month or impose a 30-day waiting period between transfers. In any event, the transfers can occur more frequently and quickly than in a balanced-forward plan.

Note – Investment firms often refer to transfers between funds as exchanges – particularly when the transactions involve funds in the same fund family.

§5.08 Reporting

[A] Participant Statement Timing

Participant statements, together with the summary allocation report, generally are provided to the plan sponsor of a balance-forward plan 30 to 60 days after the end of the valuation period. As mentioned earlier, investment statements from the trustee or investment manager must be received before the allocation work can be started and it usually takes three to 15 business days after the end of the accounting period to receive the statements. The recordkeeper generally expects to complete the reports between ten and 30 business days later.

Daily valuation plans tend to provide participant statements and the employer summary allocation report on a quarterly basis. Since daily valuation plans know the value of the account each day, the reports can be prepared more quickly. Reports are normally sent out ten to 15 business days after the quarterly period ends. In fact, statements for plans using daily valuation may be delivered to the plan sponsor or directly to participants' homes long before the investment statements for a balance-forward plan have even been received from the trustee or investment firm!

[B] Presentation

Balance-forward plan accounting is performed on an accrual basis, in dollars. This has an effect on what is presented in the employer reports and participant statements. Information is presented in dollar values, whether or not the plan permits the participants to direct the investment of their account balances. The reports seldom show shares.

Accrued items are reflected as part of the account balance at the end of the valuation period. Participants may track from their payroll vouchers the amount of elective deferrals they made for the quarter, for example, and can expect to match that amount on their account statement for the quarter, even though the last payroll of the quarter is not actually invested by the last day of the quarter. The balance-forward plan accrues the investment, whether it is contributions, dividends declared but unpaid or capital gains declared but unpaid, into the related accounting period and reflects it on the participant's statement.

Daily valuation plans report on a cash basis, and statements may present dollars and shares held in each fund. Most daily systems generate other statistical data on these statements, in an effort to respond to demands from participants that more information be reported about their accounts such as individualized rates of return, transactional information, election percentages and deferral rates. This allows participants to independently validate the information being reported to them, whether it is on a paper statement or via an automated response unit or website.

§5.09 Paying More Attention

Participants have become more knowledgeable about investing and know how to locate information about their investments. Reporting the shares held on behalf of the participant allows the participant to track the value of his or her accounts each day by multiplying the price of the fund by the number of shares held.

Make no mistake; participants are paying more attention to their retirement plan accounts. They monitor how quickly their contributions are transferred to the plan and want to know the price at which their contributions are invested so they can track the number of shares they own.

Today, participants often receive reports that tell them when a mutual fund declares a dividend or capital gain distribution and how much it is. Reporting in shares also gives the participant the ability to make sure their accounts are credited all distributions declared by the mutual funds.

[A] Fund Values

A participant can look up a mutual fund's price (NAV) in the newspaper if he or she invests in a fund that is available to the general public. The price can also be obtained on the Internet.

By looking up the fund symbol and going to pricing, a participant can look up the current day's price as well as pricing history. The exact price reporting format varies among newspapers and Internet services, but there is usually a column labeled NAV. This is the price at which the mutual fund company redeems the shares, although sales loads may affect the value of an individual's shares. The next column is labeled offer price, which is what it costs to buy new shares of the fund. There also probably is a column that shows how much the NAV changed that day (+ or -).

§5.10 Investment Options

[A] Balance-Forward Investment Options

Balance-forward plans offer a wide variety of assets for participants to choose from, including:

- Mutual funds;
- GICs;
- Money market accounts;
- Real estate;
- Limited partnerships; and
- Employer stock.

Sometimes the investment choices may be valued daily by the investment firm; others, once a month. Real estate, limited partnerships, privately held employer stock and other illiquid investments may only be valued annually. Some of the investment choices may trade daily, twice a month, monthly or only periodically, when there is a market.

Balance-forward plans are more easily able to offer a wide variety of investment options since they have fewer transfer opportunities and limited valuation dates. This sometimes makes transactions more manageable since there are fewer to execute.

Balance-forward plans can invest in assets that have allocated and unallocated features. An **allocated contract** is an investment that is tracked at the participant level by the issuer, typically an insurance company. An **unallocated contract** is one that is tracked at the plan level rather than the participant level. The administrator handles the tracking for participants who invest in an unallocated contract.

[B] Daily Valuation Investment Options

To be efficient, investments offered in daily valuation plans must:

- Be traded daily;
- Have a price per share that can be obtained daily;
- Be able to be bought and sold in fractional shares;
- Be available for purchase in shares for the full dollars and cents available to be

spent;
- Be set up so that dividends and other income immediately reinvest in the investment; and
- Have trade information available the day after any trade occurs.

These stipulations temper the types of investments that are offered by daily valuation plans. Most mutual funds, money market funds, stable value funds and pooled GICs can meet these standards. Employer stock that is publicly traded and traded daily can also be offered within this framework.

These suggested standards are necessary so that the daily plan can determine the value of a share each day, allow daily transfers, and efficiently track participant holdings without extra accounting.

§5.11 Automated Response Capabilities

Participants usually have more than one way to make changes in or inquire about their retirement accounts in daily valuation plans. These may include:

- Contacting the company benefits manager;
- Contacting the recordkeeping firm directly;
- Completing standard forms;
- Contacting a voice response unit (VRU), also know as interactive voice response (IVR);
- Transferring to a live operator through the IVR;
- Connecting to a website or web response unit (WRU) via the Internet; or
- Interacting with a kiosk at the company location.

The last four alternatives, taken together, are often referred to as automated response units or ARUs. They are designed to provide information to participants 24 hours a day seven days a week and allow them to initiate certain transactions. ARUs are used extensively in daily valuation plans, allowing participants in these plans to initiate transfers anytime, eliminating paper requests and speeding up the transfer process.

Many plan sponsors seek service providers with arrangements that include these automated systems in an effort to reduce their own human resource department's involvement in day–to–day plan administration. Some employers feel pressure to make these options available to stay competitive with benefit packages offered at rival firms.

It is through these automated response units that participants initiate transactions. By calling a toll-free telephone number, a participant can either speak with a live operator or step through an interactive unit, using the telephone's keypad. To insure privacy, participants normally use their Social Security Number and a personal identification number (PIN) to establish their identity and gain access to their account. Contrary to conventional thinking, surveys have shown participants with unlimited access to their accounts tend to make fewer investment transfers than those who do not have constant access.

ARUs generally give participants access to information about their current account balance, the ability to inquire about loan availability, check the status of an outstanding loan, determine amounts available for hardship withdrawal, review their vested percentages, project account balance amounts to retirement age, hear the number of shares held in each investment fund and verify the value of each investment. The ARUs also allow participants to initiate transfers of existing assets, make changes in investment elections for future contributions, modify their PIN, initiate loans or do loan modeling, request distributions and enroll themselves in the plan.

Fast becoming a requirement for many plans is the option of a website that allows a participant to make requests and inquiries over the Internet. Some recordkeepers have eliminated manual entry entirely by requiring that all participant transfers and exchanges be made via the automated response units; no forms are accepted. This can translate into lower recordkeeping costs to the plan sponsor and less liability for the recordkeeper. However, it does force participants to use technology that they may be uncomfortable with.

Balance-forward plans tend not to use ARUs, although some retirement plan administration firms offer this service for balance inquiries. By their very nature, balance-forward plans do not anticipate on-demand response to participant inquiries or transaction requests.

§5.12 Comparison of Daily and Balance-Forward

Balance-forward and daily valuation plans each have unique features and both valuation methods continue to be offered by most retirement plan administration firms. Small employers, or employers that are just setting up a plan, tend to start with the balance-forward approach, because there is not enough money in the plan to warrant the sophistication of daily valuation. (However, due to cost efficiencies of new technology daily valuation opportunities have been provided for small employers and start-up plans.)

As participants' accounts grow in value, however, the participants become more interested in the investment choices offered to them, want better and more current information and want the option to make investment changes more frequently and quickly. When participants express their interest in these subjects, the balance-forward plan is converted to a daily plan. Following is a chart comparing the differences between daily and balance-forward features.

Daily	Balance-Forward
Accounting Method 1. Share accounting 2. Cash basis 3. Value determined daily 4. Transactions reported as they occur	**Accounting Method** 1. Dollar accounting 2. Accrual basis 3. Value determined at a specific date 4. Transactions reported months later

Daily	Balance-Forward
Earnings Allocation 1. Uses several methods depending on type of asset: a. Weighted allocation method for dollar par assets b. Accrual allocation method for dollar par assets or bond mutual funds c. Shares held on declaration date method for mutual funds 2. Allocate when received	**Earnings Allocation** 1. Combine all income and expenses and allocate as one amount a. Weighted allocation method b. Beginning balance less withdrawals and distributions plus some portion of contributions during period 2. Allocates after the end of the period
Distribution Processing 1. Processed at any time 2. Value received is vested amount on date shares are sold 3. Takes 30-45 days after date of termination to receive distribution [assumes one-month hold-out]	**Distribution Processing** 1. Processed after the valuation has been performed 2. Value received is vested amount as of the last valuation date 3. Takes 45-135 days after date of termination to receive distribution
Transfer Processing 1. Transfers can be allowed daily 2. Transfers occur no later than first business day after request 3. Requested by form or on automated response system	**Transfer Processing** 1. Transfers restricted by plan document 2. Transfers occur 45-60 days after valuation period 3. Requested by form
Participant Statements 1. May be provided quarterly 2. Mailed 10-15 business days after quarter ends 3. Presented on a cash basis 4. May present both dollars and shares	**Participant Statements** 1. Provided after each valuation 2. Mailed 30-60 calendar days after valuation period ends 3. Presented on accrual basis 4. Usually presented in dollars only
Investment Options 1. More restrictive to accommodate daily 2. Participant direction is common	**Investment Options** 1. No restrictions, except as imposed by ERISA 2. Participant direction is not as common; plan sponsor/trustee directs investments
Automated Response Units 1. Offered by most daily plans	**Automated Response Units** 1. Seldom offered
Reconciliation 1. Performed daily 2. Compares shares held	**Reconciliation** 1. Performed with each valuation 2. Compares dollars held
Department Structuring 1. Functionalized	**Department Structuring** 1. Nonfunctionalized

§5.13 Key Terms

Accruing: Describe the task of posting income to the participant's account based on what the trust expects to receive at the end of the accrual period.

Allocated Contract: An investment tracked at the participant level by the issuer.

Dollar Accounting: A methodology used in balance-forward plans to track investment information based on dollars bought or sold.

Par Value: The face value of a share.

Posting: Describes the task of crediting or debiting a participant's account to reflect activity affecting the account balance.

Share Accounting: A methodology used in daily valuation plans to track investment information based on shares bought or sold.

Unallocated Contract: An investment tracked at the plan level by the issuer.

§5.14 Review of Key Concepts

- Balance-forward plans perform accrual accounting and track investment information on a dollar basis. Daily valuation performs cash accounting and tracks investment information on a share basis.

- Daily valuation performs asset reconciliation every business day, whereas balance-forward reconciles as of the valuation date.

- Earnings allocation methods are more exact under the daily valuation process than under balance-forward.

- Distributions and transfers can normally be processed quicker under the daily valuation process than under the balance-forward method.

- Investments in a daily valuation plan are limited to those that can be traded daily, have a price per share that can be obtained daily, be able to be bought and sold in fractional shares, be available for purchase in shares for the full dollars and cents available to be spent, be set up so that dividends and other income are immediately reinvested in the investment and have trade information available the day after the trade occurs. Balance-forward plans can offer a wider range of investment options.

§5.15 Review Questions

[A] True or False

______ 1. Distributions from a balance-forward plan can be processed quickly since the funds are always available from the pooled account.

______ 2. Transfers between funds from the same fund families are often referred to as exchanges.

[B] Multiple Choice

3. All of the following are characteristics of investments suitable in a daily valuation plan, **EXCEPT**:

    A. Traded daily
    B. Share price can be determined daily
    C. Bought and sold in fractional shares
    D. Dividends are not reinvested in the investment
    E. Trade information is available the day after any trade occurs

4. All of the following statements regarding transaction processing are **TRUE, EXCEPT**:

    A. Balance-forward plans generally require distributions to terminated participants to be processed after the valuation is completed for the valuation date following the termination of the participant.
    B. In a daily valuation plan, distributions are sometimes delayed to ensure that the participant's final payroll contribution has been processed.
    C. Both balance-forward and daily valuation plans can allow transfers to be made at any time.
    D. Balance-forward plans can be valued monthly, quarterly, semiannually or annually.
    E. Daily valuation plans track shares in each fund that are held for the benefit of the participant.

5. All of the following statements regarding valuation of participant accounts are **TRUE, EXCEPT**:

   A. Balance-forward plans report the value of the account daily.
   B. Balance-forward accounting reflects accruals.
   C. Daily valuation accounting reports all transactions when they occur reflecting cash basis accounting.
   D. Daily valuation produces more precise reporting for participant accounts.
   E. When the unrealized gain or loss in a participant's account is based on shares held times price per share on the valuation date, the accounting method is referred to as share accounting.

6. All of the following statements regarding investments in a daily valuation plan are **TRUE, EXCEPT**:

   A. Employer stock that is publicly traded daily can be offered in a daily valuation plan.
   B. Since limited partnerships are popular investment choices, they are offered in a daily valuation plan.
   C. The investments available are usually more limited to allow for daily valuation.
   D. Suitable investments for a daily plan allow for easy tracking of participants' holdings.
   E. Mutual funds are suitable investments for a daily valuation plan.

§5.16 Answers

1. **False.** Distributions from a balance-forward plan can be processed only after the most recent valuation has been completed. In general, distributions are processed much more quickly in daily valued plans. §5.06

2. **True.** Transfers between funds from the same fund families are often referred to as exchanges. §5.07

3. The correct answer is **D.** §5.10 [D]

   A. Incorrect. This statement is true because investments in daily valuation plans should be traded daily.
   B. Incorrect. This statement is true because investments in daily valuation plans should have share prices that can be determined daily.
   C. Incorrect. This statement is true because investments in daily valuation plans should have shares that can be bought and sold in fractions.
   D. Correct. This statement is false because investments in daily valuation plans should have dividends reinvested in the investment.
   E. Incorrect. This statement is true because investments in daily valuation should have trade information that is available the day after any trade occurs.

4. The correct answer is **C.** §5.06 and §5.07

   A. Incorrect. This statement is true because balance-forward plans generally require distributions to terminated participants to be processed after the valuation is completed for the valuation date following the termination of the participant.
   B. Incorrect. This statement is true because in a daily valuation plan, distributions are sometimes delayed to ensure that the participant's final payroll contribution has been processed.
   C. Correct. This statement is false because balance-forward plans generally only allow transfers once per valuation period.
   D. Incorrect. This statement is true because balance-forward plans can be valued monthly, quarterly, semiannually or annually.
   E. Incorrect. This statement is true because daily valuation plans track shares in each fund that are held for the benefit of the participant.

5. The correct answer is **A.** §5.03

   A. Correct. This statement is false because daily valuation plans report the value of the account daily.
   B. Incorrect. This statement is true because balance-forward accounting reflects accruals.
   C. Incorrect. This statement is true because daily valuation accounting reports all transactions when they occur reflecting cash basis accounting.
   D. Incorrect. This statement is true because daily valuation produces more precise reporting for participant accounts.
   E. Incorrect. This statement is true because when the unrealized gain or loss in a participant's account is based on shares held times price per share on the valuation date, the accounting method is referred to as share accounting.

6. The correct answer is **B.** §5.10

   A. Incorrect. This statement is true because employer stock that is publicly traded daily can be offered in a daily valuation plan.
   B. Correct. This statement is false because limited partnerships are not popular investment choices and they are generally not offered in a daily valuation plan.
   C. Incorrect. This statement is true because the investments available in a daily valued plan are usually more limited than balance-forward.
   D. Incorrect. This statement is true because suitable investments for a daily plan allow for easy tracking of participants' holdings.
   E. Incorrect. This statement is true because mutual funds are suitable investments for a daily valuation plan.

Chapter 6:
Fiduciary Considerations

§6.01 Learning Objectives

- Discuss the fiduciary's role in choosing and monitoring plan investments.
- Summarize the objectives to balance when deciding what investment alternatives to offer in a participant-directed plan.
- Explain opportunity to exercise control and providing a broad range of investments under ERISA §404(c).
- Differentiate between providing investment education and investment advice to plan participants.
- Explain two common investment practices that shift liability for investment decision making from the participant back to the fiduciary.
- List some responsibilities of administration firms that are considered ministerial and do not give rise to fiduciary status.
- Explain when elective deferrals must be deposited into the trust.

§6.02 Introduction

One of the liabilities a fiduciary has deals with the selection of investments for the plan and monitoring the performance of such investments. When fiduciaries allow participants to choose how the assets in their account balance are to be invested, some of the liability shifts to the participant if the provisions in ERISA §404(c) are followed. These regulations have an impact on the types of investments that are offered in many plans using daily valuation.

Here we look at the rules in effect under this ERISA section and how plan sponsors can comply with guidance published by the DOL.

§6.03 Who Is a Fiduciary

The identification of the fiduciary is very important.

Under ERISA §404, a person becomes a **fiduciary** with regard to a plan if he or she:

- is paid to give investment advice with respect to any money or other property of a plan; or
- has any discretionary authority or responsibility to manage the plan or its assets.

ERISA §404 spells out the duties of a plan fiduciary. The DOL is responsible for enforcement of it.

Generally, a fiduciary is:

- An employer who sponsors a plan because of the employer's authority to engage service providers and fund managers;
- An investment advisor or a trustee who is appointed to manage plan assets;
- A trustee or plan administrator named in the plan document; or
- Any person who provides investment advice to the employer or plan participants for a fee.

Our focus is on how the fiduciary rules affect selection of plan investments as well as relationships involving retirement plan administration firms working with daily valuation that might create fiduciary liability for the retirement plan administration firms.

A fiduciary is required to act for the exclusive benefit of plan participants and with the care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would use in the same circumstances. This is sometimes referred to as the prudent man or prudent expert rule.

A fiduciary may minimize his or her fiduciary liability under ERISA §404(c) in plans that permit a participant to exercise control over the investment of assets in the participant's account. Until 1987, few plan sponsors offered participant-directed accounts, but those who did acted under the general assumption that the trustee would not be held liable for investment losses suffered in those accounts. The DOL affirmed that notion when it issued proposed regulations under ERISA §404(c) in 1987, which were later modified and finalized in 1992. The final regulations set forth the conditions by which plan fiduciaries may be able to relieve themselves of liability with respect to investment decisions made by plan participants to the extent the requirements of ERISA §404(c) are satisfied. According to the statute, a participant does not become a fiduciary just because he or she exercises control over the assets in his or her accounts. That general rule is interpreted in great detail in the final regulation. (DOL Reg. 2550.404(c)-1)

Keep in mind that there is no requirement that a plan offer participants any investment choice at all in a defined contribution plan, including a 401(k) plan. Some employers simply put all plan assets into a single professionally managed fund. If participants are permitted to direct investments, some plans limit the types of money that may be directed (e.g., elective deferrals but not the employer contributions) rather than allowing them to direct their entire account. Investment direction may be limited to a selection of mutual funds or permit participants to invest in almost anything of their choice.

Transferring the investment responsibility to the employees appeals to employers, but it is important to note that some fiduciary responsibility and potential liability cannot be transferred. In addition, a plan sponsor may inadvertently fail to take all of the actions necessary to relieve itself of potential fiduciary liability.

§6.04 Selecting and Monitoring Investments

First, some basics about fiduciaries and investments. The named fiduciary is always responsible for choosing and monitoring the investment options made available to participants. Some employers prefer brand-name mutual funds—those also available to individual investors—because participants can follow their investments in the newspaper. While this can help build employee awareness of investing, brand-name funds can be more expensive than institutional funds and once participants get attached to them it may be difficult to change even if the plan sponsor thinks another fund would be superior. Emphasizing brand-name funds may distract participants from focusing on the risk/return characteristics of the overall asset class.

Acting prudently in the context of selecting investment options means in part, that the funds made available to participants are expected to perform reasonably well relative to other similar investment products. For example, if the investment options are an array of mutual funds, prudence does not mean that the fiduciary must offer the outstanding fund in every investment category or constantly switch funds looking for the best performer. It does mean the fiduciary must periodically (at least annually) review how each fund has performed relative to other funds in its class and make changes when appropriate. Other considerations in selecting the investments include the fund's history, the expenses of the fund and the diversification of the list of funds.

In evaluating funds, the fiduciary should compare each fund to the performance of funds of the same type and with the same investment objectives. Often, this is accomplished in part by a comparison to an index such as the S&P 500 or the Russell 2000 Index. In addition, Morningstar and Lipper offer commercial services that constantly monitor the performance of mutual funds.

The fiduciaries that are responsible for selecting and monitoring funds should carefully document the criteria used to make fund comparisons and how the results fit with these criteria. All investment choices that were considered should be documented including why they were accepted or rejected. Typically, there should be an investment policy statement and formal minutes of fiduciary meetings should be maintained, together with copies of all of the materials reviewed for the meeting. Some would view this process as due diligence but it also serves to document the fact that the fiduciaries acted prudently in decision-making.

There are several objectives to balance when deciding what investment alternatives to offer in a participant-directed plan:

- Present a broad range of investment choices so that participants can fashion a diversified investment portfolio suited to their own needs.
- Offer suitable funds for each given investment class—for example, a consistently high-performing fixed-income fund or equity fund.
- Prevent participants from being overwhelmed by the number of investment choices.
- Monitor investment management fees to make sure they are reasonable.
- Minimize administrative costs that are absorbed by the accounts of participants.
- Improve participation by making the plan attractive and understandable to all participants.

The approach that best serves one of these objectives might not be the best for another. A mutual fund family might offer an inexpensive, turnkey package for an employer's 401(k) plan, but its funds might not be as good as other alternatives. On the other hand, participants might be intimidated by the task of choosing among too many investment options. An employer's decision to comply with ERISA §404(c), however, forces certain steps to be taken.

§6.05 Shifting Responsibility to Participants

Fiduciaries are in the awkward position of having to follow a participant's investment directions while remaining ultimately responsible for the investment results unless the plan complies with ERISA §404(c). Most plan sponsors opt to designate a group of funds in which the participants' accounts may be invested, rather than allowing each participant to invest in anything he or she chooses. Mutual funds, common/collective trust funds and employer stock are popular choices.

Effectively shifting investment responsibility under ERISA §404(c) has two requirements. The participants must have:

1. The opportunity to exercise adequate control over the assets in his or her account; and
2. A broad range of investment alternatives from which to choose.

[A] Opportunity to Exercise Control

The plan must present the participant the opportunity to exercise control over the assets in his or her account.

This requirement has three components: plan design, frequency of investment instructions and disclosure.

1. Plan Design

The right of the participant to direct investments must be set forth in the plan document. The specific provisions must identify the fiduciary to whom the investment instructions may be given and who is obligated to comply with the instructions. Participant instructions may be given by telephone or other electronic means, but the DOL is very concerned that participants have the opportunity to receive written confirmation of the instructions they have given. Many daily valuation systems receiving instructions through automated response units (e.g. IVR) routinely generate such confirmations.

The plan document, or a separate document that is incorporated by reference into the plan, must contain the necessary language to adequately describe the plan sponsor's intent to comply with ERISA §404(c).

2. Frequency of Investment Instructions

Participants must be allowed to change their investments with a frequency that matches the investment volatility. A plan that allows daily investment changes meets this requirement.

Each of the core funds, described below, must permit transfers at least once in any three-month period. It is this rule in the ERISA §404(c) regulations that makes daily valuation the most workable solution for an employer wanting to comply, thereby shifting some fiduciary liability.

3. Disclosure

The opportunity to exercise control rule states that plan sponsors as fiduciaries have a duty to provide specific information to the participant and provide specific time frames for doing so. Referring participants to a source of information such as a vendor website and requiring them to obtain the information from that source, is considered insufficient by the DOL.

Here's what the fiduciary must provide in order to comply with ERISA §404(c):

- An explanation that the plan is intended to comply with ERISA §404(c) and that ERISA §404(c) relives plan fiduciaries of liability. The summary plan description

(SPD) distributed to participants is an appropriate place to clearly state the plan sponsor's intention to comply, in whole or in part, with ERISA §404(c). However, this could also be communicated in an investment policy statement provided to the participants or a separate notice.

- A description of the investment alternatives that are available (if limited by the plan sponsor), including a general description of the investment objectives and risk and return characteristics, and the type and diversification of assets comprising the portfolio of the investment.

- The identity of any designated investment managers.

- An explanation of how a participant may change investment instructions, including any restrictions on transfers to or from a specific investment.

- A description of the transaction fees and expenses (e.g. commission, sales load) affecting the participant's account.

- The name, address and phone number of the plan fiduciary responsible for providing information and an explanation of the additional information that may be obtained on request.

- A copy of the most recent prospectus for investments subject to the Securities Act of 1933. If investment in employer securities is permitted, there are additional disclosures.

- Any materials provided to the plan relating to the exercise of voting, tender or similar rights incidental to ownership once the participant has invested in that security.

The participant may also request additional disclosures that must be provided if requested such as the current value of the participant's interest in the investment option, the value and investment performance of investment alternatives and the annual operating expenses of investment alternatives.

[B] Broad Range of Investment Alternatives

Satisfying the second requirement under ERISA §404(c), in order to effectively shift the fiduciary's liability involves presenting the participants with a broad range of investment alternatives. Specifically, the investment choices made available must provide the participant with a reasonable opportunity to affect the level of return and the degree of risk to which his or her accounts are subject. A plan that permits participants to invest in any asset of their choice automatically satisfies this broad range requirement.

Risk can best be described as your ability to sleep if your investments drop 10, 20, 30, 40 or even 50% in a year. Those who lose sleep after a 10% decline have a low tolerance for risk and usually are comfortable with more stable funds.

Return is why a person invests and what many investors pay the most attention to, without regard to the risk. Return, usually expressed as a percentage, shows how much your investment has gained or lost during the measurement period.

Presenting participants with a broad range of investment alternatives can be accomplished by offering three investment alternatives, often called **core funds**, although most plans offer more than three fund choices. Each of the three core options must be diversified and each core option on its own must represent a diversified portfolio of investments. Most mutual funds satisfy this criterion. Typical examples of three different funds that collectively meet the broad range standards are:

1. A money market fund;
2. A bond fund; and
3. An equity (stock) fund.

Two fundamental management decisions must be made by the plan sponsor choosing investment alternatives for its plan: how far up the high end of the risk/return curve to go and how many alternatives to offer at the low end of the curve. The decisions should begin with a careful consideration of the covered employees, both in terms of the ages of the group and the general level of investment knowledge. Employers must be sensitive to the tendency of participants to sometimes invest too conservatively and of the insecurity felt by many participants in making investment decisions. Many plan sponsors select a broad range of investments, across all asset classes, to allow participants to appropriately diversify their account balances for all risk tolerance levels.

In the end, the two general requirements of the ERISA §404(c) rules, opportunity to exercise control and broad range of investment alternatives, go hand in hand to better prepare participants for their retirement years.

Please refer to Appendix C for a Sample ERISA §404(c) Administrative Procedure.

[C] Investment Education and Investment Advice

Providing specific information to the participant to comply with ERISA §404(c) has spawned a new service: investment education. ERISA §404(c) does not require that investment education be provided; however, as participant-directed plans have grown in popularity, plan sponsors have become increasingly concerned about a participant’s ability to make educated investment decisions with respect to retirement funds. Participant seminars, newsletters and retirement counseling have become more popular as an employer-provided benefit. The most recent trend is investment education provided on websites.

Beyond education is investment advice. Investment advice is more specific than general employee investment education. Participants clamor for specific investment advice and may ask retirement plan professionals, plan trustees, participant call center representatives or people running enrollment meetings, "Which investment is the best?"

As a result, plan sponsors sometimes employ the services of an investment advisor to assist participants in investment decision-making. For a fee, participants can contact an investment professional. Based on the participant's answer to certain questions with respect to risk-tolerance, current investment elections and years to retirement, the investment advisor can offer investment advice. The advice provider can then recommend a fund or funds offered in the retirement product that the provider considers best for the participant based on the responses and possibly the current economic conditions. Participants are then free to accept the advice or not.

Ever watchful of stumbling into fiduciary territory, plan sponsors became wary of just how much information they could convey without crossing the line. What is investment advice rather than investment education?

In order to clarify the difference between investment advice and investment education, on June 11, 1996, the DOL issued Interpretive Bulletin 96-1 [Participant Investment Education]. This guidance clarified what forms of investment education could be provided to participants without subjecting the presenter (be it the plan sponsor or retirement plan administration firm) to fiduciary liability. In order to not be construed as investment advice, information must be general - not referring to particular investments - and the providers of the education must be selected and monitored in the same fashion as any other vendor engaged by the plan sponsor.

The Bulletin distinguished between investment education and investment advice by identifying four areas that qualified as education. Those areas are:

1. Providing general plan information;
2. Providing general financial and investment information;
3. Explaining asset allocation models; and
4. Presenting interactive investment materials.

The common thread throughout the Bulletin is the reminder to avoid recommendations of specific funds or investments.

Insurance and mutual fund companies often provide some basic investment education services as part of their enrollment programs. Pocket-sized calculators that let a participant project account balances based on different contribution and interest assumptions, color-coded asset allocation materials, Power Point presentations and videos are becoming common among vendors. New businesses are emerging specifically to service this educational need.

§6.06 Mapping and Default Funds

The protection offered under ERISA §404(c) is available only for investments made as a result of a participant's affirmative election. Two common investment practices, default funds and mapping from one fund to another, shift the liability for investment decisions back to a fiduciary, even if only temporarily.

[A] Default Funds

Sometimes a participant fails to make an election with regard to the investment of his or her account balance. This might occur because of an absence from work or the inability of the plan sponsor to locate a terminated participant. Rather than leave the funds uninvested, the plan sponsor or other fiduciary, instructs the recordkeeper to deposit those monies into a default fund(s).

Participants are usually given notice of the default fund(s) at the same time the investment options are presented to them. Of course, a participant whose accounts are deposited in the default fund can easily transfer dollars to other investment options by using either a written election form or the plan's automated response systems.

[B] Mapping of Funds

From time to time, the plan fiduciary may decide to replace one or more of the investment options available to participants. For example, suppose a plan has investments in the ABC Index Fund that was under performing in its asset class so the fiduciary decides to replace that option with the DEF Index Fund.

There are two ways in which the transition can be accomplished:

1. All participants can make new elections with regard to the investment of their account balances in the fund being eliminated. Using this method preserves the protections of ERISA §404(c); and

2. Alternatively, the plan sponsor can liquidate the existing fund and transfer the proceeds to the new fund. Because the participant has not participated in the decision to move the fund, the asset loses all protections under ERISA §404(c).

The decision to map investments under alternative two above is generally communicated to participants. Participants can change their investments after the mapping transactions have been completed, at which point ERISA §404(c) protection is restored.

§6.07 Retirement Plan Administration Firms as Fiduciaries

Retirement plan administration firms moving into the world of daily valuation may find themselves under increased exposure as a possible fiduciary. This can arise when the firm takes on a role in the deposit of plan contributions, or when issuing distributions, withdrawals or arranging other transactions involving the transfer of plan money. Other fiduciary concerns may arise if the retirement plan administration firm is being compensated for its services in any manner by the investment industry. Care should be taken by a retirement plan administration firm to avoid fiduciary status.

[A] Ministerial Functions

The following functions typically provided by a retirement plan administration firm are considered by the DOL to be **ministerial functions** and do not give rise to fiduciary status. These services must be performed within a framework of policies and rules set forth by the plan sponsor or as defined in the plan documents. They include:

- Applying rules to determine eligibility for participation or benefits;
- Calculating service and pay for benefit purposes;
- Preparing account statements or communications to employees;
- Maintaining participant work records;
- Preparing reports required by governmental agencies;
- Calculating benefits;
- Explaining the plan to new participants and advising participants of their rights and options under the plan;
- Collecting contributions and applying them according to the plan's provisions;
- Generating reports covering participants' benefits;
- Processing claims; and
- Making recommendations to others for decisions with respect to plan administration.

The DOL regulations describing these functions were issued in 1975. Therefore, these regulations do not address some services now being offered by retirement plan administration firms that have daily valuation units.

[B] Handling Plan Money

Depositing contributions, writing distribution checks and wire-transferring money between plan accounts could trigger fiduciary status for the retirement plan administration firm if the firm is considered to exercise control of the management or disposition of plan assets on account of these activities. Fortunately, regulations indicate that a third party may handle plan funds without necessarily becoming a fiduciary, for example, if it results from the collection and application of contributions. Status as a fiduciary hinges on whether the retirement plan administration firm is processing plan assets according to plan policies and procedures, without discretion.

Absence of fiduciary status is less clear if the firm has the authority to write checks or wire-transfer funds.

Certain steps may be taken to limit fiduciary exposure by retirement plan administration firms. Written agreements between the plan sponsor and the service provider can be useful tools to insulate the retirement plan administration firms from fiduciary status. For example, wire transfer agreements should be drafted to limit the authority of the retirement plan administration firm; likewise, the plan sponsor should receive enough information about checks and wire transfer activity in order to be considered as overseeing the retirement plan administration firm work.

It is important to have trading procedures in place and be able to demonstrate they are being followed. Distribution requests should be processed within certain established service standards. There should be established methods for tracking and validating trades. It is important to demonstrate trading is occurring at the direction of the plan sponsor, other fiduciary, or participant rather than at the discretion of the retirement plan administration firm. If the firm appears to exercise discretion in the trading process, it could be considered a fiduciary and be liable for coincidental investment losses that occur.

[C] Fee Sharing

Fee sharing is becoming more common as retirement plan administration firms and mutual fund companies feel pressure to compete on price. Now, various forms of alliances in the industry commonly result in payments from mutual fund companies, directly or indirectly, of a percentage of plan assets for services performed by the retirement plan administration firm.

The mutual fund uses 12b-1 fees (discussed further in Chapter 8) to cover these payments on the basis that the recordkeeping performed by the retirement plan administration firm is a shareholder service required of the mutual fund. In many cases, the retirement plan administration firm offsets the fee it normally charges the plan by the amount of the asset-based payment from the mutual fund. This arrangement probably does not make the retirement plan administration firm a fiduciary.

Two DOL advisory opinions issued in May, 1997, give some direction to those who participate in fee sharing arrangements. Again, these opinions are discussed in Chapter 8.

§6.08 Timing of Elective Deferral Deposits

Participants contribute to 401(k) plans through payroll deduction. The employer withholds these dollars in the same fashion as it deducts taxes or other employee benefit contributions on each paycheck. It is essential that these elective deferrals be transferred to the employer’s plan in a timely manner and not remain part of the employer’s general assets.

For instance, some employers accumulate and transmit payroll withholdings at the end of each month; others make deposits after each pay period. Employers should be aware that the DOL might determine that monthly transmittal of plan assets violates the requirement to hold plan assets in trust unless there was a valid need to do so.

In general, DOL rules demand that participant elective deferrals become plan assets and, therefore, must be deposited to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer’s general assets, but no later than the 15th business day of the month following the month in which they are withheld. For employers that cannot meet that time frame, the regulations allow a ten-business day extension. However, in order to take advantage of the extension, the employer must obtain a bond or irrevocable letter of credit and give written notice to the participants of the delay. Employers must pay interest on the late contributions if there are more than two extensions in any plan year.

Failure to transmit the contributions in a timely manner can result in liability for failure to hold plan assets in trust. Employers may be forced to make good any losses resulting from the failure to timely place the assets in trust and to restore any profits the employer may have gained from the use of the plan assets. Excise taxes and other penalties may be imposed if the late deposit is considered a prohibited transaction.

What is a prohibited transaction? The Internal Revenue Code and ERISA both contain outright prohibitions against direct or indirect economic transactions involving plan assets and certain parties related to the plan. Failure to transmit participant contributions in a timely fashion is generally a prohibited transaction. This is because by delaying the transition of contributions to the trust, the participant’s contributions are in the general assets of the employer. This could then be considered a loan from the plan to the employer since the employer could be using the assets for business purposes. A loan from the plan to the employer is a prohibited transaction.

IRS Form 5500 asks whether all employee monies have been transmitted to the plan “as of the earliest date on which such contributions can reasonably be segregated from the employer’s general assets.” The DOL is aggressively pursuing any situation brought to its attention where the employer may be holding back participant contributions. Loan payments are also subject to this standard.

Matching contributions and other non-deferral dollars contributed by the employer are not considered plan assets until actually deposited to the plan. The timing of deposits of such contributions, therefore, is not subject to the same rule as described above for elective deferrals.

§6.09 Key Terms

Core Funds: Three investment alternatives (money market, bond and equity) that provide a broad range of risk/return characteristics allowing a participant to diversify his or her portfolio.

Fiduciary: Any person (individual or corporation) who exercises discretionary authority or control over the management or disposition of plan assets, renders investment advice for a fee or has discretionary authority or responsibility for the plan administration.

Ministerial Functions: Functions, typically performed by retirement plan administration firms that do not give rise to fiduciary status.

Return: Usually expressed as a percentage it reflects how much an investment has gained or lost during a measurement period.

Risk: The ability to tolerate fluctuating return on investments.

§6.10 Review of Key Concepts

- One function of the fiduciary is to choose and monitor the investment options made available to participants. Fiduciaries can shift some of the investment responsibility to the participants by complying with the ERISA §404(c) regulations issued by the DOL.

- A fiduciary must balance offering a number of funds that provide a broad range of investments without overwhelming the participants with too many choices and minimizing investment fees and administrative costs absorbed by participant accounts with adding funds in hopes of improving participation.

- Under the ERISA §404(c) regulations participants must have the opportunity to exercise control over their account assets and there must be a broad range of investment alternatives from which to choose.

- The participant’s opportunity to exercise control over assets must be established through the plan design, spelled out in the plan document and must be disclosed to the participants by providing specific information.

- The broad range of investments offered to the participants must give the participant a reasonable opportunity to affect the level of return and the level of risk.

- Investment education is general plan information, general financial and investment information, explanation of asset allocation models and using interactive investment material. Investment advice is specific information about a fund and recommendations of a fund.

- Default funds and mapping are two practices that shift the fiduciary liability from the participants back to the fiduciaries.

- Ministerial functions such as applying eligibility rules, calculating benefit payments, and preparing account statements do not cause retirement plan administration firms to be considered as a fiduciary.

- Elective deferrals must be deposited to the trust as soon as administratively feasible after being withheld from a participant's paycheck, but no later than the 15th business day of the month following the month in which they were withheld.

§6.11 Review Questions

[A] True or False

______ 1. Generally, retirement plan administration firms who calculate participant benefits are not acting as fiduciaries.

______ 2. ERISA §404(c) requires that investment education but not investment advice be provided to plan participants.

______ 3. Fiduciaries are liable for investment results when a participant fails to choose an investment and thus his assets are deposited into the plan's default fund.

______ 4. In order to minimize liability, fiduciaries should choose brand name funds recognized by participants.

______ 5. A money market fund, bond fund and equity fund are three funds that satisfy the diversification standards under ERISA §404(c).

______ 6. Making the decision to remove a poorly performing fund is a ministerial function that does not give rise to fiduciary status.

[B] Multiple Choice

7. All of the following must be in place to shift investment responsibility to participants, **EXCEPT**:

   A. The plan document must specify participants' rights to direct investments.
   B. The fiduciary must counsel each participant on investments at least once a year.
   C. Participants must be notified of how they may change investments and how frequently.
   D. Participants must be notified that the plan intends to comply with ERISA §404(c).
   E. Participants must be provided with the name, address and phone number of the plan fiduciary.

8. All of the following statements regarding employers' timely deposits of elective deferrals are **TRUE, EXCEPT**:

   A. Employers cannot ever be held liable if they deposit elective deferrals into the plan trust by the 15^{th} business day of the month following the month in which they were withheld.
   B. To take advantage of an extension, employers need to obtain a bond or irrevocable letter of credit.
   C. Employers may need to pay interest on late contributions.
   D. Excise taxes and penalties may be imposed if the untimely deposit is a prohibited transaction.
   E. Participants need to be notified of the delay in depositing elective deferrals.

9. All of the following statements regarding participants' opportunity to exercise control over their assets are **TRUE, EXCEPT**:

   A. The right of the participant to direct investments is set forth in the plan document.
   B. Participants must be notified via email when the automated response units are not available to post the latest prices.
   C. The fiduciary to which the investment instructions must be given must be identified.
   D. Who must comply with participant investment instructions must be identified.
   E. The DOL is concerned that participants have the opportunity to receive written confirmation of the instructions they have given.

10. All of the following are fiduciary responsibilities regarding plan investments, **EXCEPT**:

   A. Selecting investments
   B. Comparing plan investments to others with the same objectives
   C. Documenting the criteria for making fund comparisons
   D. Providing an investment policy statement
   E. Switching investments to the best performer in the category

11. All of the following are considered investment education, **EXCEPT**:

   A. Recommending a specific investment for a participant
   B. Providing calculators that help participants project their account balance at normal retirement age
   C. Providing general financial information
   D. Explaining asset allocation models
   E. Explaining risk and return

§6.12 Answers

1. **True.** Generally, retirement plan administration firms who calculate participant benefits are not acting as fiduciaries. §6.07 [A]

2. **False.** ERISA §404(c) requires neither investment education nor investment advice. §6.05 [C]

3. **True.** Fiduciaries are liable for investment results when a participant fails to choose an investment and thus his assets are deposited into the plan's default fund. §6.06 [A]

4. **False.** In order to minimize liability, fiduciaries should choose investments that are expected to perform reasonably well relative to other similar investments. Brand name funds may or may not satisfy that criteria. §6.04

5. **True.** A money market fund, bond fund and equity fund are three funds that satisfy the diversification standards under ERISA §404(c). §6.05 [B]

6. **False.** Making the decision to remove a poorly performing fund is fiduciary function. §6.07 [A]

7. The correct answer is **B.** §6.05

   A. Incorrect. This statement is true because in order to shift liability to the participant the plan document must specify participants' rights to direct investments.
   B. Correct. This statement is false because there is no requirement that the fiduciary counsel participants on investments at least once a year.
   C. Incorrect. This statement is true because in order to shift liability to the participant, participants must be notified of how they may change investments and how frequently.
   D. Incorrect. This statement is true because in order to shift liability to the participant, participants must be notified that the plan intends to comply with ERISA §404(c).
   E. Incorrect. This statement is true because in order to shift liability to the participant, participants must be provided with the name, address and phone number of the plan fiduciary.

8. The correct answer is **A.** §6.08

   A. Correct. This statement is false because elective deferrals must be deposited as soon as administratively feasible, not necessarily by the 15th business day of the month following the month in which they were withheld.
   B. Incorrect. This statement is true because to take advantage of an extension, employers need to obtain a bond or irrevocable letter of credit.
   C. Incorrect. This statement is true because employers may need to pay interest on late contributions.
   D. Incorrect. This statement is true because excise taxes and penalties may be imposed if the untimely deposit is a prohibited transaction.
   E. Incorrect. This statement is true because participants need to be notified of the delay in depositing elective deferrals.

9. The correct answer is **B.** §6.05 [A]

   A. Incorrect. This statement is true because the right of the participant to direct investments is set forth in the plan document.
   B. Correct. This statement is false because the opportunity to exercise control does not include email notification of ARU updates.
   C. Incorrect. This statement is true because the fiduciary to which the investment instructions must be given must be identified.
   D. Incorrect. This statement is true because who must comply with participant investment instructions must be identified.
   E. Incorrect. This statement is true because the DOL is concerned that participants have the opportunity to receive written confirmation of the instructions they have given.

10. The correct answer is **E.** §6.04

   A. Correct. This statement is true because selecting investments is a fiduciary responsibility.
   B. Correct. This statement is true because comparing plan investments to others with the same objectives is a fiduciary responsibility.
   C. Correct. This statement is true because documenting the criteria for making fund comparisons is a fiduciary responsibility.
   D. Correct. This statement is true because providing an investment policy statement is a fiduciary responsibility.
   E. Incorrect. This statement is false because switching investments to the best performer in the category is not necessarily a prudent fiduciary choice.

11. The correct answer is **A.** §6.05 [C]

  A. Incorrect. This statement is false because recommending a specific investment for a participant is investment advice not education.
  B. Correct. This statement is true because providing calculators that help participants project their account balance at normal retirement age is investment education.
  C. Correct. This statement is true because providing general financial information is investment education.
  D. Correct. This statement is true because explaining asset allocation models is investment education.
  E. Correct. This statement is true because explaining risk and return is investment education.

Chapter 7:
Appropriate Investments for Daily Valuation Plans

§7.01 Learning Objectives

- Explain the three basic asset classes that mutual funds invest in.
- Differentiate among the different types of mutual funds.
- Explain the characteristics of guaranteed investment contracts (GICs).
- Define an equity wash restriction and explain why it may be imposed.
- Differentiate between a mutual fund and an exchange-traded fund.
- Discuss the administrative issues when employer stock is offered as a participant investment.
- Explain two methods commonly used to account for employer stock as a plan investment in a daily valuation plan.

§7.02 Introduction

While there are many investment vehicles available, some are more appropriate to daily valuation than others. This chapter describes many investment vehicles which are most often seen in daily valuation plans.

§7.03 Investment Overview

There are a variety of vehicles available to the individual investor: stocks, bonds, mutual funds, annuities, certificates of deposit, unit investment trusts (UIT), commodities, options and initial public offerings (IPO). However, not all of these investments are considered appropriate for participant-directed retirement accounts, especially in a daily valuation environment.

Commodities, options and IPOs are often considered inappropriate for the investor who is not adequately educated to understand the risk associated with the investment. Employer privately held stock may be inappropriate if it is not valued by an objective third party on a regular basis. Similarly, UITs and limited partnerships or real estate may be inappropriate if they cannot be traded as frequently as necessary to allow for in-service withdrawals and termination of participant accounts.

Mutual funds are clearly the most popular choice for participant-directed money. Certainly, publicly traded mutual funds are ideal for daily valuation plans because a dollar-certain amount can be invested. Mutual funds can be purchased in fractional shares, investing every penny available. A current value is established for each fund after the close of business on the New York Stock Exchange (or some similar exchange) each day the exchange is open. The time when a mutual fund sets its net asset value (NAV) is specifically disclosed in the mutual fund's prospectus.

Recordkeeping systems easily accommodate accounting for mutual funds using share accounting. In fact, it is this very feature that has caused mutual fund companies to expand their operations to offer packaged recordkeeping services for plans. It is exactly what they have been doing for shareholders for years.

If a plan sponsor is intending to comply, in whole or in part, with ERISA §404(c) to gain its liability protection, clearly a minimum of three funds with different risk/return potentials must be provided, usually a stock fund, a bond fund and a money market or cash equivalent. The plan sponsor is typically the fiduciary who selects the funds that are offered to participants.

A fiduciary more appropriately selects the type and mix of funds if he or she understands the investment time horizon of the plan's participants. A predominantly young workforce with well over 20 years to retirement may prefer a variety of aggressive equity-type funds. In contrast, if the participants are over age 50, the fiduciary may favor a fund mix that includes more fixed-income, bond and balanced fund choices. Age is just one deciding factor, however, and the investment options should allow appropriate diversification for all risk tolerance levels.

§7.04 Asset Classes

Each mutual fund invests in one or more of the three primary asset classes as defined in its prospectus:

- Stocks;
- Bonds; and/or
- Cash investments.

A **mutual fund** is an investment company that pools the funds of many investors to purchase a portfolio of individual securities. The mutual fund is actually the container that holds various shares of stock or bonds and cash investments. The Securities Exchange Commission (SEC), under the Investment Employer Act of 1940, regulates mutual funds. A bank custodian typically holds the assets of a mutual fund.

[A] Stocks

A share of **stock** is a security that represents proportionate ownership in a corporation. Of the three asset classes, only stocks can provide both an income stream (in the form of dividends) and a long-term growth element. The terms stock and equity are often used interchangeably.

In contrast to mutual funds, individual stocks may only be purchased in whole shares; fractional shares may not be purchased except when dividends are reinvested. If a plan has $1,000 to invest, but a stock purchase amounts to $990, the plan holds the balance, or $10, in a cash investment.

A common stockholder may receive income in the form of dividends, which are not guaranteed. Common stock usually comes with voting rights. Preferred stockholders, on the other hand, have a right to receive a dividend before common stockholders but seldom have voting rights. Preferred stock is often convertible into common stock.

There are other common terms used to describe stock:

- Blue-chip companies are those considered to be our nation's largest and most consistently profitable. Such companies are well established, with household names like IBM.
- Growth stocks are stocks of companies whose equity value is expected to grow faster than average.
- Value stocks are shares of companies that are thought to be currently undervalued, perhaps because the employer is out of favor for some reason. An investor in value stocks is anticipating higher stock prices once the situation is resolved.
- Small-cap refers to stocks of companies with a market capitalization, or total market value, of less than $2 billion.
- Mid-cap describes stocks of companies with a market capitalization between $2 billion and $10 billion.
- Large-cap stocks are shares of stock whose market capitalization exceeds $10 billion.

Stock prices can be influenced by such factors as a corporate restructuring, acquisitions or dispositions of divisions and new product development. The value of a stock should be a reflection of an employer’s current and predicted earnings as well as its underlying asset value.

Both stock and stock funds are generally categorized by market capitalization and investment style. For instance, a stock may be categorized as a large-cap growth stock or a small-cap value stock. Stock funds are more commonly available to participants in employer-sponsored retirement plans than individual stocks.

[B] Bonds

Entities interested in raising capital may issue bonds. A **bond** is a debt instrument where the buyer lends money to the issuer of the bond and, in return, is paid a stated rate of interest at fixed intervals until maturity. Bonds are referred to as fixed-income investments. Bondholders have no equity interest in the issuer of the bond; however, they have a creditor status. Organizations such as Standard & Poor's, Moody's and Duff and Phelps evaluate corporate bonds using systems similar to those used to rate insurance companies.

Most long-term corporate bonds are collateralized. Short-term corporate bonds that are unsecured are called debentures. Federal, state and local governments also issue bonds to raise funds. Treasury bills, notes and bonds are types of bonds issued by the federal government.

Bonds are typically issued and bought and sold in increments of $1,000, which is considered the principal. The principal is to be paid back to the bondholder on or before the bond's maturity date. The principal amount is called the par or face value.

Bonds and bond funds are categorized by who is issuing the bond, when the bond matures and how likely the issuer is to repay. The maturity terms may vary by category but generally they are defined as:

- Short-term bonds normally mature in less than five years.
- Intermediate bonds have maturities ranging from five to ten years.
- Long-term bonds generally mature after ten or more years.

Bond funds are more commonly available to participants in employer-sponsored retirement plans than individual bonds.

[C] Cash Investments

Cash investments include certificates of deposit, treasury bills, commercial paper (short-term obligations of corporations with the highest credit ratings) and money market funds. Money markets are the most common cash investment seen in qualified plans. Any dollar amount can be invested in a cash-type investment.

Due to the short-term nature of the loan, the risk of losing principal in a cash investment is considered very low. This generally translates into low rates of return when compared to stocks and bonds. With a cash investment, an investor runs the risk of not having enough growth to keep pace with inflation.

§7.05 Types of Mutual Funds

There is an old saying: Don’t put all of your eggs in one basket. Plan sponsors usually offer different types of investments to allow each participant to diversify his or her portfolio. A participant who can choose among stock, bonds and/or cash investments can achieve diversification by spreading his or her assets among the different types of investments offered. A mutual fund, by virtue of its structure, already offers some diversification since the mutual fund has holdings in more than one employer or institution.

Funds have a variety of names. When a bank runs a fund, it is called a commingled account. Separate accounts traditionally are funds that are run by insurance companies, although other institutions have begun using that term to identify certain arrangements they manage. When an investment employer runs such a fund, it is called a mutual fund. What's important? The type of securities the fund buys and the investment style it uses.

There are actively and passively managed funds. In an **actively managed fund**, the manager constantly analyzes individual holdings of a mutual fund in an attempt to outperform a selected market index. Actively managed funds do not necessarily perform better or worse than a passively managed fund; however, fees are usually higher because of the work involved to operate the fund. A **passively managed fund** means the fund manager, through the use of computer software, creates a portfolio whose holdings copy those of a particular type (i.e., a stock or bond index). The passively managed account then only invests in the stocks or bonds that are part of that index fund.

The most common types of mutual funds offered in participant-directed plans are corporate or government bond funds, indexed funds, balanced funds, sector funds, growth and income stock funds, growth funds, international and global funds, lifestyle funds and age-based funds.

[A] Corporate or Government Bond Funds

Corporate or government bond funds invest mainly in bonds issued by corporations and bonds issued by the US Government or one of its agencies. A bond fund can be actively managed or passively managed.

[B] Indexed Funds

Indexed funds are passively managed. For example, an S&P 500 index fund buys the same 500 stocks that make up the index. Other index funds track with the Russell 2000, which monitors the stocks of 2000 small companies, and the Shearson Lehman Brothers Government and Corporate Bond index, which tracks the performance of investment-grade bonds.

[C] Balanced Funds

Balanced funds are attractive to participants because they invest in a relatively fixed combination of both individual stocks and bonds. The fund's manager has some discretion with changing the mix, as disclosed in the fund's prospectus. Balanced funds can offer both income and growth, providing more diversification than a typical stand-alone stock fund or bond fund.

[D] Sector Funds

Sector funds refer to mutual funds that concentrate in one segment of the market, such as energy, technology or gold.

[E] Growth and Income Stock Funds

Growth and income stock funds invest mainly in stocks of large- and medium-sized companies and seek to provide a balance between current dividend income and long-term growth. These funds are typically stocks of companies that show steady growth with a consistent record of paying dividends to shareholders.

[F] Growth Funds

Growth funds are mutual funds whose managers seek the stock of companies whose earnings are expected to grow faster than average. Funds that invest in companies that may involve higher risk while having strong growth potential are known as aggressive growth funds. These funds usually react more visibly to short-term market swings. A participant selecting these funds is counting on the holdings of the fund being worth considerably more in the future.

[G] Value Funds

Value funds are mutual funds whose managers seek the stocks of undervalued companies that are believed to appreciate based on general economic and market conditions. Although value funds invest primarily in securities that are believed to be undervalued relative to their underlying profitability, there is no assurance that the shares will appreciate in value. Value funds tend to do well when growth funds do poorly and vice-versa they will perform poorly when growth funds do well.

[H] International and Global Funds

International funds invest only in non-US securities while global funds invest in both US and non-US securities.

[I] Lifestyle Funds

Fast becoming popular options are lifestyle funds (also known as asset allocation funds, strategic allocation funds or lifecycle funds). These are actually a blend of other fund types (not individual stocks or bonds) with the mix driven by predefined investor models. These funds are particularly popular with participants who are wary of making individual fund decisions, since they provide professional asset allocation and broad diversification.

Asset allocation is not the same as investment selection. Investment selection refers to the process of choosing specific funds or stocks within a particular asset class. Asset allocation involves choosing investments across the three broad asset classes (stocks, bonds and cash investments), rather than putting all funds into a single category. Participants should focus on their risk tolerance (the ability to watch the market go up and down and still sleep at night) together with their investment time horizon. If a participant is nearer to retirement age, for example, his or her risk tolerance is probably lower inasmuch as the participant may want to be more secure in the absolute value of his or her portfolio.

With a lifestyle fund a portfolio manager makes the asset allocation decisions. The fund is frequently rebalanced so that it maintains the defined relationship between investment in stocks, bonds and cash. Participants choose the lifestyle fund whose mix most closely matches their personal investment objectives. Participants invest 100% of their contribution into the lifestyle fund that matches the investment risk profile that they have chosen. Participants may consider changing to another lifestyle fund as they grow older or as their financial situations change.

[J] Age-Based Funds

Another investment option becoming popular is the age-based fund or target maturity fund. These funds also are designed so that participants invest 100% of their contribution into one fund. Each fund offered matches a projected retirement date. The funds are diversified and structured to grow more conservative as the fund's target date approaches. For example, a person planning to retire in the year 2045 chooses the Target Retirement 2045 Fund. In the early years, the fund is invested heavily in stocks, but as the years go on, the mixture of investments gradually is less concentrated in stocks and more concentrated in bonds and cash equivalent instruments. Participants in age-based funds do not need to rebalance their account on a periodic basis, nor do they need to consider transferring out of the fund as they grow older. Participants in age-based funds need to maximize their contribution to the fund since it grows more conservative and has less potential for return on the investment as years go by.

[K] Money Market Funds

Money market funds invest in very short-term obligations that are constantly being bought and sold. Cash, treasury bills, certificates of deposit and commercial paper are typical holdings. Interest rates paid to the fund may fluctuate, but the original investment remains whole.

Unlike the traditional mutual funds described above, money market type funds trade at a share price of $1. Interest is credited only once each month. In the context of a money market fund, the interest is a dollar (or share) amount representing the investment return the fund has earned during the period.

It should be noted that the manner in which the interest is credited to participants invested in the fund might vary based upon the recordkeeping system used and the procedures adopted by the institution responsible for that task. For example, what happens when a participant transfers money out of the money market fund before the monthly interest has been credited?

There are at least two possible results:

1. He or she receives no interest allocation for the portion of the month during which his or her funds remained invested in the money market fund; or

2. The manager of the recordkeeping system assigns a daily income factor that represents the expected rate of return for the month, and the participant shares in that rate of return for the period he or she remains invested. In simple terms, the rate of return is a percentage obtained by dividing the dollar amount of the interest by the dollar value of the shares outstanding as of the beginning of the allocation period.

Recordkeeping practices vary with regard to interest that trails a transfer or distribution out of a money market fund, as described above. In some instances, the distribution or transfer includes only the actual cash available from the money market at the time of the transaction, with a trailing distribution or transfer when the interest is actually recorded by the recordkeeper. Other operations may go ahead and distribute or transfer all of the cash attributable to that participant, including the income calculated using the rate of return factor, treating the income portion as an advance against the money market fund. The money market is made whole when the interest is actually paid at a subsequent date.

A money market fund is sometimes referred to as a stable value fund; however, that term is more often used to refer to a fund that invests primarily in guaranteed investment contracts (GICs). These funds have some potential for the principal to be lost if the insurance carrier experiences financial setbacks.

§7.06 Mutual Fund Considerations

[A] Valuing a Participant Account

A participant's account may contain several mutual funds, all with different share values. To determine the total value of the account, each mutual fund is valued separately and then the results are added together.

Example 7-1. Account Value. A participant has 100 shares of a bond fund and 300 shares of a stock fund in her account. If the price per share for the bond fund is $10.00 and the price per share for the stock fund is $15.00, the total value of the participant's account is calculated this way:

Bond Fund = $1,000 (100 shares x $10.00 per share)
Stock Fund = $4,500 (300 shares x $15.00 per share)
Total = $5,500

[B] Mutual Fund Dividends

Mutual funds may have income in the form of dividends. Capital gains result when a mutual fund sells a security and receives a profit. Those capital gains, along with dividends and interest paid by the underlying securities, are passed on to the shareholder of the mutual fund. However, in most retirement plans, these capital gain distributions are reinvested by the shareholder into more shares.

[C] Fund Families

It is common to offer funds from the same fund family. A fund family is a group of mutual funds offered by the same organization. Examples of fund families include Fidelity, Vanguard Group and T. Rowe Price. Plan sponsors are often drawn to such arrangements because of the convenience and services provided. Of course, a fund family may not have the best funds in every fund category. Many fund families are now offering outside mutual funds to retirement plans in addition to their own to accommodate the needs of plan sponsors.

Another delivery system available to plan sponsors may be referred to as a mutual fund supermarket, and such arrangements provide access to and trading for mutual funds from a variety of unrelated fund families. The menu of mutual funds may continue to be somewhat limited in a supermarket approach, or it may be open to the entire universe of mutual funds. The trend for larger plans is toward multiple fund families.

[D] Group Contracts

Insurance companies offer mutual funds through various types of group contracts issued to plans. In addition to GIC-type options (discussed below), the group contract holds investments in separate accounts maintained by the insurance employer. These separate accounts are the vehicles holding the various mutual funds. Each mutual fund owned by the insurance employer usually resides in its own separate account. Those separate accounts are offered to all of the customers of the insurance employer. Depending on the investment options offered to participants of a specific plan, one or more of the separate accounts become part of the group contract held by the plan. The group contract is said to wrap around the component GIC and separate account features.

Participants in an employer-sponsored retirement plan who invest in the separate accounts own units of the separate accounts, not the shares of the mutual fund. The separate accounts established by an insurance employer are regulated by individual state insurance boards and are exempt from regulations by the Securities and Exchange Commission if they are available only to investment funds from retirement plans that are qualified under IRC §401.

§7.07 Guaranteed Investment Contracts (GICs)

A **guaranteed investment contract (GIC)** is sold by an insurance company. It guarantees the payment of a specific rate of interest on the amount of money invested for a specific period of time. It is common to see GIC contracts with guaranteed interest rates for one, three, five and ten years. The “guarantee” refers only to the rate of interest to be credited on the contract; the guarantee does not extend to the principal amount invested.

When a GIC is entered into, the insurance company invests the GIC funds in a portfolio of securities that are scheduled to mature around the time the GIC matures. The insurance company assumes the market and credit risks relating to the portfolio that underlies the contract. A GIC is issued as an obligation of the insurance company’s general account. There is no US government agency guarantee of interest or principal, similar to what could be in place if the same funds were used to purchase a certificate of deposit at a bank.

States have established guarantee (rescue) funds to protect life insurance and individual annuity policyholders. Many states also extend their protection to retirement plan participants, but the amount of coverage is usually limited and varies from state to state.

These contracts were very popular during the early 1980s, when interest rates were in the double digits. The failures of Executive Life and Mutual Benefit Life insurance companies in the early 1990s strained consumer confidence at about the same time participant direction was becoming more common. Many plans continue to offer a GIC, or a GIC alternative, since the interest rates are usually higher than that of a money market fund, and the rate is guaranteed for a longer period. These investment choices still appeal to participants who are nearing retirement or those who are less comfortable choosing among bond and equity funds.

From a recordkeeping standpoint, these individual GIC contracts present special systems challenges. GICs are accounted for on a dollar basis, rather than a share basis. In addition, interest is credited at specific intervals, not on a daily basis. Finally, the GIC is not a publicly traded vehicle that can be easily valued each day.

[A] Pooled GICs

A pooled GIC is a managed pool of GICs issued by different insurance companies and is often referred to as a stable value fund. This approach provides diversification among a number of carriers, in much the same way that a mutual fund investing in a number of different companies spreads its risk. Large banks, institutional money managers and mutual fund companies are largely responsible for the management of these pooled GICs.

The recordkeeping for pooled GICs is generally easier than for individual GIC contracts since the accounting may be managed on a share basis, rather than a dollar basis.

[B] Synthetic GICs

The structure of synthetic GICs is more complex and difficult to communicate to participants. These GICs generally only make sense where there are substantial dollars available for investment, so they are an option only for very large plans. From the investor's standpoint, synthetic and traditional GICs look alike. The difference between the two is the ownership of the underlying assets of the GIC. In a traditional GIC, the insurance employer owns the assets. The plan owns the assets in a synthetic GIC.

A synthetic GIC usually has a maturity of one to five years, similar to traditional GICs. The investment itself has two components: a portfolio of securities owned by the plan and a book value wrapper provided by a third party. The plan sponsor or its designated investment manager selects the securities that are part of the portfolio. The third party issuing the wrapper contract protects the principal value of the monies invested in the underlying portfolio, providing payments to participants at book value. It is the wrapper contract that makes the portfolio look like a GIC.

The recordkeeping for synthetic GICs should be similar to that of a pooled GIC, although it may depend on the GIC manager.

[C] Bank Investment Contracts (BICs)

A bank investment contract is another type of GIC, but it is issued by a bank rather than an insurance employer. Although they have been around for a number of years, BICs have not penetrated the investment market to the same degree as traditional and pooled GICs. The recordkeeping for a BIC is similar to that of a traditional GIC, since it is not typically sold in shares.

[D] Equity Wash Restrictions

An **equity wash restriction** is one that requires that participant-directed transfers from a fixed rate investment contract be made to an equity fund. The money must then remain in the equity fund for a specified period of time. An equity wash restriction applies most often when a plan offers more than one stable value fund, including pooled contracts such as GICs or BICs, or a plan has a self-directed brokerage account option.

An equity wash restriction is intended to prevent participants from transferring directly from one competing fund to another. A competing fund is generally an investment fund that has similar risk/return characteristics to a fund invested in stable value (*i.e.,* insurance) contracts. Money market funds, certain fixed-income funds and some balanced funds are examples of so-called competing funds.

When an equity wash restriction is in place, participants must first transfer plan assets to a non-competing fund, such as an equity fund, for a set period of time (usually 90 days) before plan assets can be transferred into a competing fund.

The rationale of an equity wash restriction is to protect the interests of participants who choose funds that invest in stable value contracts. Issuers of stable value contracts are concerned that as short-term interest rates rise, participants seeking higher rates of return may transfer plan assets from one stable value fund to a competing fund because the competing fund may be able to respond more quickly to interest rate changes. This may adversely affect the rate of return for the participants who remain in the stable value contract.

The investment manager of the stable value fund imposes the equity wash restriction because it is required by the issuers of the underlying contracts. Restrictions on competing funds and the use of equity washes have been standard in the insurance industry for many years.

Equity wash restrictions are often not understood or explained to participants and tend to create a great deal of confusion. They may also be difficult to manage on the plan's automated response systems. Because of the difficulty with communicating and administering an equity wash restriction, some stable value funds avoid the equity wash restriction by not allowing competing funds to be in the same plan.

§7.08 Life Insurance

A plan may provide (incidental) death benefits through individual life insurance policies. Life insurance coverage is considered incidental if less than 50% of the employer's contributions, including the employee's elective deferrals, is used to purchase whole life insurance, or if no more than 25% is used to purchase term life insurance or universal life insurance.

Individual life insurance contracts are not ideal investments for daily valuation plans, although such contracts may be appropriate options for a participant-directed plan. Recordkeeping becomes more complex since the policy is not valued on a daily basis. Premiums may be paid annually or periodically, while cash value increases annually.

§7.09 Other Investments

[A] Brokerage Accounts

One of the hottest trends in the participant-directed market is to allow participants to set up self-directed brokerage accounts (SDBA). This type of account is an added investment option where participants may choose from an array of investment vehicles (individual stocks, bonds and mutual funds) not offered in the plan's core investments. It is attractive to participants who are willing to take on added risk and cost. It is also attractive to the plan fiduciary who desires to offer alternative investments without adding a large array of core funds.

When participants use brokerage accounts, there is normally a delay in processing the actual transactions between the investment funds used by the plan and the self-directed accounts. Brokerage accounts have up to a three-day settlement period so that when a participant transfers from one of the funds allowed under the plan to an SDBA or from an SDBA to an investment fund in the plan, the money could remain uninvested for three days. This also means that a participant could experience delays in getting loans or distributions from the plan.

One challenge being faced by recordkeepers revolves around how often the brokerage firm sends total investment information on the participants' accounts. If the brokerage firm only provides periodic updates on the account, any information given on an automated response system is not up-to-date and thus inaccurate. As a result, recordkeepers may not use automated response systems to handle transfers to or from the SDBA; rather, they may be required to use a customer service representative or complete a written request. Recently, however, trading partners are more commonly able to provide daily SDBA updates electronically to facilitate electronic transfers via automated response systems.

[B] Managed Accounts

As an alternative to standard mutual fund options, a sponsor may decide to offer participants investment accounts that are actively managed by professional advisors. Certain accounts may be offered to all participants at a plan level or on a participant-by-participant basis. At a plan level, these accounts may have more broadly based objectives and strategies; whereas, at the participant level they are tailored to the goals and objectives of that particular participant. These accounts offer a more customized approach and typically involve higher fees and are better suited for large account balances.

[C] Hedge Funds

These funds are unregistered, private investment pools that are typically available only to investors with significant amounts to invest – maybe as low as $25,000, but many times upwards of $1 million or more. These high minimums are meant to limit participation. They are exempt from regulation by the SEC and federal securities law and generally are not subject to any limitations as to holdings, fees or leveraging (borrowing to invest). Hedge funds are typically not valued daily.

The term hedge implies an investment strategy whereby competing strategies are employed at the same time (*e.g.,* long and short-term bonds in the same portfolio). However, most hedge funds currently use a variety of different investment strategies. The primary differences from a mutual fund are their private status, exemption from regulation and the inability of average investors to qualify for their high minimums. Therefore, hedge funds are not appropriate for daily valued defined contribution plans.

[D] Unit Investment Trusts

Unit investment trusts are similar to mutual funds. Professional money managers, most often through a brokerage house, establish them. The money manager acquires stocks or bonds based on the objective of the unit trust. After the stocks or bonds are acquired, they remain in the portfolio until the unit investment trust is completely liquidated. There is very little trading within the portfolio after it has been established; thus, the cash portion of the portfolio is very small.

The unit investment trust remains in existence for one to five years. It is then liquidated and a new trust is established. Unit investment trusts are closed funds. After it has been established, no new investors can acquire units of the trust. However, investors can liquidate their portion of the trust before the trust maturity date.

The advantage to using a unit investment trust is that it is diversified similar to a mutual fund. It contains many stocks or bonds. The investor buys units of the trust rather than individual stocks and bonds. The investor owns a proportional share of all the stocks or bonds in the portfolio. The portfolio remains the same so that the investor knows what is owned at all times. The unit investment trust is valued daily based on the market closing price of the securities held within the trust.

Unit investment trusts are more often seen in retirement plans that are trustee-directed. Since the trust is a closed trust, it makes the product difficult to administer in daily valuation.

[E] Common/Collective Trust Funds

Common/collective trust funds hold the assets of qualified plans maintained by a number of unrelated plan sponsors. These funds are managed by the trust departments of banking institutions and are subject to regulation by the Controller of the Currency.

Common/collective trust funds are invested as a single fund in a diversified portfolio of securities in much the same way that a mutual fund functions. The investments of common/collective trust funds are determined by the investment objective of the portfolio. Common/collective trust funds typically have lower fees than mutual funds because they are not sold to the retail market and are not subject to the registration requirements of mutual funds. The funds may lack the name-brand recognition that participants favor and cannot be easily monitored since performance information is not widely reported, which may complicate the education process and lessen their appeal.

Recordkeeping for such funds varies depending on the institution managing the fund. In many instances, the funds are not valued on a daily basis and the electronic systems are not in place to communicate values between the institution and the recordkeeper. Of course, banks are recognizing this gap and working to overcome this obstacle.

[F] Individual Annuity Contracts

Individual annuity contracts are only normally set up when a plan is designed and administered by an insurance employer. In those plans, the individual annuity contract may have a fixed rate of return or a variable rate of return. Some contracts allow the participants to transfer monies to separate accounts, which operate like mutual funds.

Typically, these pooled or individual contracts do not allow a participant to transfer assets to another investment. If a participant does take money out of such contracts, there may be severe surrender charges or penalties. Other recordkeepers may be reluctant to take on the administration of a plan with individual contracts due to reporting problems and concerns about which employer is responsible for distributions and tax reporting.

[G] Exchange-Traded Funds (ETFs)

Exchange-traded funds (ETFs) are similar to mutual funds but have the trading flexibility and continual pricing of individual stocks. Most ETFs are registered investment companies. They are created when a securities firm acquires stocks that generally match the holdings of an index. Investment advisors have a tendency to recommend ETFs over mutual funds because of their continuous trading features.

There are several differences between a mutual fund and ETFs.

- ETFs are sold through a brokerage firm. Mutual funds are sold directly by the mutual fund company or a broker.
- ETFs are bought and sold at any time during the day while the exchange is open at the fluctuating ask or bid price during the day. Mutual funds are bought and sold using the price at the end of the day.
- ETFs may not have an automatic dividend reinvestment program. It is dependent on the brokerage firm's capabilities, and the broker may charge for this service. Mutual funds have automatic dividend reinvestment programs at no charge.
- ETFs may have lower operating expenses than mutual funds. However, ETFs also have brokerage commissions and other costs to buy and sell ETF shares.

[H] Fixed Income Alternatives

Treasury Inflation Protected Securities (TIPS), floating rate funds and convertible bond funds may be considered as fixed income alternatives for retirement plan participants as they age and become more risk averse. TIPS are a form of investment where the principal adjusts each year based on inflation. They pay a small amount of interest but have a hedge on inflation. Floating rate funds offer protection against increasing interest rates through their adjustable rate notes. Convertible bond funds offer a conversion into a company's stock, thus offering diversification in fixed income.

§7.10 Employer Stock

Some plan sponsors decide to offer participants the right to direct the investment of their accounts to employer stock in addition to other investment options. In some instances, the option may be limited to certain sources of funds, such as elective deferrals, match or profit sharing. Other plans automatically invest matching contributions in employer stock, and the participant may or may not be allowed to transfer in or out of the employer stock option. There are fiduciary and securities rules that apply when employer stock is an investment option; however, these areas are beyond the scope of this course.

Recordkeeping for employer stock that is publicly traded is no different from that of any other stock. The stock is priced daily on the exchange where it is traded, and the price is set at the close of each business day. However, stock may be bought or sold throughout the day based on the price a willing buyer or seller gives. This is different from mutual funds that are bought or sold based on the closing price for the day. Shares of stock may only be bought or sold in whole shares. Mutual fund shares can be bought or sold in whole and fractional shares.

When employer stock is not publicly traded, however, recordkeeping involves periodic updating of the share price, rather than daily updating. In some instances, the share price may change only once each year. Regardless of the frequency of valuation, the daily recordkeeping system must be managed differently for such employer stock accounts from the methods used to update other daily valuation investment options.

As noted throughout this chapter, many investments do not work as easily as mutual funds do in the daily valuation environment. Let's turn to some of the issues that come up when working with employer or other individual stocks.

[A] Employer Stock

Employers have many different methods for offering employer stock as an investment option in qualified plans. Some employers establish an employee stock ownership plan (ESOP), which by definition is intended to invest primarily in employer stock. Other employers offer employer stock either as an investment option in a 401(k) plan or, for example, as a matching contribution.

When plan participants of daily valuation plans are given the option to invest in the employer's stock, ideally the stock should be actively traded on one of the major stock exchanges so that the stock can be valued daily. The daily value of the stock is necessary to allow for transfers between the different investments, calculation of the amount available for loans, and ease of distributing funds for hardship withdrawals and to participants who have terminated employment.

There are two methods for tracking employer stock on a daily valuation system:

1. The liquidity fund method tracks the actual number of shares allocated to a participant's account; while
2. The unitized method assigns a unit value to the stock account.

Both methods are explained in more detail later in this chapter.

There are several other unique features to an employer stock investment option. These features add a number of tasks to the recordkeeper's to do list that do not exist with mutual fund investment options.

[B] Voting Rights of Employer Stock

If the shares of stock owned by the plan have voting rights, some companies require the trustee to pass through to the participants the voting on all issues. If the proxy voting passes through to the participants, the recordkeeper provides certain information to the employer that handles the proxy information. The information normally includes the participant's name, address and the total number of shares in the plan as of a specified date. If the plan uses the unitized stock account consisting of both shares of stock and cash, then the stock account units are converted into shares of stock.

Occasionally a retirement plan administration firm has multiple plans for the same employer and each plan may have a separate unitized stock account. In these situations, the employer handling the proxy mailing may require that data for all plans be consolidated.

After the proxy votes are tabulated, the trustee reports the voting to the employer. Invariably, some of the participants do not return their proxy votes. Therefore, the trustee has written instructions from the employer regarding how the shares are to be voted, although he or she always has a fiduciary responsibility to vote for the exclusive benefit of the participants and beneficiaries of the plan.

[C] Blackout Periods for Restricted Employees

Plans holding publicly traded employer stock may be subject to blackout periods for restricted employees. Under the SEC rules, the blackout periods are times during the year when certain employees with insider information, referred to as 16(b) employees, cannot buy or sell shares of employer stock. These periods are typically the first two to three weeks of an employer's fiscal quarter when the employer is calculating its earnings for the prior quarter. The SEC does not allow employees with confidential information to trade employer stock until that information is made public. Otherwise, the employees with this information may have an unfair advantage over other potential investors. These blackout periods may require a recordkeeper to develop different processing transactions for transfers, loans and distributions for these employees.

Typically, restricted employees have a special code identifying them on the recordkeeping system. If they attempt to initiate a transaction that involves employer stock, the recordkeeper is alerted and must contact the corporate Secretary to determine if a blackout period exists. If there is no blackout period, then the transaction can be processed normally. If a blackout period exists, then the plan sponsor must have a written policy in place which sets forth how the transactions should be processed.

One method of handling transaction requests from restricted employees is to defer all transactions involving employer stock from those participants until the end of the blackout period. For example, if a restricted employee requests a transfer from Fund A to Fund B, the transaction is not posted until the end of the blackout period even though it does not involve the stock account.

Another method allows the transactions to be processed but excludes the employer stock from the transaction. In our example, the restricted employee's transfer from Fund A to Fund B is fully executed at the time it is requested since it does not involve employer stock.

The first method is easier to administer but it may be perceived to be less fair to the participant. The second method is more cumbersome to process and causes a doubling of transaction codes but is more equitable for the participant.

If a restricted employee requests a new loan or hardship withdrawal, the amount actually available from the plan during a blackout period could be less than requested due to the restriction on the employer stock. The participant must then be given the option to defer the transaction until after the blackout period has ended.

The employer may treat the trustee as an "insider" for purposes of the blackout period. The trustee is unable to buy or sell any employer stock during that period. This may not be a severe limitation if the unitized stock account holds a cash portion in addition to the employer stock. The trustee can process transfers, loans and distributions for non-16(b) participants without buying or selling stock by using the cash portion of the account. However, if the unitized stock account holds only employer stock and the trustee is considered an insider for trading restrictions, then no transactions involving employer stock can be processed during the blackout period.

[D] Pass-through Dividends

An employer may decide to pay its dividend in cash rather than reinvesting it in the employer stock. When this happens, the dividends are called pass-through dividends. This is most likely to occur when a C Corporation has a plan with an ESOP feature, and the employer takes a special tax deduction because the dividend is paid to the participants rather than invested in the trust. Note: the tax ramifications of pass-through dividends are beyond the scope of this course.

There are special processing considerations if:

- The employer pays the dividends; or
- The trustee and recordkeeper handle the payment of dividends to the participants.

If the employer pays the dividends directly, it needs an electronic file of all the participants invested in the unitized stock account as of the record date along with their addresses, Social Security Numbers and shares of stock in the plan. If the plan itself makes the payments, the dividend is paid to the trustee. The trustee pays the dividend to the participants invested in the employer stock on the record date. This translates into individual checks for each participant and additional tax reporting at the end of the calendar year.

[E] Contributions of Shares Versus Cash

An ESOP [or an ESOP with a 401(k) feature] may receive employer contributions in the form of shares of stock rather than cash. The employer must have a procedure for determining the value of the stock that it contributes to the plan.

Some companies use the closing price on a specific stock exchange on the day the stock is transferred to the trustee, while others use the average of the high and low prices on the day the stock is contributed. What is important is that a set procedure for valuing the stock is in place and that it is consistently followed. This prevents any suggestion that the employer is manipulating the value of the stock for its own purposes.

When participants are allowed to invest any portion of their accounts in employer stock, it works more smoothly if the employer makes the contributions in cash and lets the recordkeeper allocate the contributions to the correct funds. Periodic contributions used to purchase employer stock rarely equal an exact number of whole shares of stock, so the employer would have to make a portion of the contribution in cash along with the shares of stock. By making the total contributions in cash, the trustee can maintain sufficient liquidity in the unitized stock account to accommodate transfers, loans and withdrawals or other distributions. If the cash position in the account gets too high, the trustee can always buy additional shares of stock either from the employer or on the open market.

[F] Processing Transfers and Withdrawals

Transactions that result in sales of employer stock often take three business days to settle. This means that a participant must wait at least three days to get a loan or distribution from the plan.

One way plans solve this dilemma is to keep a predetermined portion of the unitized stock account in cash, typically from one to five percent of the total value of the unitized stock account. This cash portion allows a participant to immediately transfer out of the unitized stock account and gives the recordkeeper the ability to process loans and withdrawals or other distributions on a timelier basis.

The unitized stock account should hold only employer stock, according to some practitioners, because the participants may lose the benefit of the gain in the value of the stock when the employer does very well. On the other hand, the participants do not feel the full impact of any decline in the value of the employer stock if some portion of the account is held in cash. The reality is that the loss of some potential gain is offset by the fact that brokerage charges may be reduced if a portion of the unitized stock account is kept as cash. Without a portion of the account in cash, the trustee is forced to sell small blocks of employer stock in order to process transfers, loans and distributions. This increases the number of trades to be made, which increases the brokerage costs.

[G] Benefit Payments

When a participant takes a distribution from a plan with investments in an employer stock, the participant normally has the option of cashing in the stock or taking the stock "in-kind." When the stock itself is distributed, the recordkeeping system must be ready to provide several different calculations.

If the unitized stock account is used in the form of a combination of stock and cash, the system must calculate how many shares of stock are equivalent to the value of the unitized stock account. In most cases, there is a small amount of cash to be paid out in addition to the shares of stock. The trust is not required to withhold taxes from the distribution if it means some of the stock must be liquidated. All of the taxes to be withheld are taken from the non-stock portion of the distribution even though the stock is included in the calculation of the amount of the taxable distribution.

After a participant elects to take shares of the employer stock as part or all of the distribution (i.e., an in-kind distribution), the participant also must decide to take the stock either as physical certificates or as a direct transfer into a brokerage account. Most trust companies prefer to handle the distribution of stock as a direct transfer to a brokerage account. This process is easier and much safer and faster than having stock certificates issued to the participant.

When a participant takes an in-kind distribution of stock, the cost basis must be determined and reported as part of the taxable distribution on Form 1099-R. The net unrealized appreciation is not taxable until the stock is sold.

[H] Recordkeeping of Employer Stock Accounts

Unlike buying or selling of mutual funds, stock may be bought or sold only in whole shares. When a trade is placed, a purchase is made for as many shares as possible, but small amounts of cash may be left over. The shares of employer stock are allocated among participants, as is the cash. How are these two elements tracked in the daily valuation software?

Two common methods are used.

1. The first method tracks the real number of shares and the actual price per share; however, the cash portion is tracked in what is often referred to as the stock liquidity account; and

2. The second method unitizes the total value attributable to the participants' accounts, assimilating the shares and cash into a single unit value.

1. The Stock Liquidity Account

Using the first method, the participant's account has both an employer stock account that tracks the number of shares allocated to the participant as well as a stock liquidity account - a dollar par fund that holds the cash. The values of both can be spoken separately on the IVR and reported separately on other automated response systems maintained for the plan.

The processing of specific transaction types involving employer stock varies from that already described in this chapter.

Purchase and Sales under the Stock Liquidity Account Method

Purchases and sales of employer stock may only involve whole shares. A participant's account, however, may hold fractional shares as a result of the allocation of the whole shares among the participants.

Example 7-2. Stock Liquidity Method. Assume the splits of five participants' contributions result in $1,250 available to purchase employer stock. The $1,250 is used to purchase as many whole shares as possible. A price per share of $15.65 results in the purchase of 79 whole shares, leaving cash of $13.65. The shares and cash are allocated to the five participants, as follows:

Participant	Contribution To Invest	Shares Allocated	Cash Used For Stock	Stock Liquidity Account
A	$300.00	18.960	$296.72	$3.28
B	250.00	15.800	247.27	2.73
C	550.00	34.760	543.99	6.01
D	100.00	6.320	98.91	1.09
E	50.00	3.160	49.46	.54
Totals	**$1,250.00**	**79.000**	**$1,236.35**	**$13.65**

Withdrawals under the Stock Liquidity Account Method

The account of a participant who requests a distribution may include employer stock. As illustrated above, the account may hold fractional shares.

Suppose participant C is 100% vested in his account when he terminates employment and requests a total distribution of his account. There are 34.76 shares of employer stock and $6.01 in the stock liquidity fund per the above chart.

The plan sells 34 shares of stock, since only whole shares may be sold. The cash raised from the sale of the stock, together with the $6.01 in the cash account, are distributed to the participant. What happens to the liquidation of the fractional (0.76) share in the participant's account?

Some plan sponsors pay the value of the fractional share—determined using the price per share at the time of the sale of the 34 whole shares—to the participant using the cash allocated to other participants in the stock liquidity fund. In effect, the cash is borrowed from other participants. The fractional share is moved from the terminated participant's account into a dummy participant account called the stock management account. This account holds all fractional shares from the liquidation of other participant accounts to make similar distributions.

When the fractional shares accumulated in the stock management account are equal to a whole share, the share is sold so the stock liquidity fund can be reimbursed. If the sale of the share creates more cash than was owed to the liquidity fund, the excess is allocated to a stock liquidity account for the dummy participant. The stock liquidity account remains at a deficit if the sale results in less cash than is needed to make it whole. The recordkeeper must separately track these transactions in order to stay in balance.

The plan sponsor may decide that it is easier to make special contributions to the plan to cover the value of fractional shares when distributions are made. This cash is not reflected as part of the assets on the daily valuation software, so it must be separately tracked outside the system. These "advance" contributions are ultimately applied against the normal employer contributions made to the plan.

Dividends under the Stock Liquidity Account Method

This recordkeeping method makes it easy to identify participants who hold stock at the time the dividend is declared. The dividend is allocated to participants as of the record date using a pro rata formula.

Loans under the Stock Liquidity Account Method

Plans using daily valuation attempt to minimize the number of purchase and sales of employer stock due to the brokerage costs associated with sales of a small number of shares. The plan can only sell whole shares, so the sale may produce more or less cash than was originally intended.

These are just two of the reasons that many plans with employer stock specifically exclude the employer stock from the assets that may be liquidated to provide the loan. Other plans have procedures that require the employer stock account to be the last asset liquidated in order to make a loan.

The second method of tracking the value of the employer stock account uses a single account, rather than two separate accounts as described above.

2. Unitized Employer Stock Accounts

A unitized employer stock account tracks the shares and cash in a single account on the recordkeeping system. The two pieces—the actual stock share value plus the uninvested cash—are added together, with the total being divided by the real number of shares held. This creates a fictitious price per share that is reported on the daily valuation system.

Example 7-3. Unitized Stock Account. Assume the same facts as in Example 7-2 above. The $1,250 of contributions purchased 79 whole shares and left $13.65 uninvested. In a unitized environment, the $1,250 is divided by the number of shares to create a unit price of $15.823 ($1,250 / 79). The table shown earlier can be translated to the unitized method, as follows:

Participant	Contribution To Invest	Units Allocated
A	$300.00	18.960
B	250.00	15.800
C	550.00	34.760
D	100.00	6.320
E	50.00	3.160
Totals	**$1,250.00**	**79.000**

As may be noticed, the units allocated under this method equal the shares allocated under the first method. What is different is the price per share used by the daily valuation software to create a value for the unit.

Processing Dividends under the Unitized Employer Stock Account Method

When companies pay dividends, the shareholders as of a certain date, known as the record date, receive the dividends issued by the employer. If an investor sells the stock between the record date and the date the actual dividend is paid, the seller receives the dividend. The buyer of the stock does not receive the dividend, but the price that is paid for the stock is normally reduced to reflect the fact the seller receives the dividend after the stock is sold.

The unitized recordkeeping method may make it difficult for the recordkeeper or the trustee to determine which participants were invested in the unitized stock account on a certain day and to allocate a dividend to those participants, particularly if the participant has transferred out of the unitized stock account before the actual dividend has been paid. Some recordkeepers and trustees eliminate this problem by increasing the unit value of the stock account on the record date by the accrued dividend. When the dividend is actually paid, the unit value of the account is reduced by the dividend amount accrued, but the value of the account is increased by the dividend received. In this manner, the participant in the unitized stock account on the record date is credited with the declared dividend.

§7.11 Key Terms

Actively Managed Fund: The manager constantly analyzes individual holdings of a mutual fund in an attempt to outperform a selected market index.

Bond: A debt security issued by a government or corporation promising repayment of a specified amount, plus interest, by a stated date.

Cash Investments: Include certificates of deposit, treasury bills, commercial paper and money market funds.

Equity Wash Restriction: Typically requires that participant-directed transfers from a fixed rate investment contract be made to an equity fund and remain in that equity fund for a specified period of time before transferring to another fixed income fund.

Exchange-Traded Funds: Similar to mutual funds but have the trading flexibility and continual pricing of individual stocks.

Guaranteed Investment Contract (GIC): A contract issued by an insurance company that guarantees a set rate of interest.

Mutual Fund: As defined by the Investment Company Act of 1940, an investment that pools the funds of many investors to provide them with professional management, diversification and other advantages. The fund’s stated investment objective indicates what kind of investments (stock, bonds, money market instruments and other securities) the fund’s manager may include in the portfolio.

Passively Managed Fund: The fund manager, through the use of computer software, creates a portfolio whose holdings copy those of a particular type of index.

Stock: A security representing an ownership interest in a corporation.

§7.12 Review of Key Concepts

- A mutual fund is an investment employer that pools the funds of many investors to purchase a portfolio of stocks, bonds and cash investments. The Securities and Exchange Commission regulates mutual funds.

- There are many different types of mutual funds such as indexed funds, balanced funds, bond funds, sector funds, growth and income stock funds or international funds. These fund types are actively managed, passively managed or some may be either.

- Guaranteed Investment Contracts (GICs) are sold by insurance companies. The contract guarantees the rate of interest on the amount of money invested for a specific period of time. The principal invested is not guaranteed. Insurance companies are regulated by each state in which the contract is sold.

- Exchange-traded funds are similar to mutual funds but have the trading flexibility and continual pricing of individual stocks.

- Employer stock investments create additional administration issues due to proxy voting, blackout periods for restricted employee and pass through of dividends.

- Employer stock offers unique challenges to processes in a daily environment due to stock being bought or sold only in whole shares. There are two methods to track the stock in a daily environment. One is using the liquidity fund method the other is to unitize the stock.

§7.13 Review Questions

[A] True or False

______ 1. Exchange-traded funds are more flexible than mutual funds because they are bought and sold throughout the day, and mutual funds are bought and sold using the price at the end of the day.

______ 2. In the stock liquidity method of accounting for employer stock in a plan the real number of shares, price per share and cash are tracked.

______ 3. Employer stock should only be offered in retirement plans if it is increasing in value.

______ 4. The three asset classes that mutual funds invest in include common stock, preferred stock and fixed income.

______ 5. Exchange-traded funds are made up of bond securities while mutual funds are made up of stock securities.

[B] Multiple Choice

6. All of the following are characteristics of an individual GIC, **EXCEPT**:

   A. The insurance company guarantees both principal safety and a specific interest rate.
   B. The insurance company that offers it assumes the investment risk.
   C. There is no government guarantee backing up the GIC.
   D. They are attractive to people who are risk adverse.
   E. Accounting is on a dollar basis.

7. All of the following statements regarding age-based funds are **TRUE, EXCEPT**:

   A. Participants may stay in the same fund for their entire investment lifetimes.
   B. They are designed for participants to invest 100% of their contribution into the one fund.
   C. They are based on the risk tolerance of the participants.
   D. Participants do not need to rebalance their accounts periodically.
   E. The funds grow more conservative as the retirement date approaches.

8. All of the following are reasons an equity wash restriction is imposed, **EXCEPT**:

   A. To prevent participants from transferring to a competing fund
   B. To protect the interests of participants who choose funds that invest in stable value contracts
   C. The issuers of the contract require it
   D. To prevent participants from transferring to a fixed rate fund that can respond more quickly to interest rate changes
   E. To slow down day-trading among some participants

9. All of the following statements regarding lifestyle funds are **TRUE, EXCEPT**:

   A. They are a blend of other fund types.
   B. The fund manager frequently rebalances the fund back to its cash, bond and stock strategy.
   C. Participants should choose a lifestyle fund based on their risk tolerance.
   D. Participants may consider changing to a different lifestyle fund as they grow older.
   E. They are best suited for participants who want to make their own investment decisions.

10. All of the following statements regarding accounting for employer stock are **TRUE, EXCEPT**:

   A. In the stock liquidity method, employer stock is used exclusively to provide employee loans.
   B. In the unitized method, the price per share reported is fictitious.
   C. In the stock liquidity method, the participant has two accounts.
   D. In the stock liquidity method, the stock management account holds all of the fractional shares.
   E. In the unitized method, employer stock and cash are in one account.

§7.14 Answers

1. **True.** Exchange-traded funds are more flexible than mutual funds because they are bought and sold throughout the day and mutual funds are bought and sold using the price at the end of the day. §7.09 [G]

2. **True.** In the stock liquidity method of accounting for employer stock in a plan the real number of shares, price per share and cash are tracked. §7.10 [H]

3. **False.** Employer stock should only be offered in retirement plans if it is a prudent investment choice, it need not always increase in value. §7.10

4. **False.** The three asset classes that mutual funds invest in include cash, bonds and equities. §7.04

5. **False.** Exchange-traded funds are made up of the same types of securities that make up mutual funds. §7.09 [G]

6. The correct answer is **A.** §7.07

   A. Correct. This statement is false because the insurance company only guarantees a specific interest rate.
   B. Incorrect. This statement is true because the insurance company that offers it assumes the investment risk.
   C. Incorrect. This statement is true because there is no government guarantee backing up the GIC.
   D. Incorrect. This statement is true because GICs are attractive to people who are risk adverse.
   E. Incorrect. This statement is true because GIC accounting is on a dollar basis.

7. The correct answer is **C.** §7.05

   A. Incorrect. This statement is true because participants in age-based funds may stay in the same fund for their entire investment life times.
   B. Incorrect. This statement is true because age-based funds are designed for participants to invest 100% of their contribution into the one fund.
   C. Correct. This statement is false because age-based funds are only based on time horizon and not on risk tolerance.
   D. Incorrect. This statement is true because participants do not need to rebalance their accounts periodically.
   E. Incorrect. This statement is true because age-based funds grow more conservative as the retirement date approaches.

8. The correct answer is **E.** §7.07 [D]

   A. Incorrect. This statement is true because an equity wash restriction is designed to prevent participants from transferring to a competing fund.
   B. Incorrect. This statement is true because an equity wash restriction is designed to protect the interests of participants who choose funds that invest in stable value contracts.
   C. Incorrect. This statement is true because the issuers of the contract require equity wash restrictions.
   D. Incorrect. This statement is true because an equity wash restriction is designed to prevent participants from transferring to a fixed rate fund that can respond more quickly to interest rate changes.
   E. Correct. This statement is false because equity wash restrictions are not designed specifically to slow down day-trading among some participants.

9. The correct answer is **E.** §7.05 [I]

   A. Incorrect. This statement is true because lifestyle funds are a blend of other fund types.
   B. Incorrect. This statement is true because lifestyle fund managers frequently rebalance the fund back to its cash, bond and stock strategy.
   C. Incorrect. This statement is true because participants should choose a lifestyle fund based on their risk tolerance.
   D. Incorrect. This statement is true because participants may consider changing to a different lifestyle fund as they grow older.
   E. Correct. This statement is false because lifestyle funds are not suited for participants who want to make their own investment decisions.

10. The correct answer is **A.** §7.10

   A. Correct. This statement is false because employer stock is not used exclusively to provide employee loans in the stock liquidity method.
   B. Incorrect. This statement is true because the price per share reported is fictitious in the unitized stock method.
   C. Incorrect. This statement is true because the participant has two accounts in the stock liquidity method.
   D. Incorrect. This statement is true because the stock management account holds all of the fractional shares in the stock liquidity method.
   E. Incorrect. This statement is true because employer stock and cash are in one account in the unitized method.

Chapter 8:
Analyzing Investment Fees

§8.01 Learning Objectives

- Discuss the plan fiduciary's responsibilities regarding assessing fees and disclosing fees/expenses to participants.
- Explain mutual fund sales charges, 12b-1 fees and how mutual fund share classes affect investment fees.
- Define investment management fees, custodial and transfer agent fees, transaction fees, sub-transfer agent fees and shareholder servicing fees.
- Explain how assessing a market value adjustment for a guaranteed investment contract (GIC) affects a participant account.
- Discuss the additional expenses incurred in an annuity contract.

- Explain revenue sharing and its affect on participant account balances.

§8.02 Introduction

Fees related to plan investments often represent the most significant factor of a plan's overall expenses. This is especially true for participant-directed 401(k) plans where these fees can reduce the investment return participants experience if applied against their accounts. Thus, it is important to understand the various fees and expenses that can be charged.

This chapter focuses on fees and expenses as they relate to:

- Mutual funds (sales charges, 12b-1 fees, share classes and management fees);
- Annuity contracts (structure, guaranteed options, contract expenses);
- Funding arrangement with banks; and
- Alliances and revenue sharing arrangements.

§8.03 Investment Fees and Expenses

[A] Shifting the Burden

There was a silent revolution during the last decade. It affected millions of plan participants, yet few have complained or are alarmed. Even today, a large number may not understand the long-term impact. Plan sponsors stopped paying many of the expenses associated with the ongoing operations of retirement plans, including administrative and recordkeeping costs as well as fees associated with the investment of plan assets. That burden has been shifted to plan participants.

While participants may have ignored the shift, the DOL did not. ERISA fiduciary requirements demand that a plan sponsor consider costs charged to its plan when choosing investments and in selecting a service provider. A fiduciary is obligated to use plan assets to pay no more than reasonable fees for necessary plan services. A fiduciary should consider what services are necessary and appropriate to further the purposes of the plan. Judgments should be made about the quality of the services to be provided and the likelihood that services will be delivered as promised. In a perfect world, assuming equal services and performances, the fiduciary should choose the lowest-priced provider to deliver the services. Unfortunately, it is not that simple and the provider with the lowest expenses is not necessarily the best choice.

[B] Fee Disclosure

A plan sponsor should have documentation that identifies various fees and expenses that it used in evaluating a number of competing vendors or service providers. In mid-1998, the DOL issued a 19-page pamphlet entitled "A Look at 401(k) Plan Fees" that is aimed at helping participants understand the fees and expenses associated with their

401(k) accounts. This guidance also may help plan sponsors and other plan fiduciaries in developing questions to ask to determine the reasonableness of fees.

The DOL continues to focus on fee disclosure. On July 15, 1999, new 401(k) fee disclosure materials were released to help employers, especially small employers, understand the investment and administrative fees and expenses that are charged to their plans. The materials include a worksheet entitled “401(k) Plan Fee Disclosure Form” and a pamphlet, “A Look at 401(k) Fees for Employers.” The pamphlet highlights the obligations employers must fulfill in the operation of a plan by describing their fiduciary duties under ERISA. It also includes ten basic questions employers should answer in considering fees and expenses paid for investment, sales, administrative and compliance services.

Copies of these materials are available directly from the DOL Employee Benefits Security Administration (EBSA) Website at **www.dol.gov/ebsa**. Go to Pension Publications and then to Consumer Pension Publications and Compliance Assistance-Pension Publications.

In May 2003, the DOL issued a Field Advisory Bulletin guidance addressing the allocation of plan expenses/fees among participants in a defined contribution plan. In the Bulletin, the DOL acknowledges that ERISA does not specifically address how plan expenses may be allocated among participants and beneficiaries. Therefore, the Bulletin takes the position that a plan sponsor has “considerable discretion” in determining how expenses are allocated. According to the DOL, a method of allocating expenses set forth in the plan document becomes “part of defining the benefit entitlements under the plan” and must be followed by a plan fiduciary as long as it is not inconsistent with other ERISA requirements. Also, the DOL notes that the summary plan description (SPD) must describe any provision resulting in the imposition of a fee or charge on a participant or beneficiary which is a condition to the receipt of benefits under the plan, as well as any circumstances that may result in the offset or reduction of benefits.

If the plan document does not set forth a method for allocating expenses, the fiduciary must select an allocation method that is consistent with general fiduciary duties, including the duty to act solely in the interest of plan participants and beneficiaries. As long as a “rational basis” exists for the method selected, the method does not fail merely because it disfavors one class of participants versus another.

The new guidance establishes that plan sponsors and fiduciaries have significant flexibility in establishing rules for allocating expenses among participants in defined contribution plans, including whether plan expenses are allocated on a pro rata or per capita basis when charged to the plan as a whole or whether expenses are charged to individual participants. The Bulletin also states that plan expenses for the following defined contribution plan activities may be charged to the accounts of the specific participant or beneficiary: processing hardship withdrawals; calculating benefits under different distribution options; making distributions; and processing QDROs. The Bulletin also clarifies that different allocation methods may apply to different participant groups.

[C] Paying Plan Expenses

Very large employers have traditionally required that the plan pay as much of its own expenses as possible, thereby limiting the overall cost to the company. Other employers want to pay the operating expenses of a defined contribution plan in order to maximize the investment return realized by participants on their account balances. Of course, the employer may realize tax benefits in the form of additional tax deductions under IRC §162 for directly paying plan expenses. This still happens in very small plans, particularly where the plan assets are substantially attributable to the owners of the business. It is happening less frequently in plans covering 20 or more participants.

Costs generally fall into one of two categories:

1. <u>One-time fees</u>*:* These are event-driven expenses that occur as a result of a specific event such as setting up a new plan, the conversion of an existing plan to a new service provider, or termination of a plan. Thus, they do not occur on an ongoing basis.

2. <u>Ongoing fees:</u> These are recurring expenses that result from the routine operation of the plan, for example, the administrative costs.

There are four principal ways fees are calculated:

1. Asset-based expenses are based upon the amount of assets in the plan and are usually expressed as percentages or basis points. Throughout the industry, fees and expenses are often quoted in the form of basis points rather than in percentages. One basis point is equal to one one-hundredth of a percent. For example, 25 basis points would equal .0025 or 0.25%.

2. Person-based or per head fees are based upon the number of eligible employees or participants in the plan. For a 401(k) plan, it is usually not limited to the number of participants who are actually contributing; rather, it is based on the total number of eligible participants.

3. Transaction-based expenses and fees arise from the execution of specific plan-related activities, such as the buying and selling of securities or transactions resulting in participant withdrawals or loans.

4. Flat rate fees may be charged for services unrelated to assets, number of employees, or transactions. A flat fee may be charged to prepare the annual reporting series or compliance work for example.

This chapter focuses on those fees that recur from year to year in the investment management, administration, compliance and recordkeeping aspects of the plan. Although important to the plan sponsor as decision-maker, plan set-up or conversion fees, and plan document fees do not impact the plan sponsor's bottom line or the overall performance of the plan assets year in and year out.

Similarly, flat rate fees such as charges for Form 5500 preparation, as well as census-based fees charged by retirement plan administration firms for statement preparation are not emphasized here. These fees can be easily identified and should be incorporated into the plan sponsor's analysis of the total annual cost of the plan.

[D] Focus on Investment Expenses

Fees related to plan investments usually represent the largest portion of a defined contribution plan's expenses. This is especially true for participant-directed 401(k) plans. This chapter describes the wide variety of fee arrangements associated with various platforms available to plan sponsors to provide investments and daily valuation services. For purposes of this chapter, a platform refers to any bundled provider or unbundled alliance of service providers that provide the plan sponsor with the administrative, recordkeeping and investment management services necessary to run the plan.

The platform is the vehicle for distributing the investment product effectively to the plan sponsor. Plan sponsors should quantify these platform expenses along with the itemized and census-based fees charged annually to determine the true cost of operating the plan.

General industry trends on service and expense levels are explained for platforms involving mutual funds and insurance company annuity contracts since these represent the primary funding vehicles available to many plan sponsors. The variety of arrangements available in the industry is changing constantly; therefore, this chapter should be viewed as a starting point for evaluating any particular situation.

It should be noted that larger plan sponsors often contract with investment managers directly to manage a portfolio of assets in accordance with a specific investment objective (i.e. Large-Cap Stock, International Stock, Intermediate Bond). This is done to reduce investment management expenses associated with the purchase of retail mutual funds or group annuity contracts. Since these arrangements are only available to the largest plan sponsors, they are not addressed specifically in this chapter.

§8.04 Mutual Fund Arrangements—Part I

Mutual funds have taken a prominent place in the funding arrangements for defined contribution plans; especially 401(k) plans. Although mutual funds may offer lower costs than might be incurred when buying individual securities, the combination of internal and external fees charged by mutual funds can be quite expensive. Funds that are sold through brokers and insurance agents may have higher fees charged by the mutual fund to cover paying the broker or insurance agent.

Mutual fund investors may experience a variety of charges. Typical fees for mutual funds include:

- External fees such as front-end loads/sales charges and back-end loads/sales charges;
- Internal fees such as 12b-1 fees and management fees.

[A] Sales Charges

The ease of trading open-end mutual funds makes them particularly attractive for daily valuation plans. An **open-end mutual fund** is an investment company whose portfolio, which may consist of stocks, bonds, or cash equivalents as dictated by the fund's investment objective, is actively managed on an ongoing basis. These funds issue new shares continuously and redeem shares at the request of shareholders.

In contrast, a **closed-end mutual fund** issues redeemable shares but does not issue new shares and, therefore, does not lend itself to the daily valuation environment. When a purchase is made of a closed-end fund it is dependent on finding a willing seller of shares. Thus a closed-end fund that is thinly traded may not be able to make a purchase or sell on a daily basis.

Most mutual fund companies that impose sales charges allow shares to be purchased at net asset value (NAV) without the imposition of any sales charges, when certain conditions are met. NAV is the price at which mutual fund shares are redeemed by investors. This may or may not be the same as the public offering price (POP), which is the price at which mutual fund shares are purchased.

The difference between NAV and POP is any sales charge, or load, that is being applied to the purchase of shares. Not all mutual fund companies impose sales charges, in which case NAV and POP are the same. Funds that apply back-end and/or front-end loads are called loaded funds.

Care should be taken to determine whether such factors as the number of plan participants, the size of the plan's assets and/or its ongoing contribution stream satisfy a particular fund manager's NAV requirements. For example, a loaded fund may allow for purchase of its shares at NAV without the load if $500,000 of fund purchases will be made during the first thirteen months of the relationship, measured from the date of the first purchase. At the time of the initial purchase, the plan sponsor may need to sign a letter of intent, which is a letter that enumerates the conditions under which the plan may purchase shares without a sales load. This allows all shares to be purchased at NAV from the outset.

No-load funds are offered to investors at NAV. **No-load funds** are mutual funds that have neither a front-end nor back-end load. These funds eliminate sales commissions by selling their shares through direct distribution. A no-load fund can still include a 12b-1 service fee of 25 basis points or less. If the 12b-1 fee is greater than 25 basis points, the fund cannot be sold as a no-load fund.

Sales charges, when imposed, usually take one of two different forms.

1. Front-end loads are assessed when fund shares are purchased.

2. Back-end loads are assessed when fund shares are redeemed. Retirement plan administration firms often refer to these back-end loads as Contingent Deferred Sales Charges or CDSCs. CDSCs are typically charged against redemptions other than exchanges within the same fund family. In either case, these charges are designed to subsidize the fund company's cost of distributing fund shares. This cost takes the form of commissions. They can be reduced or eliminated under certain circumstances, so always refer to the fund prospectus.

A front-end loaded fund usually pays a sales commission up front in a range between 4% and 6%. For example, a $10,000 contribution to a plan purchasing such funds with a 6% front-end load only purchases shares with $9,400. This is significant as it eliminates the ability for that $600 to grow and compound on a tax-deferred basis inside the plan. In that regard, it is not a one-time hit on the contribution. The plan (or the participant) is deprived of the earnings on this $600 on an ongoing basis.

A back-end loaded fund allows all funds contributed to buy shares at the time of purchase. Many contingent deferred sales charges phase out gradually over a period of five to eight years; therefore, shares held for that length of time do not have a sales charge imposed upon them. However, if each new share purchase is subject to a new back-end load, the plan sponsor's ability to change investment providers is severely hampered, unless the sponsor is willing to subject the assets still within the back-end charge period to a sales charge at liquidation. The NAV for a share with a back-end load takes into account the amount of the load. The back-end load reduces the NAV that is used to calculate the value of shares being redeemed.

In either form, these sales charges are expenses that must be factored into the plan sponsor's decision to buy these funds with plan assets. Mutual fund shares should be purchased at NAV whenever possible. In fact, most daily valuation platforms outside of the mutual funds industry, as well as those run by no-load mutual fund companies, require that shares be purchased at NAV. This generally requires the use of no-load funds, unless loaded funds can be purchased utilizing the letter of intent discussed above to enable shares to be purchased at NAV.

Recently funds, particularly no load funds, have been charging a CDSC to prevent market timing. This may be charged if a sale occurs within 60 days up to one year following the purchase of shares.

[B] SEC Rule 12b-1 Fees

Funds often pay a portion of their assets to cover distribution expenses related to advertising and sales support. The 12b-1 fees typically pay for these costs. These fees are paid to registered personnel for selling shares and providing ongoing services. Payments made by a mutual fund to cover its own distribution expenses are subject to the conditions set forth in Securities and Exchange Commission (SEC) Rule 12b-1. These fees are assessed daily and paid monthly or quarterly over the life of the investment, unlike the one-time sales loads discussed above.

The National Association of Securities Dealers (NASD) classifies 12b-1 fees into two categories:

1. <u>12b-1 distribution fee</u>: This fee cannot exceed 0.75% per year of the fund's average net assets. This fee represents a sales charge, which is paid out of the fund's assets over time; and

2. <u>12b-1 service fee</u>: This fee is limited to 0.25% per year of the fund's average net assets. This fee is intended to provide compensation for costs incurred by those outside parties servicing accounts for shareholders. In the context of 401(k) plans, these fees are often paid to transfer agents, bank trustees, insurance companies or retirement plan administration firms that are providing the recordkeeping function.

The NASD does set a maximum overall sales charge (including 12-b1 fees) that is allowed under any circumstances of 8.5%. Under a complex set of NASD rules that govern maximum sales charges, funds with 12b-1 fees must have sales charges that are lower than the 8.5% mentioned above. Mutual funds that assess a 12b-1 distribution fee, but no 12b-1 service fee, may have a total sales charge of no more than 7.25%.

Funds that charge both types of 12b-1 fees cannot have a total sales charge that exceeds 6.25%. A fund with neither a front-end load nor a back-end load cannot legally be represented as a no-load fund unless its combined 12b-1 fees do not exceed 0.25 (i.e., 25 basis points) of net assets annually.

[C] How the Share Class Affects Fees

Mutual fund companies now price their shares according to several different schedules of sales charges and fees. These pricing differences must be taken into consideration when evaluating and selecting funds. The only differences among the various classes are the types of sales charges assessed and whether 12b-1 service fees apply. All shareholders, regardless of the class of shares they hold, are owners of the same investment portfolio.

A discussion of the most common share classes follows.

1. Class A Shares

Class A shares generally are assessed a front-end commission load and an optional annual 12b-1 service fee. Many Class A shares do not impose a 12b-1 distribution fee. Cumulative discounts such as breakpoints, letters of intent, and rights of accumulation are offered to Class A shareholders who purchase shares in volume over a period of time. These discounts allow for the purchase of front-end load Class A shares at NAV as discussed above.

2. Class B Shares

Class B shares are sold with no front-end load. They are subject to 12b-1 distribution and service fees. Contingent deferred sales charges, or back-end loads, also apply if shares are redeemed before the end of the redemption period specified in the prospectus. 12b-1 distribution fees may be reduced after a Class B fund manager recovers a certain amount of distribution fees and interest. This reduction often takes the form of a conversion to Class A shares when the value of the fund reaches a certain level or after a certain period of time. This threshold varies from fund to fund. In many cases, the conversion to Class A shares does not happen automatically when the fund value reaches the level required for conversion.

It is important that each fund prospectus be reviewed to determine the asset level required for conversion and the procedure necessary to request conversion. Class B shares might be used in small plan situations where a separate account is established by the mutual fund for each participant. Class B shares can be difficult to manage in the daily valuation environment, particularly when the shares are converted to Class A shares.

The difficulties are in the following areas:

- What value is displayed on the automated response systems?
- How are back-end loads explained?
- Can the recordkeeping system convert B to A shares?

3. Class C Shares

Class C shares, known as level-load shares have no front-end load, but do have both 12b-1 distribution and service fees. They may also have a back-end load associated with them if sold within a certain period of time. Some Class C shares have 12b-1 distribution fees that continue indefinitely, while others automatically convert to Class A shares after a certain period of time. Again, the prospectus should be reviewed since the conversion of these shares varies a great deal from one fund family to another.

4. Class I Shares

Class I shares, which are institutional mutual fund shares, are a lower cost version of the share types discussed above with no front-end or back-end loads and no 12b-1 distribution or service fees. While most mutual funds are sold at a retail level, Class I shares are sold to investors making substantially larger purchases, often through investment advisory firms, where the costs of distribution associated with the retail market do not exist or are significantly reduced.

Many 401(k) plans meet the requirements to purchase Class I shares and their availability may depend on the platform chosen in which to operate the plan; however, the requirements to purchase Class I shares vary from fund to fund. Plan sponsors must refer to the fund's prospectus and ask their 401(k) vendors about the availability of Class I shares.

A person working in a financial institution may see Class M or some other class of shares with features similar to Class I shares. The characteristics of these institutional shares can be very similar to the Class I shares discussed here. Always check the prospectus for details on share classes.

5. Class R Shares

Retirement shares, or Class R shares, were developed primarily for the retirement plan industry. There were certain attributes of other share classes that caused problems. For example, Class B shares involve back-end loads which complicate the exchange process and penalize participants for transferring money. Class A shares on the other hand, involve up-front sales loads and finders' fees, reducing participant contributions. Some may even contend that the use of Class A shares may encourage brokers and advisors to periodically recommend fund changes to generate subsequent commissions (churn).

The mutual fund industry's answer was to develop Class R shares that typically do not have a front-end or rear-end load (thus are traded at NAV) and include a level, basis-point trailer for commissions. This makes trading easy and creates a level stream of commissions that encourages continued asset retention and accumulation regardless of the funds being used.

6. Hybrid Classes

There are many other hybrid versions of shares (e.g., Class D shares) which combine the sales charges and expenses discussed above in different ways. Plan sponsors should understand how each of these components is handled in the shares purchased for their plan.

Following is a table showing the share classes and whether a type of charge applies or not:

	Share Class			
Type of Charge	**A**	**B**	**C**	**I/R**
Front-end load	Often	No	No	No
Back-end load (CDSC)	No	Yes	Often	No
12b-1 distribution fee	No	Yes	Yes	No
12b-1 service fee	Often	Yes	Yes	No

§8.05 Mutual Fund Arrangements—Part II

[A] Investment Management Fees

Regardless of the manner in which sales charges may or may not be imposed on mutual fund shares, all are subject to certain fund expenses that are necessary to manage a portfolio of securities. The largest single fee assessed against a mutual fund is the investment management fee. It is assessed as a percentage of the average daily net assets of the fund and is sometimes quoted in basis points. These fees range from as low as 0.10% (10 basis points) to as high as 3.00% (300 basis points) and are paid as compensation to the fund's managers. Investment management fees are charged against fund assets and are included in the calculations of the net asset value.

[B] Custodial, Transfer Agent and Transaction Fees

Custodial and transfer agent fees are assessed annually against the fund's assets to compensate those who hold title to and transfer the fund's securities and track shares held by investors. These charges are very small in comparison to the investment management fees. Sometimes a mutual fund company is its own transfer agent and tracks shares held by investors.

Transaction fees are incurred in the process of managing the portfolio by acquiring and liquidating securities. These fees are either incorporated into the investment management fees or paid directly by the fund to the brokerage firm that processed the transaction requested by the portfolio manager. These fees are paid from the assets of the mutual fund as a direct charge against the assets.

Custodial fees, transfer agent fees and transaction fees in total usually amount somewhere between 0.50% and 1.00% for the average mutual fund. The largest component of these fees is the transaction costs of buying and selling securities within the fund.

[C] Sub-Transfer Agent Fees

As mentioned in the previous section, custodial and transfer agent fees are assessed to a fund to compensate those who hold title to and transfer the fund's securities. If a retirement plan administration firm is trading with a mutual fund company at a plan level or via omnibus trading, the retirement plan administration firm and/or custodian is the one actually tracking individual participant accounts. Thus, the retirement plan administration firm and/or custodian are considered as providing the sub-accounting for the fund company.

It is less expensive for the fund company to operate in this manner. In return, the fund companies are often willing to share this cost savings with the administrative firm and/or custodian. This is usually referred to as sub-transfer agent fees (sub-TA fees) – revenue that fund companies return to custodians and retirement plan administration firms in the form of revenue sharing. This may occur as a certain dollar amount per participant or as a percentage of assets held.

The amount of sub-TA fees available depends largely upon the fees the fund company is charging for that fund. A no-load fund with very low management fees may not make any sub-TA fees available, whereas a heavily loaded fund may be willing to provide considerable sub-TA revenue sharing.

[D] Shareholder Servicing Fees

Revenue sharing also may take the form of shareholder servicing fees. Revenue sharing may include these fees in lieu of 12b-1 fees. An administrative firm that is not registered with a broker-dealer cannot legally recapture 12b-1 fees; so shareholder servicing fees are paid instead. The two are mutually exclusive.

Revenue sharing is an attractive option to help offset administrative expenses, allowing administrative firms to competitively price the services they offer. However, there are ethical issues involving fund recommendations (heavily loaded vs. no-load) and disclosure of the corresponding revenue sharing captured.

Part of the decision process between load and no-load is the additional services that may be provided by the broker offering load funds. If there are education and enrollment meetings, counseling, on going monitoring, and reporting, then the additional cost of load funds may be justified. Neither choice is good if the performance is sub-par or if the plan does not get good service. Sometimes being able to have good service is more important than better performance.

Investment advisors who do not receive 12b-1 fees or revenue sharing from the fund typically charge a fee of between 25 to 125 basis point of the plan assets depending on the amount of advice and size of the account. An investment advisor may provide general investment education to individual participants, provide rate of return analysis, evaluate fund performance, or even assist participants with their investment choices. The investment advisor may charge the participant or the plan for services. In any event this is a fee that the fiduciary also needs to consider as it evaluates the services being provided to the plan and participants.

§8.06 Expense Ratios

The method by which the assortment of fees levied against mutual funds should be evaluated is through a comparison of their expense ratios. The expense ratio can be described as the best measure of a mutual fund's efficiency. Simply put, it is the ratio of the fund's expenses to the fund's net assets. As a general rule, funds that impose sales charges and 12b-1 service fees have a higher expense ratio than no-load funds. Therefore, if everything else were equal, no-load funds would always be preferable when compared to load funds. The plan sponsor must obviously consider performance and good and bad performers can be found in both load and no-load fund family offerings.

It is important to evaluate a specific fund's expense ratio in comparison with other funds that have the same investment objective. For example, a fund that purchases U.S. stocks in a passively managed index fund following the S&P 500 should have a much lower expense ratio than an international stock fund that does significant research to manage a portfolio of assets from around the world.

In reporting the rate of return on a fund, the total return is usually reduced by the amount of the expenses. The expense ratio is netted from the total return and is reflected in the NAV.

§8.07 Mutual Fund Trading Platforms

Plan sponsors today are faced with any number of ways to purchase their assets and administrative services within the mutual fund environment. Mutual fund families themselves may provide administrative services. These arrangements are proprietary to varying degrees, as they are designed to provide the opportunity to market that particular fund family's mutual fund offerings. Some packages offer only the opportunity to purchase funds managed by that family, while others are more open and offer other fund family choices to plan sponsors.

Broker-dealers are firms in the business of buying and selling securities. A firm may act as both a broker (agent) and dealer (principal), but not in the same transaction. To encourage broker-dealers to distribute their product through their brokers, a mutual fund family may present a bundled package for plan sponsors. If that fund family decides to make outside funds available, it may do so only for funds that allow some combination of 12b-1 distribution and service fees to be used to generate revenue for the bundled provider.

There are other platforms that offer a greater variety of funds, again with varying degrees of flexibility. There are wide ranges of variations on these platforms as offered by banks, insurance companies, brokerage firms, and retirement plan administration firms. Many limit their fund options to those that can be traded electronically to facilitate same day trading. Others look for funds from which they can capture 12b-1 distribution and service fees, either to increase revenues or to offset costs, so as to make them more competitive as a service provider. In any event, depending on the objective of the party who has put the platform together, the mutual fund choices within any platform offering may cover a wide range of fees and fee components.

It is critical for the plan sponsor to look through the platform to the underlying mutual funds and identify which cost components are present to determine the total cost of the program. It is always possible to determine in each and every situation where the money goes as long as the plan sponsor knows what questions to ask to help it follow the dollars to those parties that derive revenue from the funds being purchased.

§8.08 Annuity Contracts

An annuity is a periodic payment. An annuity contract provides the funding for the periodic payments. Annuity contracts are sold by insurance companies and are popular funding vehicles for small participant-directed plans; especially 401(k) plans.

There are two types of annuity contracts:

1. Immediate Annuities: An immediate annuity is a way of paying out a sum of money to a person regardless of how long the person lives. For example, when a participant retires and receives a lump sum annuity from the retirement plan, the participant may buy an immediate annuity. Then the annuity distributes amounts to the participant over a period of time.

2. Deferred Annuities: Deferred annuities typically allow a participant to make more than one deposit to the deferred annuity thus it accumulates financial value over a period of time. Note, however, some deferred annuities allow for only a single premium payment. At some point the contract converts to a payout option and begins making periodic payments to the participant.

Within each of these types of annuities are fixed and variable products. A fixed rate annuity typically accumulates value at a rate fixed in the contract. That fixed rate, however, may be a minimum rate and the actual rate may change from year to year based on other market conditions. A variable rate annuity provides the participant choices in which to invest the funds. The participant bears the investment risk under a variable annuity. The insurance company bears the risk under a fixed annuity.

[A] Options Available within the Annuities

This section focuses on the variable rate annuity contracts. These contracts provide investments from a combination of proprietary investment accounts, proprietary and non-proprietary mutual funds, and guaranteed investment contracts or GICs. The combinations vary greatly, as do the fees and features included in each contract.

Insurance company separate accounts are set up within variable annuity contracts to offer a variety of investment options with different styles, similar to the different investment objectives addressed by mutual funds. The investment management fee charged by the separate account, on average, is lower than the fee charged by a comparable mutual fund, although other expenses within the variable annuity contract discussed below usually make the purchase more expensive in total.

Separate accounts are regulated by state law and to this point in time have not been subject to the same disclosure requirements as those imposed by the SEC on mutual funds. This, along with the fact that separate account performance data is not as easily accessible as mutual fund performance information, is often a concern to plan sponsors and participants who seek independent information on their investment options.

The mutual funds that can be found inside variable annuity contracts cover a wide range of feature and fee combinations that can be tricky for a plan sponsor to evaluate. The questions that follow assist the plan sponsor in evaluating the costs and performance history of the mutual fund offerings within the contract.

1. What are the expense ratios for each of the mutual fund options available in the plan?

   A plan sponsor doing a proper evaluation of options should not accept an average expense ratio of the funds available for the purpose of comparing the cost of alternative investment programs. If participants flock to the more expensive funds due to their higher profile or historical performance, a straight average artificially lowers the total cost of the annuity contract for comparison purposes.

2. Are the mutual funds offered proprietary (managed by the insurance company or an affiliated company) or non-proprietary (managed by an outside investment management company)?

   Proprietary mutual funds offered in the contract typically have lower expense ratios than those of a non-proprietary nature. Often times, the non-proprietary funds within the contract are selected in part because they pay 12b-1 fees or other marketing allowances to the insurance company. The plan sponsor should consider a careful comparison of these costs, as well as performance issues.

3. Are the mutual funds offered identical to the retail funds quoted daily in financial publications or are they clone funds - managed in a style similar to the retail fund?

   Participants like being able to follow their funds in the newspaper. A clone fund is essentially a separate account of the insurance company managed by a particular mutual fund company that is intended to mirror another successfully managed fund.

   Although that management company may try to manage the separate account in the same fashion as its more visible retail fund, there is no way to insure that the performance of the clone matches that of the retail fund. Buy and sell decisions may actually be made by someone other than the managers of the retail funds and they may occur at different times and prices than those made by the retail funds. In fact, it is often the case that the performance of the two funds may vary significantly over time. For these reasons, clone funds may create a great deal of confusion for plan participants.

Similar to a clone fund, an investment option within an annuity contract may actually have a specific mutual fund as its underlying investment, rather than just attempting to mirror the mutual fund's asset management. In this case, the assets are actually managed as part of that retail fund, but it carries additional expenses and thus has a different share value than the retail fund. This can be as confusing to a participant as a clone fund, so participant communication is critical.

§8.09 GIC Expenses

One of the unique features of a variable annuity contract is its ability to offer participants a true guaranteed investment option. While mutual fund companies can offer money market funds and stable value accounts that can be traded on many daily platforms, only insurance companies can offer true guaranteed accounts that promise a rate of return over a specified period of time. This type of guarantee is attractive to many conservative investors.

It is often difficult to determine the cost of such an option because returns are typically quoted at the net rate credited to the investor. In evaluating competing guaranteed options, plan sponsors should be sure to identify whether the rate being quoted is gross (expenses are not deducted in computing the rate to be credited) or net (expenses are deducted in computing the rate credited to the contract). If the insurance company quotes a gross rate, it is important to understand the charge levied against the gross rate for comparison purposes. These charges are often made on a sliding (i.e., declining) scale as the size of the assets in the account grows.

It is interesting to note that these guaranteed account contracts are usually the only accounts inside the group annuity contract that are considered to be a general asset of the insurance company and, therefore, subject to the claims of creditors. In the unlikely event that the issuer of such a contract were to become insolvent, the assets in the guaranteed account would not be protected against creditor's claims and participants investing in such accounts would have to rely on the insurance coverage provided by the State in which the contract was purchased to reimburse the plan for any losses. Assets invested in the other insurance company separate accounts and mutual funds are considered to be beyond the claims of creditors.

Finally, when considering a guaranteed investment contract, or GIC, plan sponsors should be sure they understand what options are available if the decision is made to liquidate the contract before its maturity. Most contracts contain provisions to enable the insurance company to impose a market value adjustment at the time of liquidation to discourage investors from liquidating GICs when the guaranteed rate paid by the GIC is less than what could be obtained on the current market. Many impose the market value adjustment only in circumstances where that adjustment lowers the value of the contract.

A rule of thumb is that if current market interest rates are higher than the contract's guaranteed rate, then the market value adjustment works against the contract holder and lowers the contract value. Most contracts provide a book value payout option over periods that range from three to seven years as a way to avoid the imposition of the market value adjustment. During the payout period, interest is often credited at below market rates. Under those circumstances, an analysis should be made to determine whether liquidation should be made currently at market or over time at book value.

Conversely, where current market rates are lower than the contract's guaranteed rate, the market value adjustment formula might actually result in an increase in the contract's value but the insurance company only pays book value. In other words, if the market value adjustment results in a higher contract value, many contracts do not give the plan the benefit of that adjustment.

The book value option presents other challenges in a participant-directed account plan, since some of the plan's assets are not available on automated response units for balance inquiry or transfer, nor are they reported on the plan's new platform. A sample copy of the investment contract should be reviewed to make certain this provision is understood before execution of the contract.

§8.10 Contract Expenses

Variable annuity contracts are tax-sheltered investment vehicles by nature. They contain a layer of expense above and beyond the underlying investment management fees. This charge goes by various names, such as:

- Contract charge;
- Asset charge; or
- Wrap fee.

They range in size from 0.10% to 2.00% and are charged annually to the entire contract. With some annuity contracts, the charge is reduced as the retirement plan accumulates assets to be managed by the company offering the contract.

This charge is designed to cover the annual administrative expenses associated with the contract and to cover the mortality and expense risk associated with the guaranteed death benefit of the contract. Guaranteed death benefits are applicable primarily to individual variable annuity contracts. Most guarantee that in the event of death, the contract holder's beneficiary can receive no less than the sum of the contributions made to the contract, regardless of the actual performance of the accounts he or she has invested in. This death benefit is of questionable value for a contract of any duration and leads one to question the utilization of such a contract.

Plans that use variable annuity contracts are using a tax-deferred investment vehicle to fund an arrangement that is tax deferred regardless of the nature of the underlying investments. The additional expenses involved with most of these contracts should be examined closely and be determined to have value over and above tax deferral.

In many situations, the contract charge discussed above is the only charge that appears in the marketing materials used by the insurance company. Once again, it is critical that the plan sponsor obtain the investment management charges associated with the underlying investments to have a complete picture of the cost of the investment contract. At least one insurance company is known to quote two different contract charges, depending on the mutual funds chosen by the plan sponsor to make available to participants. The lower contract charge is available when the plan sponsor chooses from a group of mutual funds with higher than average expense ratios. These funds distribute 12b-1 fees to the insurance company, which allows it to lower the contract charge. The version of the contract that imposes the higher contract charge uses mutual funds with lower expense ratios and no 12b-1 fees. Interestingly, the sum of the higher contract charge and the expense ratios of the mutual funds available under that approach is less than the total fees under the "low cost" approach.

Additional charges for services such as investment advice and self-directed brokerage accounts also should be added to the total cost of the contract. These charges may be paid by the plan sponsor, assessed against plan assets or against individual accounts as a flat or per usage fee.

By this example, one can see just how critical it is to identify each and every separate fee component that is included in the annuity contract in order to get a true representation of the contract's cost. Most annuity contracts also have a per participant charge designed to cover the cost of voice and/or Internet access and statement preparation, which should be added to the total cost of the contract. Compliance testing, Form 5500 preparation, and other administrative requirements are typically not included under the annuity contract and need to be added when reviewing the total cost of the plan.

In the face of all this complexity, and the layers of fees associated with them, annuity contracts do have a place in the funding of small and/or start-up defined contribution plans, especially 401(k) plans. Without such contracts, it might not be possible for the sponsor of a small plan to provide diversified investment options that go across fund family lines, coupled with same day trading. If, however, rapid growth of the plan or the plan sponsor is anticipated, the additional expenses and the back-end loads often attached to annuity contracts make them an expensive choice over the long run for many plans.

§8.11 Daily Valuation Arrangements at Banks

Banks that offer daily valuation services have become an interesting combination of the traditional retirement plan administration firm and investment provider. Most banks not only offer, but also promote, their own proprietary mutual funds as funding vehicles for daily valuation plans. They also offer outside funds to varying degrees depending on the market they target.

Plan sponsors should examine the arrangements offered by banks in the same manner as any other provider, taking care to identify each plan component and the costs related to them. There may be different fee structures for administrative services at a bank, which depend on the mutual funds selected by the plan sponsor. The plan sponsor must evaluate those differences in cost while taking performance issues into account.

Banks also bring a different dimension to the equation in that they can act as the plan's trustee. The trustee receives and holds plan assets in trust for the plan's participants. Trustees also may have responsibility for managing plan investments; however, in most participant-directed plans, the trustee does not assume this responsibility. Where the trustee's function is only that of the holder of plan assets, they are referred to as directed trustees or custodians.

Many plans, particularly those of a smaller size, appoint individual trustees, usually from the management or employee groups in the plan sponsor's organization. An outside trustee, such as a bank, provides some protection from fraud or mismanagement on the part of individual trustees and, therefore, shares some of the fiduciary responsibility and liability associated with the plan. Plan sponsors also should realize that they ultimately are the plan fiduciary, with the responsibility to monitor and direct the activities of other plan fiduciaries, including the plan trustee.

Bank trustee fees take many forms. Some are flat fees charged periodically, others are asset based and some are a combination of these two types. In some cases, banks that are providing a bundled package of administrative and investment services along with trustee services do not explicitly disclose the portion of the fee associated with the trustee function. This can make it difficult to compare the pricing of all components of a bank package with those of other potential providers. However, some banks are very good about full disclosure especially those with collective funds. If it is not possible to identify the cost of the trustee component, plan sponsors may want to ask some of the other potential providers to include a quote for outside trustee services in their proposal. Many retirement plan administration firms have established relationships with outside trust companies that act in the capacity of a directed trustee for a fee.

Many banks provide access to their daily valuation platform to small or start-up plans that would not be available on other multi-fund family platforms. This provides the small plan sponsor another investment approach in addition to an annuity arrangement.

§8.12 Alliances and Revenue Sharing Arrangements

Retirement plan administration firms committed to the daily valuation market face ever-increasing challenges from investment providers who attempt to bundle the administrative, recordkeeping, investment and even the documentation and consulting aspects of the plan into a seamless package. Our discussion of fees associated with investment management in mutual funds and annuity companies makes it clear that investments are the area where the bulk of the revenue is generated.

Many of the bundled providers have significantly reduced or eliminated the explicit fees associated with plan administration and recordkeeping, converting these fees to soft dollars imbedded in the investment management and distribution expenses of the funding vehicles.

Soft dollars are the subject of much controversy in the discussions of fees and expenses being charged to plans. **Soft dollars** is a term used to describe expenses covered by increased investment management fees that a bundled provider is able to keep. In essence, the plan sponsor appears to pay artificially low administrative fees because the expense has been transferred to the participant in the form of often exorbitant investment management fees. Soft dollars also take the form of 12b-1 fees and commissions paid to a retirement plan administration firm in an unbundled product, allowing that firm to reduce its fees. The main issue with such soft dollar costs is that they are typically asset-based fees, replacing the more traditional flat or per-head fees. Therefore, as the size of the plan assets grow, these fees increase significantly, even when there has been no increase in the number of plan participants. The true cost of running the plan is much less visible when soft dollars are involved.

Traditional retirement plan administration firms are looking for appropriate alliances with mutual fund companies and other investment providers in order to share in a portion of the 12b-1 distribution and servicing fees, as well as sub-transfer agent fees. This enables them to price their services more competitively. However, the manner in which this shared revenue is packaged and presented to plan sponsors may raise some interesting ethical issues.

For example, heavily loaded funds with considerable revenue sharing available may be recommended without any disclosure to the plan sponsor/trustee of the shared revenue arrangement. Without a corresponding credit to service fees, this can lead to soft dollars that contribute to increased profits of the administrative firm – unbeknownst to the plan sponsor.

Alternatively, there may be some credit against plan sponsor fees. Again, without disclosure, it is up to the integrity of the administrative firm as to whether the revenue is shared equitably.

On the other hand, an administrative firm may disclose available revenue sharing along with fund selection and offer a direct credit against their service fees. In this instance, the decisions of revenue sharing/reduced fees or higher fees with the use of no-load funds rests squarely on the plan sponsor/trustee, with little discretion on the part of the administrative firm. This helps assure equitable treatment of the plan sponsor regarding fees and revenue.

There are, of course, many variations in between. No arrangement is either right or wrong. The best arrangement is likely based on good business decisions that ethically match the needs of participants and the plan sponsor.

In the course of evaluating alliances and revenue sharing arrangements, it is also important to keep in mind the opinions expressed by the DOL in two advisory opinions.

In its Advisory Opinion 97-15A issued to Frost National Bank (Frost), the DOL stated that potential fiduciary violations could be avoided so long as Frost offset any fund payments received against fees otherwise due Frost on a dollar-for-dollar basis. Frost served as trustee to its client plans and often exercised investment discretion in the suggestion of particular funds as investment options for plan participants. Frost also retained the right to modify fund lineups by adding and deleting fund options. Under those circumstances, Frost was considered by the DOL as a plan fiduciary that exercised discretion or control over plan assets, and as such, required that all revenue received from the funds be used to offset fees.

Coincident with the issuance of this opinion, the DOL issued Advisory Opinion 97-16A to Aetna Life Insurance and Annuity Company (now known as ING) on the same issue with a different result. Aetna provided investment options managed internally as well as mutual funds managed by unrelated investment companies through group annuity contracts issued to participant-directed plans. Aetna also provided administrative and recordkeeping services through this platform. Aetna did not act as plan trustee and argued that it was not a plan fiduciary in any capacity to its clients.

Aetna used an elaborate procedure for changing funds in its investment lineup. Plan sponsors were given advance notice of any anticipated change and were given the option to accept or reject proposed changes. If a plan sponsor failed to respond to a proposed change, consent to the change was implied in a manner similar to failure to vote a proxy. Aetna disclosed only that unrelated mutual funds paid fees to Aetna, without disclosing the specific amounts to clients. The DOL opined that Aetna, as a non-fiduciary, could keep these payments from the mutual funds without the requirement to offset other fees charged to its clients' plans.

As a result of these two opinions, all plan service providers need to examine their role as it relates to the plans they serve and determine whether they have the ability to keep any 12b-1 distribution or service fees, sub-transfer agent fees, or any other form of compensation that may be available from investment providers. This decision hinges on whether or not they feel they are plan fiduciaries, or more importantly, whether the courts or government agencies like the DOL view them as fiduciaries in the event of a dispute. This issue is beyond the scope of this chapter, but its resolution provides the ultimate roadmap as to acceptable fee arrangements for alliances based on current DOL pronouncements.

§8.13 Summary of Investment Expenses and Fees

Employees bear an increasing responsibility to fund their own retirement, often with a 401(k) plan as their only retirement vehicle. Employees also are paying the majority of plan expenses through the investment management costs and sales charges associated with the funding options made available to them. Largely through the efforts of the DOL, employees are becoming more aware of cost and performance issues relating to their plans. They expect their plan sponsors are fulfilling their fiduciary obligations by managing their plan costs effectively.

Plan sponsors need to develop the means to evaluate the costs and benefits of their plans, even when they are not anticipating making changes. Plan sponsors must identify each separate cost component in order to better understand the total costs of the plan.

§8.14 Key Terms

Closed-End Mutual Funds: A mutual fund that issues redeemable shares but is not open to new funds.

No-Load Funds: A mutual fund with no sales charge to buy or sell shares.

Open-End Mutual Funds: A mutual fund that issues new shares continuously and redeems shares at the request of shareholders.

Soft Dollars: A term used to describe expenses covered by increased investment management fees that a bundled provider is able to keep.

§8.15 Review of Key Concepts

- Fiduciaries must consider costs charged to the plan when choosing investments and in selecting a service provider. The fees must be reasonable fees for necessary plan services. The fees must be disclosed to participants.

- Costs generally are either one-time fees or ongoing fees and are calculated in one of the following ways: asset-based, per head, transaction based, or flat rate.

- Classes of mutual fund shares differ based on how the fund company applies sales charges and fees. A number of different share classes are discussed.

- Management fees include investment management fees (those assessed as a percentage of the daily net assets, or basis points), custodial and transfer agent fees (those assessed to those holding title to and tracking shares held), and transactions fees (those incurred in the process of acquiring and liquidating securities held by the fund).

- Sub-transfer agent fees (sub-TA) refer to revenue that fund companies may return to custodians and administrative firms (who actually track shares held by participants) in the form of revenue sharing. This may also take the form of shareholder servicing fees, paid in lieu of 12b-1 fees when the administrative firm is not registered with the broker-dealer.

- Many GIC contracts impose a market value adjustment at the time of liquidation. If current market interest rates are higher than the contracts' guaranteed rate then the market value adjustment works against the contract holder and lowers the contract value.

- The contract charge in a variable annuity contract is in addition to the underlying investment management fee and is often called an asset charge or a wrap fee. This fee covers the additional administrative expenses associated with the contract.

- Since the area of plan investments is where the bulk of the revenue is created, a common practice is to share this revenue among related parties. This can take many different forms and disclosure to the plan sponsor can vary widely. Therefore, it is important for sponsors to seek out this information to be sure revenue is being shared equitably and appropriately.

§8.16 Review Questions

[A] True or False

______ 1. Class B shares of mutual funds are traded at net asset value but include a level basis-point trailer for sales commissions.

______ 2. Plan expenses may be allocated on a pro rata or on a per capita basis.

______ 3. A GIC contract that is liquidated prior to maturity may result in a reduction of the participant's account value.

______ 4. Class A shares include front-end loads and 12-b1 service fees.

______ 5. Revenue sharing helps to offset administrative expenses.

[B] Multiple Choice

6. All of the following statements regarding the investment management fee are **TRUE, EXCEPT**:

   A. It is assessed as a percentage of average daily net assets of the fund.
   B. Participants should reduce the fund's published NAV by this fee.
   C. It is the largest single fee assessed against a mutual fund.
   D. It usually ranges from 10 basis points (0.10%) to 300 basis points (3.00%).
   E. The fee pays the fund manager.

7. All of the following are additional fees unique to annuity contracts, **EXCEPT**:

   A. Daily valuation fees
   B. Market value adjustment for GICs
   C. Contract asset charge (CAC)
   D. Mortality and expense fees
   E. Per participant fees

8. All of the following statements regarding revenue sharing are **TRUE, EXCEPT**:

   A. It is often sub-transfer agent fees.
   B. It may raise ethical questions regarding fund recommendations.
   C. It takes place when the mutual fund company pays the administration firm for sub-accounting participant accounts.
   D. It results in a payback directly to participants' accounts.
   E. It may be the sharing of 12b-1 fees.

9. All of the following statements regarding fees and expenses are **TRUE, EXCEPT**:

   A. The DOL states that the plan document is required to state the method for allocating expenses.
   B. Payment of many fees associated with the investment of plan assets has shifted to participants.
   C. A plan sponsor should document the fees service providers charge when evaluating and choosing among them.
   D. Plan expenses may be allocated on a pro rata or per capita basis.
   E. Loan processing fees may be charged to the participant.

10. All of the following statements regarding mutual fund fees are **TRUE, EXCEPT**:

   A. Mutual fund companies may share fees they assess on plan assets.
   B. Investment advisors may charge the plan for their services.
   C. An expense ratio is the fund’s expenses over the fund’s net assets.
   D. The largest fee assessed against a mutual fund is the investment management fee.
   E. Fees for acquiring/liquidating underlying securities of a mutual fund are paid directly by participants.

§8.17 Answers

1. **False.** Class R shares of mutual funds are traded at net asset value but include a level basis-point trailer for sales commissions. §8.04 [C]

2. **True**. Plan expenses may be allocated on a pro rata or on a per capita basis. §8.03

3. **True.** A GIC contract that is liquidated prior to maturity may result in a reduction of the participant's account value. §8.09

4. **True.** Class A shares include front-end loads and 12-b1 service fees. §8.04 [C]

5. **True.** Revenue sharing helps to offset administrative expenses. §8.12

6. The correct answer is **B.** §8.05 [A]

   A. Incorrect. This statement is true because investment management fees are assessed as a percentage of average daily net assets of the fund.
   B. Correct. This statement is false because the fund's published NAV includes the investment management fees.
   C. Incorrect. This statement is true because investment management fees are the largest single fee assessed against a mutual fund.
   D. Incorrect. This statement is true because investment management fees ranges from 10 to 300 basis points.
   E. Incorrect. This statement is true because investment management fees are used to pay the fund manager.

7. The correct answer is **A.** §8.10

   A. Correct. This statement is false because daily valuation fees are not unique to annuity contracts.
   B. Incorrect. This statement is true because GIC market value adjustments are unique to annuity contracts.
   C. Incorrect. This statement is true because contract asset charges are unique to annuity contracts.
   D. Incorrect. This statement is true because mortality and expense fees are unique to annuity contracts.
   E. Incorrect. This statement is true because per participant fees are unique to annuity contracts.

8. The correct answer is **D.** §8.12

   A. Incorrect. This statement is true because revenue sharing often takes the form of sub-transfer agent fees.
   B. Incorrect. This statement is true because revenue sharing may raise ethical questions regarding fund recommendations.
   C. Incorrect. This statement is true because revenue sharing is occurs when the mutual fund company pays the administration firm for sub-accounting participant accounts.
   D. Correct. This statement is false because revenue sharing does not result in a payback directly to participants' accounts.
   E. Incorrect. This statement is true because revenue sharing may take the form of 12b-1 fees.

9. The correct answer is **A.** §8.03

   A. Correct. This statement is false as the DOL does not require the plan document to state the method for allocating expenses.
   B. Incorrect. This statement is true because payment of many fees associated with the investment of plan assets has shifted to participants.
   C. Incorrect. This statement is true because a plan sponsor should document the fees service providers charge when evaluating and choosing among them.
   D. Incorrect. This statement is true because plan expenses may be allocated on a pro rata or per capita basis.
   E. Incorrect. This statement is true because loan processing fees may be charged to the participant.

10. The correct answer is **E.** §8.05

   A. Incorrect. This statement is true because mutual fund companies may share fees they assess on plan assets.
   B. Incorrect. This statement is true because investment advisors may charge the plan for their services.
   C. Incorrect. This statement is true because an expense ratio is the fund's expenses over the fund's net assets.
   D. Incorrect. This statement is true because the largest fee assessed against a mutual fund is the investment management fee.
   E. Correct. This statement is false because fees for acquiring/liquidating underlying securities of a mutual fund are not paid directly by participants.

Chapter 9:
Daily Activities

§9.01 Learning Objectives

- Explain the process in recordkeeping for a daily valuation plan including reconciliation of fund positions, placing trade orders, processing transactions and backing-up functions.
- Explain the process involved when participants initiate transactions that affect investment funds.

§9.02 Introduction

Recordkeepers perform many functions that are repeated each day. Many of those tasks are automated. In this chapter, we compile a list of the most common functions assigned to the daily valuation recordkeeper. It is not intended to be all-inclusive as practices vary among retirement plan administration firms.

We also review processing of certain participant-initiated transactions and the affect of those transactions on investment funds, whether they are transfers, rebalancing, distributions or loans.

§9.03 Daily Activities Introduced

Recordkeepers perform multiple tasks in a variety of ways on any given day. Depending on a firm's operation, the order in which these duties are performed will undoubtedly vary, but a typical day includes most of the following functions:

- Entering daily pricing;
- Settling trades;
- Releasing trades;
- Refreshing values for participant communication (live operator/VRU/Web);
- Reviewing outstanding trades;
- Reconciling fund positions;
- Cash, loan and share balancing;
- Sending participant confirmations and personal identification numbers (PINs);
- Placing orders;
- Processing participant-driven Automated Response Unit transactions;
- Processing employer-driven transactions (contributions);
- Processing distributions, withdrawals, loan requests, transfers/rebalancing; and
- Backups and other maintenance functions.

The first function given attention in most operations is the entering of current investment prices. Let's begin there and walk through all of the functions listed above, bearing in mind that the order can change depending on the organizational structure and system capabilities of the firm handling these activities.

§9.04 Daily Pricing

The whole idea behind daily valuation is the notion that account balance values can be kept current by capturing each day's market price for each investment. Share prices are updated for all funds on a daily basis. The price represents the closing price from a particular business day. A **business day** is any day on which the New York Stock Exchange is open for trading.

On weekends or holidays when there is no trading on the stock exchanges, the price from the last business day is used for purposes of reporting participant balances on the VRU or other automated response systems. It is important to realize that there may be a business day when the recordkeeper's office is closed but the stock market is not. When this happens, it is imperative that prices are entered and trades released in proper sequence before the processing of the next business day's transactions begins.

Updating of the prices can be an automated or manual activity, depending on procedures established by the recordkeeper. Prices are frequently obtained automatically from an outside source (e.g., the trading partner) in what is known as a price file. The price file contains the prices at the close of the market for all of the existing fund choices. Loading the prices into the recordkeeping software is often a simple process, but it is very critical. Even if the majority of funds provide automated pricing updates, it is possible that a few stock or other investment prices are not available and must be manually input. Smaller companies with closely held stock often fall into this category.

If there is no automated service providing share prices, some recordkeepers obtain prices from a trading service such as Bloomberg, while others look to the Internet for prices, or a newspaper, such as *The Wall Street Journal*. When there is no automated pricing function, the prices are entered into the recordkeeping system manually; however, usually these prices can be entered at a system level for all plans using that investment.

Updating the prices is a daily activity. However, the time of day that the prices are loaded into the recordkeeping system may vary from one retirement plan administration firm to another. There are several factors that may affect the timing.

- The time that the trading partner sends the price file to the retirement plan administration firm. This may vary between trading partners.
- The staffing level of the retirement plan administration firm. Some firms provide a night crew that updates the prices in the evening; others update first thing in the morning.
- Whether a price file is received electronically or must be created manually after looking up the prices in a news service. Delivery of the news service affects the timing.

The timing of price updates can occur at the close of the day, through the evening or up to mid-morning of the next day. It is important to communicate to the plan sponsor and its employees when this activity occurs. Whether the input is automated or manual, it is extremely important that the price received for input is the audited price at the end of the day, not an estimated price.

An error in pricing can create substantial work for the recordkeeper when the error is finally discovered. Imagine incorrect prices being entered into the recordkeeper’s system on day one with the error not being caught until day 15. In the meantime, participants may have made transfers to other funds, or taken loans based on account balances using that incorrect pricing data. The longer the pricing error goes unnoticed, the more difficult and elaborate the correction process is.

For those plans whose investments are units of a separate account, such as in a group annuity contract offered by bundled insurance providers, rather than shares of a mutual fund, additional pricing steps are required. The value of the funds available inside the annuity contract is calculated by taking the NAV, plus dividends paid, plus any capital gains paid, minus any fees assessed by the separate account and dividing it by yesterday's NAV to get the day's unit value. In some cases, for those insurance companies that have sophisticated software, contract level pricing may make each plan's fund pricing unique.

§9.05 Trade Processing

[A] Settling Trades

Settling trades is a function that typically occurs immediately after the latest prices are input. The resulting shares and dollars purchased or sold are reported in the automated trade file.

When payroll is processed on the recordkeeper's system, the activity is recorded on the participant's account in dollars as unconfirmed, or pending, since the trade has not actually occurred and the number of shares purchased is unknown. When the trade is settled, the transaction is confirmed on the software, and shares are posted to the participant's account and can be heard on the VRU or seen on the retirement plan administration website.

If these processes are not fully automated, the recordkeeping system calculates the shares based upon the updated share prices just loaded into the system. For example, the trade file sent to the trading partner the prior day included an order to purchase $50,000 of Fund A. The trade file returned to the recordkeeper indicates the NAV for Fund A was $5. This translates into the purchase of 10,000 shares of Fund A.

Settling or confirming trades on a recordkeeping system should not be confused with actual trade settlement. Trade settlement is when the proceeds of a trade are actually transmitted to the appropriate party (*i.e.*, the mutual fund company) and is generally performed by the trading partner. Settlement typically occurs a day after a trade has been executed and confirmed.

[B] Releasing Prior Day Trades

After the trades have been settled and the results of the buys and sells are reconciled by plan and by fund, the trades are released on the recordkeeping system. This means they are posted, or allocated, to each participant's account in the ratio of that participant's transaction total to the total of the plan. Some recordkeeping systems will automatically release trades as soon as they are confirmed and posted. It is at this point the automated response units may be refreshed to reflect the latest activity.

[C] The Refresh Process

Refreshing is the process by which the automated response unit is updated with current account balance and pricing information.

After trades have been settled and released for the day, the automated response units are updated, or refreshed, with the new account balances and pricing. Generally, a firm establishes a deadline for performing the refreshing activity so that a participant can expect to hear current pricing and account balances by a specific time (e.g., noon of each business day). Since balances are spoken on a voice unit with the corresponding date, the failure to meet a refreshing deadline is more of a customer relations issue than anything else.

If there is a delay in the refreshing process, an automated message is typically added so that participants are aware of the cause of the delay and when they can expect it to be resolved. For those participants accessing their account information via the web, a message regarding the delay also may be added or the date of the valuation may not be changed.

The refreshing process is typically an activity selection in the recordkeeping software and is executed on a plan-by-plan basis. This process is carefully monitored and checked to ensure that all plans are properly updated.

Some recordkeeping systems refresh all participant accounts at the same time. The more participants the longer it takes to run the refresh process. Other systems refresh on demand. In other words, they refresh a participant's information only when the participant calls on the automated response system. Still other systems do not have to actually refresh the participant data because the automated response units directly access the real time recordkeeping data.

[D] Review of Outstanding Trades

Because of the potential for errors, it is important that any trades not settled and released be reviewed on a daily basis. The recordkeeper must identify the source of the problem: Was there an error in the fund identification number? Has the plan not been set up with the trading partner? Has the participant been removed from the file or transferred out of a particular fund?

§9.06 Reconciling Fund Positions

In the ideal daily environment, there are no outstanding trades, and there is never any uninvested cash. Purchases come in and trades are made that day based on the closing price for the day. Sales are settled and released, shares are purchased and sold and participant benefit payments or loan checks are cut the same day.

Practically speaking, however, it may take a couple of days for most transactions to clear, or settle. As a result, a critical part of daily recordkeeping where there are separate trust and recordkeeping systems is the monitoring of incomplete transactions. These discrepancies may appear when attempting to balance the plan's cash, loans or fund shares.

[A] Cash and Loan Balancing

Monitoring cash positions can be a great tool in limiting liability, ensuring standard deadlines are met and identifying areas of weakness in a daily operation. Retirement plan administrators learn their operation's tolerance for cash and are diligent in reporting to the appropriate parties whenever cash sits in the account for more than the acceptable period (e.g., two days).

After identifying the transaction that is causing the discrepancy and the date it was initiated, administrators follow up with the appropriate parties. Below are a few examples of improperly executed transactions that might be uncovered:

- Contributions deposited but funds not traded, so cash is uninvested;
- Shares sold to cover a distribution but no check was cut, so the cash is still in the trust;
- Fees charged to a plan but not allocated to participant balances, causing cash or share shortages;
- Shares sold to cover a new participant loan but no check was cut, so the cash is still in the trust; or
- Shares sold due to a transfer requested by a participant that created cash. The corresponding purchase inadvertently does not get made resulting in uninvested cash.

[B] Balancing Shares

In addition to monitoring cash, share positions are monitored as well. Each plan has a fund share position (total of participant shares) that can be ascertained from the recordkeeping software. The plan's fund share position is compared to the fund share position reported by the trading partner, custodian or fund company that maintains those records.

As with cash and loan balancing, routine discrepancies can be uncovered, such as dividends paid that have not been posted by the recordkeeper. Most common, however, are shares that are off ever so slightly from a rounding difference due to trading and allocation of fractional shares. Every recordkeeping operation establishes a standard tolerance for rounding. The recordkeeper must know how much variance is acceptable and notify the appropriate party if shares exceed that threshold.

Some operations resolve this discrepancy by routinely allocating the rounding difference to even up, or true-up, the accounts. Sometimes a difference in shares may be caused by the trading partner changing the price of a purchase transaction, resulting in an error in the number of shares reported initially. It may take several days to a week before this correction appears.

§9.07 Confirmations and Personal Identification Numbers (PINs)

[A] Paper Confirmation

Some recordkeepers send out a paper confirmation when participants make a change to their investment elections or request a transfer of assets. In sophisticated systems, these confirmations (confirms) are generated automatically by the software and sent directly to a participant's home address.

[B] Personal Identification Numbers (PINs)

PINs are another area where practices vary from one recordkeeper to another. Some require the participant to complete an initial selection form, while others automatically generate a PIN and mail a notice to the participant. In some practices, the PIN is automatically generated, but the participant is given the option of changing it.

§9.08 Placing Trade Orders

After all of the transactions for the day are processed on the daily system, the software typically totals all trades, by fund and by plan, and produces a report to be faxed and/or an automated trade file to be sent to the trading partner. Depending on trading deadlines and internal procedures, placing trades can occur at various times with different trading partners during each day.

At the trading partner or transfer agent level, the trade amounts for various plans may be combined to create net transactions. Buys and sells for a single fund or issue are combined, or rolled up, to minimize the cash flow and trade costs. When trade amounts are combined in this way, the trading is called **omnibus level trading**.

Omnibus level trading offers one particular advantage: many funds have minimum trade requirements. Rolling up all of the trades usually results in overcoming the minimum trade threshold. On the downside, omnibus level trading can make it more difficult to reconcile large trades across a number of plans, and it may add unnecessary delays in settling trades.

It should be noted that some trading partners and transfer agents continue to place transactions only at the plan level.

§9.09 Processing Transactions

[A] Processing Participant-Driven Transactions

If a participant initiates a transaction on an automated response unit, such as transfers or portfolio rebalancing, it must be extracted and traded by an established trading deadline (e.g., 2 PM, EST). Any transaction requested after this deadline is not traded until the following business day.

Extract refers to the process of pulling participant-driven requests from the automated response unit in order to place corresponding trades. Refresh is the process by which the automated response unit is updated with current account balance and pricing information.

When a participant initiates a sell transaction, all future requests are denied or blocked until his initial request is traded, settled and released. Depending on timing, the automated response software may allow a participant to change his mind about a transaction and stop a trade before it is executed. It is important, therefore, that blocked trades on the automated response unit be thoroughly explained ahead of time to the plan sponsor and participants and that every effort is made by the recordkeeper to keep timing on these blocked trades to a minimum.

Although this is an automated function of the daily software, the firm handling the recordkeeping must recognize the opportunity for errors to occur. The recordkeeping firm typically must make the plan and/or the participant whole by paying for any losses caused by faulty extracts of transactions initiated through an automated response unit. It is also important, for example, that investment elections be changed in a timely fashion so that future contributions are processed correctly.

In some cases, the vendor for the automated response unit package is not the same as the vendor for the recordkeeping software. The passing of information between the two component systems exposes another area for potential error. For this reason, the extract and corresponding refresh processes should be carefully monitored and thoroughly checked.

[B] Processing Transfers and Portfolio Rebalancing Transactions

A transfer may be as simple as moving money from Fund A to Fund B. A transfer from one investment to another involves the selling of the existing fund and the purchase of the new fund.

To further complicate the already two-sided nature of transfer transactions, one of the options available in most daily plans is the ability to realign an existing account balance among funds, a process that is also known as portfolio rebalancing or account realignment. Portfolio rebalancing looks at the entire account balance and moves money to and from each of the funds to produce the desired investment mix. In plan education meetings, participants are encouraged to rebalance their current account monies back to their investment strategy (*e.g.,* 30% bond funds and 70% stock funds) on a monthly, quarterly, semiannual or annual basis. The steps to complete this process on the recordkeeping system are dictated by the software.

Typically, existing shares in undesired funds are sold one day and the resulting cash is used to purchase shares in the desired funds the following day. However, it is common for an investment firm or mutual fund company to exchange his or her own funds on a same-day basis. Under some trading platforms it is now possible to perform the buy and sell on the same day among multiple fund families.

Portfolio rebalancing, like most transactions, may be received by the recordkeeper as a paper request and it may result in one or more manual trades. Many firms require these types of transactions be requested via the automated response unit. It should be noted, however, that a transfer or rebalancing request usually blocks any other activity from occurring for that participant until the transfer or rebalancing transactions are completely traded, settled and released.

Plans that have some type of restriction on investments generally have special rules regarding the processing of transfers. Restrictions on transferring monies between or among funds often occur when equity wash restrictions apply, when competing investment options (*e.g.,* money market fund and cash fund) are available and with certain types of employer stock.

[C] Processing Employer-Driven Transactions

Employers process payroll at various times: some weekly, others biweekly or even monthly. Participant contributions are withheld from employee paychecks and forwarded to the trust to be invested according to each participant's investment direction. The process of calculating the amount to be invested in each investment alternative occurs as often as the employer sends the contribution data to the recordkeeper.

Employer matching contributions and other employer contributions also may be received by the trust. The frequency of investing these contributions varies by plan and by type of contribution. For instance, employer matching contributions may be invested in participant accounts each pay period based on the amount of participant elective deferrals for the period. Alternately, the employer may remit matching contributions once a year based on the total annual participant elective deferral.

[D] Processing Labor-Intensive Transactions

Distributions and loans are labor-intensive type transactions that require more recordkeeper involvement than some other transactions that are accomplished with relative ease through the use of automated software functions. For distributions and loans, most plans continue to require some paperwork that must be reviewed to be sure it is complete. Such paperwork includes signed promissory notes for loans, spousal consent to a loan or a distribution, withholding elections and proper notification and observation of required waiting periods. Vesting percentages must be checked. Often, an administrator handles some of this work before handing over the transaction to the recordkeeper.

[E] Processing Distribution Transactions

Distributions usually involve the benefit payment made on behalf of a terminated participant, while withdrawals refer to amounts paid from the plan even though the participant remains actively employed. Plan provisions dictate whether or not in-service payments may be made. Distributions may be partial or complete and may be requested for a variety of reasons:

- Hardship withdrawal;
- In-service withdrawal;
- Separation from service with the employer;
- Required minimum distribution at age 70½;
- Refund to HCEs due to plan's failure of ADP and/or ACP nondiscrimination tests; and
- Refund of elective deferrals in excess of the IRC §402(g) limit.

The recordkeeper should verify that a specific type of payment is allowed under the terms of the plan. There may be additional requirements to be met before the payment may be made. Hardship withdrawals, for example, may be limited to certain money types.

If the distribution is on account of termination of employment or death of the participant, it is important to check that all contributions, dividends and forfeitures have been deposited and processed and that all fees have been taken from the accounts. After the existing account is completely updated, all of the shares attributable to that participant are sold. The resulting cash is then distributed to the participant or his beneficiary along with any related paperwork.

As with many of the daily functions, there are a variety of ways in which distributions are processed. The recordkeeper's relationship to the custodian dictates who is responsible for the separate distribution forms, check writing and tax reporting tasks. If the custodian and recordkeeper are at the same facility, such as a bank or trust company, it is relatively easy to deliver rush distribution checks and track information for preparing Form 1099-R. When multiple service providers are involved, however, it is more challenging. Effective verbal and electronic communications, along with established turnaround times, are required to provide timely, accurate distributions.

[F] Processing Loan Transactions

Loans can be requested either as a specified dollar amount or for the maximum allowable under the law and plan. The sources and funds available for the loan vary by plan. This loan hierarchy is identified through the plan's written loan procedures. The employer coordinates the start of loan repayments on its payroll.

Some automated response software permits the participant to work through various what-if loan scenarios. For example, "If I take a loan of $2,000 and I agree to pay it back within two years through payroll deduction, what is the amount of my repayment per paycheck?"

With some recordkeeping software systems, participants can request loans on the Internet, and the required paperwork such as the promissory note, if applicable, follows. The maximum loan available changes on a daily basis with the account balance; therefore, system generated loans can be a big help to the retirement plan administrator. It is important that the recordkeeping software limits the loan amount to the maximum allowable by law.

In addition to government regulations, loans may be subject to plan requirements, and it is important that either the software or the recordkeeper monitor these requirements as well. Some plan loan requirements include but are not limited to:

- The minimum loan amount;
- The number of outstanding loans permitted at any one time; and
- The loan interest rate calculation.

§9.10 Backup and Other Maintenance Functions

During each day there are many activities that are occurring. Some activities are controlled internally by the recordkeeper; others occur because of participant requests. Since many different people could affect information about a plan during the day, it is important to perform daily backups on the software and automated response units. These functions are often handled outside the daily unit.

Whoever performs the backup functions checks the backup systems to make sure that the system backs up each night, that all plans are backed up and that the backup is usable. The backups are stored off site to be available in case a catastrophe occurs at the daily processing site.

Because of all the variables associated with automated response units, in addition to daily backups the retirement plan administrator may randomly test the systems to be sure everything is being updated in a timely fashion and that the system is in good working order. Even more important, new plans are usually tested thoroughly the first week or so of operation to avoid unanticipated problems in the setup.

To ensure continuous access to the automated response units, mirror servers are maintained. If the main server goes off-line for some reason, the mirror server can be put in place without skipping a beat. The participants experience no lapse in service due to computer difficulties at the recordkeeper's site.

If an automated response unit must be brought off-line for maintenance, most systems activate a recording advising participants about the interruption in service and the anticipated time the system will be reactivated. Many firms are prepared to staff with live operators, however, to avoid public relations issues with plan sponsors and participants alike if desired trades cannot be placed on any given day.

§9.11 Key Terms

Business Day: Any day on which the New York Stock Exchange is open for trading.

Omnibus Level Trading: When trading amounts for various plans are combined in order to minimize cash flow and trading costs.

§9.12 Review of Key Concepts

- A critical daily function is to determine the share position of each fund on a plan basis and compare that to the share position being reported by the fund company to be sure the recordkeeping system reconciles with the fund company. Monitoring cash positions is also important.

- Once each day, all trades to be executed are sent to the trading partner. The trade may be at the plan level or rolled up for all plans (omnibus level trading).

- A transfer involves moving money from one fund to another. Portfolio rebalancing or account realignment involves selling certain funds and buying other funds to produce the desired investment mix.

- Distributions and loans may require more recordkeeper involvement in order to check certain requirements and plan provisions for such things as vesting, outstanding deposits, loan eligibility, spousal consent and withholding elections. There are a variety of ways funds can be distributed, along with the corresponding reporting and withholding requirements.

- Since many people affect the plan information daily, backing up is a critical daily function.

§9.13 Review Questions

[A] True or False

______ 1. Participants who request portfolio rebalancing are asking to have their existing account balances transferred to their new employer's retirement plan.

______ 2. Once the recordkeeper totals all trades for the day by fund and by plan, it produces a trade file that is sent to the trading partner.

[B] Multiple Choice

3. All of the following are examples of improperly executed trades that may cause a cash discrepancy, **EXCEPT:**

   A. Shares sold for a participant loan but no check was cut
   B. Contributions deposited but funds not traded
   C. A transfer of shares from one plan to another
   D. Shares sold for a distribution but no check was cut
   E. Fees charges to the plan but not allocated to participant accounts

§9.14 Answers

1. **False.** Porfolio rebalancing is when a participant rebalances the fund positions within the plan account. §9.09 [B]

2. **True.** Once the recordkeeper totals all trades for the day by fund and by plan, it produces a trade file that is sent to the trading partner. §9.08

3. The correct answer is **C.** §9.06 [A]

   A. Incorrect. This statement is true because shares sold for a participant loan but no check cut may result in a cash discrepancy.
   B. Incorrect. This statement is true because contributions deposited but funds not traded may result in a cash discrepancy.
   C. Correct. This statement is false because a transfer of shares from one plan to another should not result in a cash discrepancy.
   D. Incorrect. This statement is true because shares sold for a distribution but no check cut may result in a cash discrepancy.
   E. Incorrect. This statement is true because fees charges to the plan but not allocated to participant accounts may result in a cash discrepancy.

Chapter 10:
Mutual Fund Trading Practices

§10.01 Learning Objectives

- Define the following terms: forward pricing, trade partner, transfer agent, omnibus level trading, trading deadlines, settlement date and fund position.
- Explain the relationship between type of funds (inside, outside and alliance) and trading deadlines.
- Discuss the role of the recordkeeper, trading partner, transfer agent and mutual fund company or investment manager in a participant trade request.

§10.02 Introduction

At the heart of daily valuation is the processing of transactions. The type of activity requested dictates whether a fund is bought or sold. The recordkeeping system keeps track of all those trades.

How does all of this happen? This chapter takes an in-depth look at the path a transaction follows from the moment a participant initiates it via the plan's automated response unit (ARU) to the point in time the participant can get the results via the ARU. In this chapter, more terminology is introduced that relates strictly to the investment trading activity.

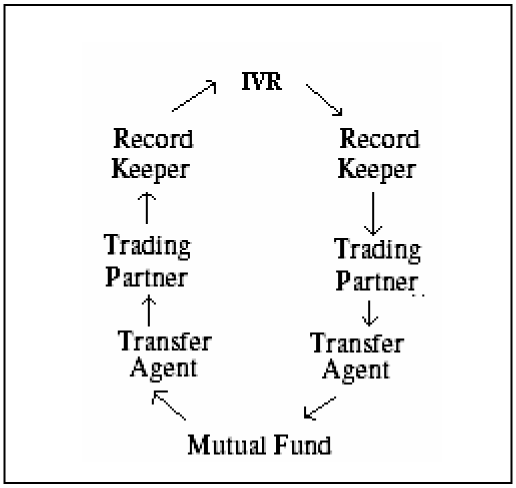
Part of understanding daily valuation involves understanding all the trading activity that occurs each day.

§10.03 Daily Valuation Is a Circle

Those new to the daily valuation world may find it confusing as the result of an outgrowth of the number of ways in which the product is delivered to a plan sponsor, as well as the variety of options available to the plan sponsor when designing its retirement plan.

There are also a number of ways that the daily valuation package can be provided. For example, a bundled daily valuation package typically has one service provider that manages the relationship and is visible to the plan sponsor and participants. There may be other service providers in the bundle, but they have no direct interaction. The various parties to an unbundled arrangement, however, are fully disclosed to the plan sponsor, and generally each has some level of direct contact with the plan sponsor and the participants.

To understand daily valuation processing, imagine it as a circle. The circle shows four parties always involved in a transaction initiated by the participant; however, it is possible that a single entity may provide more than one service through different operational units within the organization. A bank or trust company, for example, may provide both the recordkeeping service and have its own unit managing the trading activity.



At the top of the circle are the interactive systems, such as the Internet and voice response units (IVR/Web). Using the telephone or the Internet, the participant requests a transaction. This request is automatically swept into the recordkeeping system. The recordkeeper processes the transaction and forwards information to effect the required transaction to a trading partner. The trading partner works with the appropriate transfer agents for each mutual fund to complete the actual purchase or sale of fund shares.

The transfer agent settles the trade and confirms the results of the trade back to the trading partner. The trading partner returns the trade confirmation file to the recordkeeper, who updates their daily system accordingly. At that point, the data is updated on the IVR/Web, and the participant can initiate new transactions.

Increasingly, trading partners trade through a central clearing and settlement organization called the National Securities Clearing Corporation (NSCC). This organization acts as an exchange: clearing and settling all transactions between transfer agents and providing consolidated reporting and confirmation back to the trading partner. The same end result is achieved.

The challenge of daily valuation is to keep activity flowing smoothly and efficiently around the circle at all times.

§10.04 Terminology

Becoming familiar with certain terms is necessary to grasp the flow of transactions in the daily environment. Here, we introduce a number of expressions that have a particular meaning in the context of daily valuation activity.

[A] Trades

A **trade** is a purchase or sale of a security, such as shares of a mutual fund. Any trade can be reduced to one of four trade types:

1. A **dollar certain purchase** is the buying of shares with reference to the dollars to be invested. The most common dollar certain purchase involves investment of contributions.

2. A **dollar certain sale** is the selling of shares to result in cash proceeds from the sale of a specific dollar amount. Dollar par funds are easy to sell in this fashion, but it may be difficult to determine the number of shares to sell of other mutual funds to raise a precise amount of cash. The most common dollar certain sales involve sales requested by a participant for the proceeds of a loan or hardship withdrawal. In these situations the participant knows the exact dollar amount needed for loan or hardship withdrawal.

3. A **unit certain purchase** requires buying an exact number of shares. These transactions are less likely to occur, since it is the dollar value that is usually the known factor in the equation.

4. A **unit certain sale** involves selling a precise number of shares of a fund. This type of trade occurs when a terminated participant is being paid out his or her vested benefits or if a participant requests a complete transfer out of an investment.

[B] Definitions

Placing trades (or an order) means making a specific request to buy or sell a security.

Manual trading refers to trades that are placed manually requiring human intervention; i.e., someone must send a fax or make a phone call to place the trade.

Electronic trading is a method of trading accomplished by use of files and some form of electronic connection.

Links are programs, which are written to accommodate the type of software used by each party using the link so the computers can talk to each other and efficiently transfer information without manual intervention. Specially built links facilitate the transfer of electronic files.

Trade files represent a summary of the buys and sells needed to carry out the investment, transfer, distribution or other activity requested by the plan's participants. The daily recordkeeping system creates trade files each day.

Omnibus level trading refers to the practice by the trading partner, transfer agent or both, of combining trade amounts for multiple plans to create net transactions. Buys and sells for a single mutual fund are combined, or rolled up, to minimize cash flow and trade costs. It is also referred to as net trade settlement.

Trading deadline is the time by which all trades must be placed, and it is common to have more than one trading deadline each day if a variety of fund families are offered. In addition, trading deadlines may differ by transaction type. Recordkeepers, generally, establish a cut-off time based on the trading deadlines. Participant transactions requested before the cut-off time are submitted the same day. Requests made after the cut-off time are submitted the next day.

[C] Trading Partner

A **trading partner** provides daily fund pricing information and handles the placement of trades and physical movement of the money related to those trades. Other responsibilities include monitoring the dividend and capital gain income distributions. The trading partners also provide settlement information on completed trades and daily pricing by working with the separate mutual funds. Trade files are normally transmitted to the trading partner.

[D] Transfer Agent

The **transfer agent** is the entity actually responsible for the buying or selling of the mutual fund shares. Each mutual fund selects or contracts with its own transfer agent. The agent keeps track of shareholdings in retail accounts. It is common for larger mutual fund companies to act as their own transfer agent.

[E] Forward Pricing

Forward pricing means that the buy and sell prices (e.g., the NAV) are computed at the close of business of the New York Stock Exchange on the day that the order to purchase or the request for redemption is received. All purchases and redemptions by a mutual fund are made on the basis of forward pricing.

[F] Service Agreements

A **service agreement** is a written agreement that establishes the terms of service with respect to the relationship between the plan sponsor and the retirement plan administration firm. Service agreements may require contribution transactions be traded by noon of the second business day after receipt; transfers requested on an automated response unit may be guaranteed to be traded by noon of the next business day.

Service Agreements may require the service provider to make whole or otherwise compensate participants for any losses incurred as a result of the failure to meet the agreed-upon trading deadline.

[G] Inside, Outside and Alliance Funds

An **inside fund** is one managed by the same entity responsible for providing the recordkeeping services. Inside funds have more flexibility with trading deadlines if a single investment company has control over the trade prices; for example, same day trade prices are used if trades are placed by the end of the business day (e.g., 4 p.m., EST).

An **outside fund** refers to a fund traded through another vendor. Trading deadlines on outside funds are closely tied to stock market deadlines. In order to obtain today's prices, for example, the trading deadline is typically early afternoon (e.g., 2 p.m., EST).

Alliance funds are outside funds that have formed an agreement, or alliance, with the recordkeeping company to discount fees and/or offer more flexibility in trading deadlines. Alliance funds also share the same flexibility with trading deadlines as inside funds have. Banks, in particular, offer a "mix" of these fund types to their clients.

[H] Trade Settlement Dates

The investment industry does not consider a transaction to have occurred when it is initiated; rather, the transaction is deemed to have occurred only after it has been completed, or settled. The **settlement date** is the day that money from a sale is available for another purpose or the money for a purchase has been used to buy the shares. In other words, the settlement date is the day the movement of money has been completed.

Settlement times vary with the investment institution but can be as soon as same-day or as long as three business days after the trade is placed. The transaction is deemed to have occurred retroactively to its trade date once it is settled. The date a fund trade—purchase or sale—is placed is called T, its trade date.

- T+1 is the day after the trade date. This is commonly the day the trade is confirmed;
- T+2 is 2 days after the trade date. This is commonly the day the trade settles;
- T+3 is 3 days after the trade date; and
- The same principle applies for T+4, T+5 and so forth.

The length of time it takes to settle a trade is a function of the number of processing layers. Investment regulations require that mutual funds be settled within three days of the trade date, or T+3. Mutual funds that act as their own transfer agent usually can complete the process by T+2; however, when more than one fund family is involved in the transactions, it may delay settlement until day three (T+3). Stock traded on the exchange has a three-day window to be settled.

[I] Fund Positions

Fund positions are the number of shares of each mutual fund held by the plan. Fund positions may be maintained by the trading partner, trustee or custodian and are reconciled to the recordkeeping system each day.

§10.05 Trading Process

Funds are bought and sold, or traded, in response to either instruction from the plan sponsor or the elections made by participants through the use of an automated response unit or by completing a written form.

It is important to recognize that there are four parties involved in every trade:

1. The recordkeeper with its automated system;
2. A trading partner;
3. The transfer agent; and
4. The mutual fund company or investment manager with whom assets are being invested.

[A] Participant Level Request

Transactions initiated by participants involve money already on deposit with the trustee/custodian and invested in mutual funds. The request may involve moving money from one fund choice to another or withdrawing dollars for a loan or other in-service payment. Any of these participant initiated transactions require seven steps:

Step 1 Participant initiates transaction by completing written form or through automated response unit, such as voice response unit or Internet.

Step 2 Recordkeeper processes transaction; recordkeeping system creates and sends a communication to the trading partner to buy and sell shares.

Step 3 The Trading partner sends net buy and sell orders to the transfer agent (possibly via a central clearing and settlement organization, such as the NSCC).

Step 4 Transfer agent buys and sells mutual fund shares.

Step 5 Transfer agent sends communication to trading partner with results of buys and sells (again, possibly through a central clearing and settlement organization).

Step 6 Trading partner notifies recordkeeper of trade settlement.

Step 7 Recordkeeper posts trade results and updates data reported through automated response systems.

[B] Employer Level Request

Contributions are the most common form of transaction initiated by the employer.

Step 1 Employer deposits contribution dollars with trustee/custodian and forwards electronic payroll data file to recordkeeper.

Step 2 Recordkeeper processes contributions; system creates and sends communication to trading partner to buy shares.

Step 3 Trading partner sends buy orders to transfer agent.

Step 4 Transfer agent buys mutual fund shares.

Step 5 Transfer agent sends communication to trading partner with results of buy.

Step 6 Trading partner notifies recordkeeper of trade settlement.

Step 7 Recordkeeper posts trade results and updates data reported through automated response systems.

Step 8 Confirmation may be sent to the employer if appropriate for the type of transaction.

The recordkeeping system used in daily valuation maintains participant records using a share accounting method. The system is usually automated with the trading partner or directly with the mutual funds themselves in order to place the trades, confirm the trades, and receive prices, fund positions, dividends and capital gain distributions.

Most daily recordkeeping systems are automated so that the majority of activity is initiated through some Automated Response Unit (ARU) although distributions and loans might be handled manually outside that system. Each business day, the recordkeeping system creates trade files that summarize the buys and sells that are needed to complete the investment, transfer, distribution or other activity requested by a participant. This trade file is then sent electronically to initiate the trades.

Where a bank or other investment firm provides recordkeeping services as well as sells the actual funds, the trading itself is most likely managed by the trading area of the operation rather than by the recordkeeping unit. An investment company that permits participants to select funds other than those specifically managed by the investment company generally uses an outside trading partner.

§10.06 Trading Partners

Trading activity is usually managed through a trading partner. A retirement plan administration firm may work with more than one trading partner. In order for the firm to decide which trading partner is the best for them they should consider the following:

- How automated is the partner and is there already a link with the firm's recordkeeping system and the transfer agents?
- What mutual funds are available?
- How cost effective is the trading partner and are there fees for trades placed (*i.e.,* are there charges by trade and, if so, how much per trade)?
- Does the trading partner provide revenue sharing, 12b-1 fees and sub-transfer agent credits to the retirement plan administration firm?
- Do they provide a custodial relationship or does the retirement plan administration firm have to establish its own? Custodians often provide check writing and distribution processing, including Form 1099-R reporting and income tax withholding remittance.

A trading partner presents the retirement plan administration firm with a menu of mutual funds that the trading partner can trade in an automated fashion. The trading partner, in turn, is automated with the transfer agent used by the mutual fund. A transaction starts out in the recordkeeper's system, moving through the mutual fund company via the trading partner and transfer agent and back again to the recordkeeper. The electronic links are key. Without them, there is a substantial risk that trades may not be placed or confirmed effectively, although some operations still attempt to manage trading by fax or phone. This manual trading often results in trading errors.

In a daily valuation environment, there has to be immediate feedback about the trades, and that requires automation. When a relationship is established with a trading partner, it is critical to know which funds are linked through automation and which require manual trading. Some trading partners have mutual funds with which they cannot trade electronically. This could be due to the size of the fund. While this does not necessarily cause any specific problems in operation, it is, however, something to understand about any trading partner.

§10.07 Transfer Agents

The transfer agent is the entity that is really doing the buying or selling of the actual shares. The transfer agent is paid a fee to provide sub-accounting for the mutual fund's retail accounts. Many mutual funds use an organization called DST Systems; larger mutual fund companies often act as their own transfer agent or have a bank act in that role. A major stock transfer agent is Depository Trust Corporation (DTC).

It is important to investigate the level of automation between the trading partner and the transfer agent. Sometimes, it is assumed that there is automation between the trading partner and all of the mutual fund and transfer agent systems. There may be 500 funds available through the trading partner, for example, but only subsets have automated links. The other funds work with the trading partner via fax or phone instructions, returning confirmations in the same format. The trading partner manually updates the trade confirmation file that is returned to the recordkeeping system. This manual activity presents the possibility for errors on trades.

Even when automated, there can be a breakdown should the systems of a trading partner, recordkeeper or transfer agent fail to operate properly on any given day. For example, if the transfer agent's system crashes, the trade confirmation file may not return to the recordkeeping system. The recordkeeper should expect such breakdowns to occur and have procedures, or soft systems, in place that alert them to the system failures.

[A] Evaluating Trading Links

When retirement plan administration firms are setting up relationships with trading partners, they should ask questions of the various parties to understand their systems capabilities and limitations, what safety valves are in place and how often they experience problems with their trade files. How often should the recordkeeper expect to have trouble getting trades placed or confirmed?

Mutual fund companies and transfer agents are still perfecting their systems for dealing with the retirement plan market. It is important to expect additional work when dealing with mutual funds that are not traded through automated systems.

[B] Areas of Importance for a Relationship with a Trading Partner

<u>1. Advantages of Automation</u>

The electronic transfer of data is key to an efficient recordkeeping operation. Automation results in:

- More accurate information because of reduced errors when placing and confirming trades;
- Less time spent placing and confirming trades—manual trading requires making phone calls, staffing so that someone is always available to place the phone calls or send the faxes at the proper time and sifting through paper to match trade orders and confirmations;
- Elimination of manual posting of trading results; and
- Updated current balance information being available quicker as systems transmit prices.

2. Omnibus Level Trading

The recordkeeping system may create separate trade files each day at the plan level or single trade files with separate trade records for each plan. At trading time, a recordkeeper may have many such trade files/records ready to transmit to the trading partner. These files/records may have common mutual funds to be traded. If the trading partner executes each trade separately, it is known as plan level trading; however, if the trading partner rolls up all of the trades it receives in a single day, this is known as omnibus level trading or net trade settlement. Omnibus level trading is considered more cost efficient than plan level trading since it nets buys and sells from the same fund across plans and should reduce transaction costs. It also causes fewer dollars to move back and forth. It may also increase the number of investment opportunities available to the plan sponsor because many mutual fund share classes have minimum asset level requirements that can be overcome if trading at an omnibus level rather than at the plan level.

3. Continuous Net Settlement

Continuous net settlement is a service offered by the National Securities Clearing Corporation (NSCC) that is similar to omnibus level trading. Trades are still netted to reduce transaction volume and the movement of money, but trades are submitted at the plan level and netted by the NSCC. This creates efficient trading similar to omnibus level trading but allows each plan (and broker if applicable) to retain its identity at the fund company.

4. Efficient Trade Settlement

The ideal trading partner works with a single transfer of funds, rather than separate transfers to each mutual fund company involved in the trades being ordered.

5. Sub-Transfer Agent Fees

A transfer agent provides sub-accounting for shareholders of the mutual fund's retail accounts, and the mutual fund pays the transfer agent a fee for this service. In the qualified plan market, the recordkeeper is filling the role of the transfer agent by maintaining the records for the individual participants (i.e., shareholders).

The mutual fund company continues to pay the transfer agent the transfer agency fee because it is part of the fund's pricing structure, even though the service is not being provided on the retirement plan accounts. A number of mutual fund companies—through the trading partner—provide sub-transfer agent credits. These credits may be shared with the recordkeeping firm; however, the trading partner sometimes retains that income for its own purposes, perhaps offsetting their fees.

6. Balancing Fund Positions

The single most important daily activity is reconciling trade discrepancies every day. In a fully automated relationship, reconciling means the recordkeeping system looks at the trading partner's trade confirmation file to see what differences exist. Sometimes the reason for the discrepancies is obvious, for example, at the end of month or quarter when the mutual funds pay dividends or capital gains. The account balances, or fund positions, reported each day for each plan should tie to the account balances of participants. If the recordkeeper does not perform this reconciliation, the information reported on the automated response systems could be wrong.

§10.08 Working Directly with Mutual Funds

If a retirement plan administration firm wants to trade directly with the mutual fund, the firm must build the electronic links needed between its recordkeeping system and each individual mutual fund company that it wants to work with. This can be very expensive and time consuming, although there may be no other alternative especially if the fund is not available on another established trading platform.

§10.09 Mutual Fund Trading through the NSCC

The National Securities Clearing Corporation (NSCC) is a wholly owned subsidiary of the Depository Trust and Clearing Corporation (DTCC). The purpose of the NSCC is to provide the financial services industry with centralized clearance, settlement and information services. For retirement plans, this basically means the NSCC can provide a single clearing entity for all mutual fund trades, rather than trading with each mutual fund family separately. Theoretically, this brings a level of trading efficiency to the retirement plan market that can simplify the trading process and reduce the amount of time involved. This benefits both plan sponsors and participants.

It is important to understand that the NSCC provides a wide range of services. The focus here is only on mutual fund trading for retirement plans administered by a retirement plan administration firm.

There are a number of different ways that trades can be sent and settled. Please refer to Appendix D (Mutual Fund Trading Through the NSCC) for a summary of the two primary methods of trading through the NSCC.

[A] Additional NSCC Terminology That May Be Encountered

- **Fund/SERV**: This is the name of the NSCC automated system that clears and settles mutual fund trades.

- **Networking**: This is the name of the NSCC automated system that provides additional customer information, such as updated positions and dividend information.

- **Mutual Fund Profile Service**: This service provides timely information on daily prices as well as dividend rates.

- **Defined Contribution Clearance and Settlement (DCC&S)**: An extended service that leverages existing technology (as mentioned above) to provide after-hours trading for retirement plans. This higher-level service is aimed at providing additional flexibility to shorten the trading cycle.

§10.10 Key Terms

Alliance Funds: Outside funds that have formed an agreement with the recordkeeping company to discount fees or offer more flexibility in trading deadlines.

Forward Pricing: When the buy and sell prices are determined as of the close of business of the NYSE on the day the order or redemption is received.

Fund Position: The number of shares of each mutual fund that are held by the plan.

Inside Funds: A fund managed by the same entity that provides recordkeeping services.

Omnibus Level Trading: Combining trade amounts for multiple plans to create net transactions.

Outside Funds: A fund managed by someone other than the entity that provides recordkeeping services.

Settlement Date: The day that money from a sale is available for other purposes.

Trade: A purchase or sale of a security.

Trade Partner: Provides daily fund pricing information, handles the placement of trades, the physical movement of money related to those trades, monitors dividend and capital gain distributions and provides settlement information.

Trading Deadline: The time by which all trades must be placed.

Transfer Agent: The entity actually responsible for the buying and selling of mutual fund shares.

§10.11 Review of Key Concepts

- Daily valuation can be viewed as a circle. After the participant initiates a transaction, the request automatically flows through the recordkeeping system to the trading partner, who forwards the trade on to the transfer agent of the mutual fund involved. The transaction is executed, flows back through the transfer agent and trading partner, back to the recordkeeping system and is then refreshed on the VRU/Web—where the participant initially requested it.

- Trading partners facilitate daily trading by handling the placement of trades and physical movement of money related to those trades, providing settlement information on completed trades, monitoring and reporting dividends and providing daily pricing and position updates.

- The transfer agent is the entity that actually performs the buying and selling of the mutual fund shares.

- An inside fund is one managed by the same entity responsible for the recordkeeping services.

- An outside fund refers to funds traded through another vendor.

- Alliance funds are outside funds that have formed an agent with the recordkeeping company.

§10.12 Review Questions

[A] True or False

______ 1. The practice of combining trades from multiple plans to create a net trade transaction is known as leveling trades.

______ 2. The number of shares of each mutual fund held by the plan is its fund position.

______ 3. Funds offered through an alliance with the recordkeeping company offer flexibility in trading deadlines.

[B] Multiple Choice

4. All of the following are activities of a recordkeeper and its system in a trade request, **EXCEPT:**

   A. Recordkeeper receives the transaction from the automated response unit
   B. Recordkeeping system creates a communication to the transfer agent to buy and sell shares
   C. Recordkeeper is notified of trade settlement
   D. Recordkeeper posts trade results
   E. Recordkeeper updates the automated response unit

5. All of the following statements regarding fund types are **TRUE, EXCEPT**:

   A. Trades of alliance funds use same day trade prices if placed by the end of the business day.
   B. Outside funds have trading deadlines before the end of the business day in order to receive the same day's prices.
   C. Inside funds have trading deadlines by the end of the business day to receive prices of the previous day.
   D. If a single investment company has control over trade prices, same day trade prices are used if trades are placed by the end of the business day.
   E. The end of the business day refers to the stock market business day.

6. All of the following activities are required after a participant initiates a trade request, **EXCEPT**:

   A. Recordkeeping system sends buy/sell request to trading partner
   B. Trading partner collects buy/sell orders and sends them to the transfer agent
   C. Trading partner buys and sells the mutual fund shares
   D. Trading partner notifies recordkeeper of trade settlement
   E. Recordkeeper posts results and updates the automated response unit

§10.13 Answers

1. **False.** The practice of combining trades from multiple plans to create a net trade transaction is known as omnibus level trading. §10.04 [B]

2. **True.** The number of shares of each mutual fund held by the plan is its fund position. §10.04 [I]

3. **True.** Funds offered through an alliance with the recordkeeping company offer flexibility in trading deadlines. §10.04 [G]

4. The correct answer is **B.** §10.05

   A. Incorrect. This statement is true because the recordkeeper receives the transaction from the automated response unit.
   B. Correct. This statement is false because the recordkeeping system creates a communication to the trading partner to buy and sell shares
   C. Incorrect. This statement is true because the recordkeeper is notified of trade settlement
   D. Incorrect. This statement is true because the recordkeeper posts trade results.
   E. Incorrect. This statement is true because the recordkeeper updates the automated response unit.

5. The correct answer is **C.** §10.04 [G]

   A. Incorrect. This statement is true because trades of alliance funds use same day trade prices if placed by the end of the business day.
   B. Incorrect. This statement is true because outside funds have trading deadlines before the end of the business day in order to receive the same day's prices.
   C. Correct. This statement is false because inside funds have trading deadlines by the end of the business day to receive the same day's prices.
   D. Incorrect. This statement is true because if a single investment company has control over trade prices, same day trade prices are used if trades are placed by the end of the business day.
   E. Incorrect. This statement is true because the end of the business day refers to the stock market business day.

6. The correct answer is **C.** §10.05 [A]

   A. Incorrect. This statement is true because the recordkeeping system sends buy/sell request to trading partner.
   B. Incorrect. This statement is true because the trading partner collects buy/sell orders and sends them to the transfer agent.
   C. Correct. This statement is false because the transfer agent buys and sells the mutual fund shares.
   D. Incorrect. This statement is true because the trading partner notifies recordkeeper of trade settlement.
   E. Incorrect. This statement is true because the recordkeeper posts results and updates the automated response unit.

Chapter 11:
Processing Transactions

§11.01 Learning Objectives

- Discuss the process involved within a daily valued plan in executing trades to process contributions, distributions and loans.
- Describe the four types of fund transfer requests for money already invested in a participant account.
- Identify the common payroll processing problems that occur in a daily valuation plan.

§11.02 Introduction

Many transactions occur in the recordkeeping of a daily plan, although certain types are processed more frequently than others. The number of participants in the plan, frequency of payrolls processed, dividend payment schedules, the type of plan and the plan options available all work together to influence the number of transactions to be processed on any given day. This chapter focuses on the processes involved in placing each type of trade, from the initial request to the final check being cut or purchase being made.

Flowcharts are included as Appendices at the end of the course to help the reader visualize the activity that occurs.

In a perfect world, standard transaction processing occurs as outlined in this chapter without a problem. However, we all know there is no such thing as a perfect world, particularly in retirement plan administration. There are always unusual or special circumstances that add complexity to daily processing. This chapter also focuses on many of those special processing issues, such as common payroll problems.

§11.03 Transactions

A **transaction** is a trade processed as a result of contributions, dividends and other income received, transfers of funds between investments and distributions from the plan (in-service withdrawals, loans, hardship distributions and termination distributions). There are three parts to a transaction: the price per share, the dollars exchanged and the shares bought or sold.

A transaction can be **dollar certain**, that is, the dollars are the part of the transaction that is known and does not change. Or a transaction can be **unit certain** with the shares being the part of the transaction that is known.

There are three parties that can initiate a transaction:

1. The participant; transactions occur when a participant requests a transfer, distribution, loan, hardship, in-service withdrawal or a rollover.
2. The plan sponsor; initiates transactions by making contributions or by requesting asset liquidation.
3. The mutual fund company; initiates a transaction when it pays a dividend, capital gain or income on the fund.

There can be numerous parties involved in a transaction. The start-to-finish process takes longer when more service providers are involved. A single transaction may require actions by some or all of the following: participants, plan sponsors, payroll providers, recordkeepers, trustees or custodians, trading partners, transfer agents, mutual fund companies, insurance companies or banks.

The processing time may be shortened in situations where one firm plays more than one role. For instance, in some plans the trustee is also providing the recordkeeping, as well as providing the trading partner and transfer agent functions through different operating units of its organization.

There are many ways in which each type of transaction can be processed. Here, we portray some common scenarios.

§11.04 Contributions

Employers withhold elective deferrals or after-tax employee contributions from employee paychecks and forward those dollars to the trust for investment according to each participant's directions. Some employers submit each payroll as it occurs, while others submit data on a monthly basis, even though payrolls occur more frequently. Payroll information ordinarily contains contributions and loan repayments to process.

Payroll tapes, diskettes and CD's can be used by an employer to transmit data to a recordkeeper. Using the Internet, many employers send files electronically to the recordkeeper's bulletin board by e-mail or over a modem directly into the recordkeeping software. The more automated the payroll process is, the better the chance for error-free and cost-efficient processing.

In the simplest of environments, payroll information is manually input into the recordkeeping system from a paper report and compared to the dollar amount deposited to the trust. Ideally, the recordkeeping software automatically divides (or splits) the dollar amounts contributed by the participants according to their investment elections, which have already been coded into the system.

When this phase of processing is complete for the day, the software totals the investment splits. These splits are summarized across the recordkeeping system by fund and by plan, and the software creates what is known as a **trade file**, which is sent to the trading partner to order the purchases of fund shares.

Participant contributions made to a 401(k) plan are to be deposited to the trust as soon as administratively possible after being withheld from the employees' pay. The employer usually wires the money or mails a check to the trustee for deposit to the trust. In some cases, about two to three days prior to a pay date and in other cases on the day payroll is processed, the employer or payroll provider sends the recordkeeper either a paper copy or an electronic file of the payroll data. This data identifies which employees have made contributions and how much each employee contributed for the period being reported. The file also may report employer matching contributions, employee salary information, hours worked for each employee, as well as other census data elements, including home address and dates of birth, hire and termination of employment.

Most recordkeepers commit to processing payroll files within one to five business days after receipt of the file. The turnaround time for processing of payroll files is often a subject of the service agreement between the plan sponsor and the firm responsible for the recordkeeping function.

The primary purpose of processing the file is to determine how the contributions are to be invested based upon the elections of the participants. These elections are input to the recordkeeping system and used to divide, or split, each participant's contributions.

The recordkeeper communicates the investment splits to the trustee and/or investment firm. This communication may be in the form of an electronic trade file, a written instruction that is faxed or a phone call followed by a written communication.

For purposes of this chapter, transactions are assumed to be transmitted between the parties involved by means of an electronic trade file. Keep in mind that the process may not be fully automated and may involve faxes and phone calls, as well as other types of paper communications.

If the communication is received before the trading deadline, the purchases are made the same day; otherwise, the purchase is ordered the following day. Trading deadlines vary based on the type of asset being traded, the time zone of the trading partner and the efficiency of the trading agency. Money market accounts tend to have earlier trading deadlines than most mutual funds.

Often, the trustee is the entity that sponsors, or offers, the package of investments; for example, a bank may be the trustee and also the trading partner. Upon receipt of the trade file from the recordkeeper, the trustee makes an internal transfer of the funds from the separate trust account maintained for the plan to the appropriate investment accounts. The trustee credits the trust account with the number of shares of each fund purchased.

If the trustee is not the entity that sponsors the investment funds, the trustee wires the money to the transfer agent. The transfer agent handles the purchases of shares of the various mutual funds.

After the purchase is completed, the recordkeeper receives some form of communication from the trustee, the investment firm or the transfer agent that handled the trades. It contains a confirmation of the number of shares purchased of each mutual fund, the price per share and the dollar amount of the purchases. Again, this communication may be in the form of an electronic trade file, a fax, a phone call, or a trade confirmation received in the mail. This information is normally received one to three business days after the trade is made.

Upon receipt of the trade results, the recordkeeper posts the number of shares purchased with the dollars available and allocates the shares to the participants who invested contributions in each of the funds. When the data on the automated response systems is refreshed, or updated, a participant hears the change in value of his or her account.

Automation is key for every step—from delivery of the payroll data to the recordkeeper, to the receipt of the trade file from the trading partner—to ensure efficient and timely investment of the contributions.

Please refer to Appendix E, Contribution Processing, for flowcharts detailing four different illustrations of the process to invest contributions. As can be seen, more time is needed to complete the transactions as more service providers are added to the process.

§11.05 Transfers/Exchanges

Transfers involve movement of the money already invested in the participant's account. This type of transaction always involves a two-step process:

1. The selling of shares not wanted; and
2. The buying of desired shares.

Some plans allow transfers to occur at any time and as often as the participant wants. Other plans limit the number of transfers allowed during a year and/or impose a waiting period before another transfer can be requested.

Some plans permit participants to separately direct the transfers for each source of funds. For example, a participant may request realignment of his 401(k) funds but not of his matching contributions.

A transfer request may be in writing on a form that is delivered to the employer, who then passes it on to the recordkeeper. In daily valuation, the participant more typically makes the request by phone, through an interactive voice response system (IVR), or through the Internet at the plan's Website. In fact, many recordkeepers require transfers be accomplished electronically and either do not accept paper forms or charge extra to process them.

Recently, many fund companies have imposed certain limits on frequent trading, which represents multiple and frequent transfers in and out of the same fund in an attempt to time market swings. This practice inherently hurts fund performance, and thus, the potential returns of other shareholders. Fund companies may require retirement plan administration firms to monitor, report and somehow limit the ability to trade for those who are using this abusive practice.

A discussion of transfers or exchanges requires an understanding of the types of transfers that could be requested. It should be noted, however, that all of these types of transfers are not necessarily available in all plans.

[A] Realignment or Rebalancing

A realignment transfer produces a specific fund mix for the participant. The participant's instruction essentially tells the recordkeeper to make the accounts "look like this." For example, a participant wants 50% of his or her account invested in the stock fund, 25% in the bond fund and 25% in the money market fund. These percentages are input and the daily valuation system determines how much to buy and sell from each of the funds to achieve the desired result.

This type of transfer is frequently requested and is sometimes the only type of transfer available to the participant due to the complexity of the transfer process and system processing constraints. Participant education programs often encourage participants to rebalance their accounts to their original investment strategy on a periodic basis – monthly, quarterly, semiannually or annually.

[B] Dollar-to-Dollar

A dollar-to-dollar transfer allows the participant to specify the dollar amount to buy and sell in each fund. The participant may instruct the system to sell $15,000 from the money market account, for example, using the proceeds to purchase $5,000 in the bond fund and $10,000 in the stock fund. A participant may have been able to accomplish the same result using the rebalancing technique described above; however, some participants more easily deal with dollar concepts than with percentages.

[C] Percent-to-Percent

This type of transfer, again, can produce the same ultimate asset allocation as those described above. In a percent-to-percent transfer, the participant requests the sale of a certain percentage of a fund, with the proceeds invested in other funds in percentages.

Suppose a participant requests the sale of 100% of his or her money market. The participant's instruction also must provide for investment of the proceeds; for example, 25% to the bond fund and 75% in the stock fund. The daily system calculates how many shares of the money market to sell and, upon receipt of the trade results, how many dollars are used to purchase shares of the bond and stock funds.

[D] Dollar-to-Percent

A dollar-to-percent transfer allows the participant to specify the exact number of dollars to be sold from a fund, with percentages used to determine the purchases of the preferred funds. For example, a participant requests $25,000 be sold from the bond fund. 20% of the proceeds are used to purchase money market shares, and the remainder, or 80%, to purchase shares of the stock fund. The daily valuation system computes the dollar amount to purchase of each fund. This same result could be accomplished using the dollar-to-dollar method.

[E] Processing Transfers

Transfer transactions are either unit certain trades or dollar certain trades. A dollar certain trade is one where the trade is defined in terms of dollars. A unit certain trade is created with reference to the number of shares to sell.

When a transfer request is made that requires the sale of more than 80% of the shares held in a fund, a unit certain sale is usually made even though a dollar certain transfer is requested. This is necessary because the price per share fluctuates each day; thus, the value of the participant's account fluctuates, and the fluctuation may cause the value of the shares to be less than the dollars requested to be sold. In order to avoid this variance, the sale is calculated in terms of the number of shares that it takes on the day of the request to equal the amount of dollars involved in the transfer. The dollars may be more or less than what was actually requested when the actual buy or sell occurs; however, the resulting transfers are as precise as possible when compared to the participant's original request.

Depending on the timing of the transfer request, the sale portion of the transfer occurs the day the transfer is requested by the participant. Typically, the corresponding purchases occur either the same day or sometime the next day. The timing is a function of how efficient the transfer agent is, how many fund families are involved and whether the asset being bought or sold is a mutual fund, employer stock, an insurance company contract or a money market fund.

The recordkeeper communicates the necessary transactions to the trustee or investment firm using the same process described for contributions. The trade file is sent to the appropriate party to set up the sale part of the transfer and the file is returned with the results of the sale (shares, dollars).

The recordkeeper updates the daily system accordingly and then the system calculates the purchase trades needed to complete the transfer. Another trade file is sent to the trustee or transfer agent to make the fund purchases. The trade file that is returned is used to update the daily system.

During this process, the data on the automated response systems, such as the IVR or website, is being updated for the portion of the transaction that has settled. Participants are normally blocked from initiating any other transactions until all of the transactions associated with the transfer are posted.

Through technological advances, it is now common to trade both the sell and the corresponding buy the same day, even between different fund families. Again, however, it depends upon the abilities of the trading partner and transfer agents involved. With this process, sell trades are typically sent with the corresponding buy instructions. The trading partner or transfer agent values the buys after prices are determined and received and then submits the trades for execution. When confirmed the next day, the IVR/Web application is updated. Significant time can be saved while greater level of service is being provided.

The time by which the transfer must be requested to be acted upon the same day varies with (a) the fund being bought or sold, (b) whether the transaction is initiated by paper, IVR, or via the Internet and (c) trading deadlines imposed on or by the recordkeeper.

§11.06 Distributions and Withdrawals

Distributions may be requested to satisfy full or partial payment of benefits due to terminated participants. Active participants may make withdrawals if the plan permits such hardship or in-service benefits. The transaction process is similar for all of these types of benefit payments. The participant initiates a distribution or withdrawal request by completing the proper paperwork or by requesting the payment through the automated response system.

Upon receipt of a distribution request, the recordkeeper verifies the hours worked for the year of termination, determines the vested percentages for each source of money and verifies that the participant has executed the appropriate paperwork, including qualified joint and survivor waivers, if applicable. The recordkeeper usually checks to be sure the plan has received and invested all contributions for the participant, particularly if a distribution of the entire account is requested. In addition, the recordkeeper should verify whether or not the participant's state of residence requires state income tax withholding along with the federal withholding. State income tax withholding rules vary widely when it comes to retirement plan distributions.

A total distribution is processed as a unit certain sale. If more than 80% (this percentage may be as high as 95% and it varies by software and administration firms) of the participant’s balance in a fund must be sold to cover a partial distribution or a withdrawal, the sale is usually a unit certain sale. Most hardship withdrawals or other in-service payments are dollar certain sales.

The trade file is sent to the trustee or investment firm. The trades are placed and the trade file returned to the recordkeeper. The dollars and shares sold, along with the price per share, are posted to the daily system. Checks are prepared and sent either to the plan sponsor, directly to the participants or to their rollover account. This process may take as little as five days or up to twenty days, depending on the number of institutions involved and the efficiency of each.

Please refer to Appendix F, Distribution Processing, for two different flowcharts illustrating how a distribution transaction might be processed.

§11.07 Loans to Participants

Many plans permit participants to take a loan from their account. As with other transactions, participants may request loans using a variety of media. Some plans require a written loan application be submitted to the plan sponsor, while others allow the participant to initiate the loan using the automated response units, such as the interactive voice response system or the website.

Upon receipt of the loan request, the recordkeeper checks the loan limits that apply to the participant. Assuming the transaction falls within the plan’s limits, the recordkeeper prepares the promissory note and collateral agreement, although sometimes another party generates these documents.

The plan's written loan procedures must be followed when raising cash for the loan. For example, the procedures may require loans to be funded first from the 401(k) account, then from the matching account and that the cash is made available by equal withdrawals from each of the investment options in which the participant is invested. These are known as the loan hierarchy rules and they always include instructions regarding the:

- Sources of funds available; and
- Order in which the investment funds are liquidated.

Based upon the plan's loan hierarchy and other written procedures, the recordkeeper places trades to obtain the needed cash. The trades are normally dollar certain trades, unless the amount of the loan requires a liquidation of at least 80% (this percentage may be as high as 95% as it varies by software and administration firms) of the participant's balance in a particular fund, in which case a unit certain trade is made. A unit certain trade may cause the proceeds to be more or less than what is needed.

When shares are sold, the amount of the proceeds is dependent on the price per share on the day the shares are sold. A dollar certain trade involves selling the appropriate number of shares to obtain the dollars that are needed, given the share price at the close of business on the day the trade is placed. If more cash is ultimately liquidated than needed, the excess is simply reinvested to the participant's account based on the method used to liquidate the funds. Should there be a shortage of cash, the amount of the loan is usually adjusted to reflect the actual amount of cash available from the sale.

The recordkeeper sends the trade file to the trustee or investment firm. The trades are executed to obtain the cash for the loan. The trade results are sent back to the recordkeeper and posted on the system. The trustee receives the cash and forwards the loan paperwork along with the check for the loan to the plan sponsor. The plan sponsor has the participant execute the loan paperwork in exchange for the loan check. It may take ten to twenty days to process a loan. In some cases the check may be sent directly to the participant if the loan paperwork was signed in advance of receipt of the check.

Transactions that affect a loan generally follow the same pattern as those for distributions, as illustrated in the flowcharts in the preceding section.

It is important to be aware that some recordkeepers now offer paperless loans: loans that can not only be requested via IVR/Web but also can be processed electronically. The loan check is prepared and sent without manual intervention. Generally, certain conditions must be met, and by endorsing and cashing the check, the participant is deemed as accepting the conditions of the loan.

§11.08 Common Payroll Processing Issues

Certain problems routinely surface during the processing of payroll information. Some of those problems are missing investment election forms, ineligible participants, participants already paid out and processing payroll contributions when the amount on the file does not match the deposit.

[A] Missing Investment Election Form

The processing of payroll data to develop the trade file is contingent upon the participants' investment elections already being coded into the recordkeeper's software. The plan sponsor can instruct the recordkeeper to allocate the money to a default fund if the investment direction form has not been submitted for a participant. The use of a default fund must be disclosed to the participant, and the plan sponsor identifies the default fund as part of the plan installation or conversion process. Note that setting a default fund is a fiduciary decision as discussed in Chapter 6 and shifts the investment liability back to the fiduciary.

Procedures vary in this regard. Sometimes the employer requires the recordkeeper to hold the contribution until the investment election form can be obtained; however, this may involve delaying the investment of the entire payroll withholding, not just the withholding for the individual participant whose election form is missing.

[B] Ineligible Participant

The employer may inadvertently submit a contribution for an employee who is not yet eligible to participate in the plan. When this occurs, a common correction method is the inclusion of an equivalent negative contribution for the employee on a subsequent payroll. This, in effect, "repays" the employee through payroll thereby correcting the error.

Negative contributions are discussed in further detail later in this chapter.

[C] Participant Already Paid Out

The daily environment significantly speeds up the time by which a distribution can be made to a terminated participant. It is important to confirm that all payroll deductions are recorded on the daily system before any distribution is made to the participant so that costly second (and subsequent) distribution payments can be avoided. Contributions that are submitted after a participant has already taken a distribution are known as **trailing contributions** and can be rejected by the system if the participant's record is already specially coded to refuse any further additions to the account because a distribution on account of termination of employment has been made.

[D] Payroll Contribution Amount Does Not Match Data File

This can occur for a variety of reasons, such as a spreadsheet error made by the person who created the data file or a payroll service provider has a programming error in the creation of the electronic data it submits to the recordkeeper. It is common for this to happen when an ineligible employee is discovered before the file is sent over to the recordkeeper, for example, or when the payroll administrator has issued a manual check that was not incorporated into the payroll database. The ineligible individual is deleted from the data file, but the contribution amount is not adjusted from the amount deposited to the trust. Whatever the cause, the total amount deposited to the trust sometimes differs from the total shown on the file delivered to the recordkeeper.

Because of the above common payroll processing issues and the man hours involved in troubleshooting these types of problems, most automated recordkeeping systems allow for an automatic debit (ACH) from the employer's payroll account. The transfer of funds occurs only after the participant records have been processed so there can be no mismatch between the data file and the deposit.

Some recordkeepers <u>require</u> the employer to enter the participant information and each payroll electronically via modem or the Internet directly into their software. By doing this, the recordkeeper is freed up from importing and auditing the employer's records. These records cannot be transmitted to the recordkeeper until the payroll issues have been resolved and the correct total deposited to the trust. This eliminates any research on the recordkeeper's part, since the employer must track down participant election forms and find any imbalances before payroll records are accepted.

[E] Negative Contributions

The reason a negative contribution occurs is not nearly as important to the recordkeeper as understanding how to process the adjustment on the daily valuation software. There are several common ways to fix the participant's record, so it is critical to understand which method applies to your software.

Manual adjustments may be required in addition to the transactions automatically processed by the daily valuation software. For example, it may be necessary to manually adjust the year-to-date contribution fields.

It is worth noting that the ability of the daily valuation software to automatically process a negative contribution varies depending on the software package being used. In some situations, processing of negative contributions is a completely manual function.

Here are two different ways to make correcting adjustments if something is processed incorrectly and results in a negative contribution. They are:

1. <u>Unit sale</u>. Contributions are processed as dollar purchases. The contribution dollars purchase a specific number of shares of a fund. When the dollar amount

of contributions processed is incorrect, the number of shares purchased is also incorrect.

Some recordkeepers determine the number of shares purchased with the original contribution and redeem the identical number of shares to reflect the negative contribution. For example, $200 dollars of contributions results in the purchase of 20 shares of Fund A (i.e., NAV = $10). When it is determined that the contribution should have been reported as $20, the trustee redeems 18 shares of Fund A. This leaves two shares of Fund A in the participant's account, which is what would have been purchased with the original $20 contribution.

It should be noted that this correction method might generate cash that is either more or less than the $180 adjustment to be made. It depends on whether the fund's NAV has gone up or down since the original purchase.

In addition, this example assumes part of the original contribution and share purchase was correct. However, what if the contribution was made on behalf of an ineligible employee? The same $200 contribution reported for the employee must be taken from the account. If share prices have decreased since the original purchase, the recordkeeper cannot recover the full $200. On the other hand, if share prices have increased, the cash raised from the redemption of all of the shares allocated to the participant raises more than $200.

2. Dollar sale. Another way to make an adjustment for an error in the contributions reported is for the recordkeeper to order a dollar sale. Using the example first shown above, the trustee redeems enough shares at the current NAV to raise $180 of cash.

   While exactly $180 flows to the trust account, the dollar sale may have required the redemption of more or less shares than was originally purchased with the $180. Thus, the participant suffers a loss to the extent the fund's NAV has declined since the original investment. If fewer shares are redeemed because the fund's NAV has increased, the participant's account experiences a gain to the extent shares remain in his or her account.

What happens to the cash that is made available from the corrections? The cash raised from the dollars or shares sold is deposited to the trust account the plan uses to hold uninvested cash for contributions, distributions, loans and so forth. The cash is normally used to offset a future contribution deposit from the employer.

There appears to be no industry standard for handling the gains or losses that arise from transactions to dispose of the negative contributions. Keep in mind that fiduciary rules require that plan assets be used for the exclusive benefit of participants. The treatment of any gain or loss that arises from transactions to accommodate negative contributions is subject to these rules. Therefore, the fiduciary should give specific direction to the recordkeeper regarding this issue.

[F] Loan Payments

We have focused on the contribution data; however, loan repayments made by payroll deduction are part of the payroll data routinely submitted to the recordkeeper. There are two common reconciling issues with loans in the daily valuation environment.

First, some plans permit an individual participant to have more than one loan outstanding at the same time. It is important in these situations for the recordkeeper to apply the separate loan repayments properly to each outstanding loan. The payroll data typically identifies any multiple loan repayments from a single participant with separate entries.

The second reconciling issue arises at the end of the loan repayment period. Often, the daily system has calculated interest that is slightly different from that shown on the amortization schedule originally issued with the loan documents. The participant stops making loan repayments, but a small balance (usually less than $20, depending on the term of the loan) remains outstanding on the system. This difference is attributable to the timing of interest accruals. Generally, the recordkeeper makes manual entries to eliminate these differences from the participant's record.

§11.09 Key Terms

Dollar Certain: The part of the transaction that is known and does not change is dollars.

Trade File: The file sent to the trading partner that summarizes the trade information.

Trailing Contributions: Contributions that are submitted after a participant has already taken a distribution from the plan.

Transaction: A trade processed as a result of contributions, dividends and other income received, transfers of funds between investments and distributions from plans.

Unit Certain: The part of the transaction that is known and does not change is units or shares.

§11.10 Review of Key Concepts

- After being withheld from participants' paychecks, contributions are forwarded to the trust for deposit. The recordkeeper determines the appropriate investment split and forwards instructions to the trading partner to execute the trades. Once trades are executed, the recordkeeper receives confirmation and the shares purchased are then allocated to individual participants, with automated response systems being updated to reflect the new values.

- Transfers, also known as exchanges, involve the movement of existing money from one account to another: selling shares in one fund and buying shares in another fund. Some plans allow participants to transfer at any time; others may limit the number of transfers during a certain period.

- Realignment, or rebalancing, involves multiple transfers to result in a specific fund mix. Dollar-to-dollar transfers involve a participant's request to transfer a specific dollar amount. Percent-to-percent transfers involve participants who identify a percentage of an account to be transferred; whereas, a dollar-to-percent transfer involves identifying a dollar amount to be transferred and split between other funds using percentages.

- Common payroll processing issues include missing investment election forms, contributions on behalf of ineligible employees, trailing contributions for participants already paid out and situations where the actual contribution doesn't match the payroll data.

§11.11 Review Questions

[A] True or False

______ 1. Due to the complexity of the transfer process and system processing constraints, a realignment transfer is sometimes the only type of transfer permitted in the plan.

______ 2. A trailing contribution is when a contribution is made for a participant who has already taken a distribution from the plan.

______ 3. Participants should be held responsible for identifying most trading errors in their accounts.

[B] Multiple Choice

4. All of the following entities are involved in the processing of contributions, **EXCEPT**:

   A. Employer
   B. Recordkeeper
   C. Trading partner
   D. ERISA attorney
   E. Transfer agent

5. All of the following may result when correcting adjustments with a negative contribution, **EXCEPT**:

   A. The unit sale may generate more or less cash than the original transaction.
   B. The dollar sale may result in a loss or gain of shares in the participant's account.
   C. Cash made available from the corrections may be deposited to the trust account.
   D. The industry standard for handling gains or losses from processing negative contributions should be applied.
   E. Manual adjustments in addition to system fixes may be required.

§11.12 Answers

1. **True.** Due to the complexity of the transfer process and system processing constraints, a realignment transfer is sometimes the only type of transfer permitted in the plan. §11.05 [A]

2. **True.** A trailing contribution is when a contribution is made for a participant who has already taken a distribution from the plan. §11.08 [C]

3. **False.** Procedures should be in place to identify most trading errors in participant accounts. §11.08

4. The correct answer is **D.** §11.04

   A. Incorrect. This is true because the employer is involved in contribution processing.
   B. Incorrect. This is true because the recordkeeper is involved in contribution processing.
   C. Incorrect. This is true because the trading partner is involved in contribution processing.
   D. Correct. This is false because an ERISA attorney is not involved in contribution processing.
   E. Incorrect. This is true because the transfer agent is involved in contribution processing.

5. The correct answer is **D.** §11.08 [E]

   A. Incorrect. This statement is true because correcting a negative contribution via a unit sale may generate more or less cash than the original transaction.
   B. Incorrect. This statement is true because correcting a negative contribution via a dollar sale may result in a loss or gain of shares in the participant's account.
   C. Incorrect. This statement is true because cash made available from correcting a negative contribution be deposited to the trust account.
   D. Correct. This statement is false because there is no industry standard for handling gains or losses from processing negative contributions.
   E. Incorrect. This statement is true because when correcting a negative contribution manual adjustments in addition to system fixes may be required.

Chapter 12:
Ethics in Dealing with Trading Errors and Corrections

§12.01 Learning Objectives

- Identify when and how trading errors may occur in the daily valuation environment.
- Discuss procedures to avoid trading errors in the daily valuation environment.
- Identify ethical concerns when correcting common trading errors in the daily valuation environment.
- Discuss the benefits of a service agreement between the service provider and the plan administrator.

§12.02 Introduction

In a daily valuation environment, when trades don't occur as expected, the task of identifying and correcting these situations creates many challenges. This chapter provides scenarios where trading problems occurred because:

- Trades were executed incorrectly;
- Trades should have been executed but were not; and

- Trades should not have been executed but were.

This chapter also offers ways to avoid trading errors and ways to identify trading errors when they are made. Methods for correcting trading errors are based on the type of trading problem that occurred.

Finally, trading accountability, error liability and ethics are discussed.

§12.03 Trading Errors

When trading occurs as expected and intended, the world of daily trading, daily valuation and instant participant access operates smoothly. However, when trades don't occur as expected, the tasks of identifying and correcting these situations create many challenges. In a daily valuation environment, trades were either executed correctly or they weren't. System capabilities may provide different methods of adjustment, but corrections are typically made prospectively with corrective trades.

So, what are typical trading problems with daily valuation plans? How does one identify trading problems? How does one determine the best course of action to correct a problem? And, how does one actually correct that problem? This chapter is intended to address these issues.

Trading problems can best be categorized into three areas:

1. Trades are executed incorrectly (i.e. they're wrong!).
2. Trades that should have been executed were not.
3. Trades that should not have been executed were.

This section provides examples of each trading category, outlines ways to avoid trading errors, identifies when trading errors have occurred, and explores how to correct the trading error and who may be liable.

§12.04 Examples

[A] Trades That Were Executed Incorrectly

Examples of situations where trades were executed incorrectly include, but are not limited to:

- The sponsor's payroll file indicates a participant contributed $200 when $20 was actually contributed (too many shares purchased).
- A distribution is processed multiple times (too many shares are sold).
- The sell side of a dollar transfer is incorrectly valued due to an incorrect price. Thus, the corresponding number of shares sold is incorrect.
- A participant's account is over-valued due to multiple allocation of the same dividend and a distribution is then processed for that participant.

[B] Trades That Should Have Been Executed but Were Not

Examples of situations where trades should have been executed but were not include, but are not limited to:

- A participant properly initiates transfers via the Internet that are not processed (due to a system error, human error, or trading partner error).
- A participant errs in initiating a transfer via the Internet and doesn't know it – the trades never get placed.
- A rollover is submitted for deposit by the participant, but didn't get processed or traded in a timely manner.
- Elective deferrals are deducted from a sponsor's payroll and the cash forwarded to the trading partner for deposit, but the sponsor doesn't provide the recordkeeper with the deposit breakdown.

[C] Trades That Should Not Have Been Executed

Examples of situations where trades should not have been executed include, but are not limited to:

- Contributions were deposited into the wrong participant's account.
- A hardship distribution is submitted for a participant who is later determined not to be eligible for the hardship withdrawal.
- Ineligible participants begin making deferral contributions.
- A billable fee is deducted from the plan rather than billed to the plan sponsor.

§12.05 Avoiding Trading Errors

The best kind of error is one that never occurs. Thus it is important to explore the capabilities of your daily trading system to establish ways trades can be tracked and monitored. As well, it is important to establish appropriate internal procedures to track and validate trades. This helps assure the trades being sent are intended to be traded that day are correct, and confirmation the following day can be validated.

[A] How to Avoid Trading Errors

From an ethical standpoint and as good business practice, all partners involved in the trading process should have written procedures to prevent trading errors when possible. Employees of the trading partners should be trained to follow the procedures and call attention to any errors that cannot be avoided with the procedures in place. The following are ways to avoid trading errors:

- Verify investment allocation percentages have been received and entered for all participants.
- Perform eligibility often enough to make sure ineligible participants don't receive contributions.
- Validate contribution splits received by sponsors and make sure the final trades sent match the original splits and that the totals are correct.
- Track contributions to be sure they are deposited in a timely manner (e.g. the service provider received the contribution from the employer but no participant allocation.)
- Track participant initiated trades made via the IVR or the web to be sure they are traded correctly, or if the transaction erred upon entry, that the participant is aware the trades are not processed.
- Establish procedures to validate distributions entered—is it the right participant, the right amounts, are there any pending trades, have balances been validated prior to transaction entry.
- Continually monitor the validity of the indicative data used on the recordkeeping system.
- Establish procedures to validate eligibility for hardship withdrawals and loans, as well as the corresponding amounts.
- Track all pending activity to be sure trades are executed in a timely manner.
- Use fully audited prices to avoid pricing errors (e.g. incorrect prices result in incorrectly valuing trades that later must be corrected).

[B] Identifying When Trading Errors Have Occurred

System capabilities and internal procedures are also critical here. A recordkeeper must have the right information at the right time to identify the error right away. On any given day, the recordkeeper needs to know what was sent the prior day, compare that to what was confirmed, so as to identify activity that remains outstanding. Reconciliation then occurs daily to be sure all your positions balance with those as reported by your trading partner.

The difficult aspect of trade errors is that they do not necessarily show up during reconciliation. For example, if a contribution is made in error to an ineligible participant, or goes to the wrong participant, positions still balance—this type of error does not show up during reconciliation. While performing eligibility and validating contribution breakdowns can avoid these errors, they may go unnoticed.

The following are some ways to identify trading errors:

- Track trades sent on any given day and compare them to confirmed trades the following day. This allows the recordkeeper to identify rejected trades or trading problems and correct them.
- Identify all pending activity to identify trades that should have been executed and were not (for whatever reason).

- Validate data to see whether ineligible participants have been receiving contributions or whether loan eligibility has been determined.
- Validate that a distribution check is correct and coincides with the participant's account balance prior to mailing the distribution.
- Provide periodic reports to plan sponsors and encourage them to review for accuracy (particularly contributions)
- Reconcile daily.

Unfortunately, participants may also discover errors as they review statements or activity on-line. Establish procedures to gather, verify, and correct errors identified by participants.

[C] Correcting Trading Errors

From an ethical standpoint, the focus of correcting trading errors is not just adjusting positions or trades. Rather, the end result of the correction should assure the participant is not negatively affected by the error. The participant should be made whole, as if the trades were executed as intended.

The same can be said for the plan sponsor. For example, assume a sponsor forwarded a contribution and breakdown with the expectation the contribution would be invested within the service provider's published standard of a few days. For whatever reason, the contribution wasn't invested for two weeks – at a time the market was going up. The contributions purchased fewer shares at a higher price and market gains were forfeited. Ethically, the lost market gains should be restored to participants on behalf of the plan sponsor. If on the other hand, the market had declined, it may be to the participant's advantage not to correct the error. However, the plan sponsor should be made aware of the delay and the consequences.

In many instances, the differences resulting in the incorrect trades can be nominal, having little financial impact on the participant. It may be far more expensive administratively to correct than it is worth. In those instances, it may be appropriate for the plan sponsor or trustee to decide if the corrections are warranted. Retirement plan administration firms also may establish and publish a financial correction threshold and receive the agreement of the plan sponsor or trustee to apply it uniformly in all situations.

As mentioned earlier, the capabilities of the daily trading system also impact how corrections are made. Prospective trades do need to be executed, but there may be a way to correct retroactively on your daily trading system.

§12.06 Correction Methods for Trading Errors

[A] Trades That Were Executed Incorrectly

When it is discovered that a trade was executed incorrectly, basically, corrective trades need to be executed so the end result is the same as if the original trade had been correct. The participant should be made whole as if the error didn't occur.

Here are some examples of how to correct trade errors:

- A participant's contribution was actually $20, but $200 was submitted – too many shares were purchased. This can be corrected by liquidating (submitting a sell trade for) the excess shares that were purchased. Proceeds can then be applied as appropriate.
- A distribution is processed multiple times – too many shares were sold. This can be corrected by repurchasing the excess shares sold. If the purchase price is higher, additional funds are needed for the purchase. If the purchase price is lower, excess funds are available.
- A dollar transfer is incorrect due to an incorrect price on the sell: the sold shares must be corrected to reflect the correct trade by either buying or selling shares. The proceeds for the buy transactions would be unchanged and thus correct.
- A participant's account is over-valued due to multiple allocations of the same dividend. Correct by withdrawing the excess dividend (if cash) or selling the shares the dividend purchased (if shares were allocated to the account).
- A distribution is processed but not paid out – too many shares were sold. This can be corrected by repurchasing the excess shares sold.

Note: In all of the above cases, the corrective action focuses on getting the number of shares correct. The cost of buying or selling these shares almost always is different than the original cost.

[B] Trades That Should Have Been Executed but Were Not

When it is discovered that a trade was not executed when it should have been, the trade needs to be executed, with adjustments made as necessary based on the results of the trade as if the trade occurred when it should have.

Here are some examples of how to correct trade errors that should have been executed but weren't:

- A participant initiates a trade that is not executed: the trade still needs to be executed. If there have been sizable market swings, review the trade results to determine if different results would have been achieved if the transfer had been executed when the participant expected. Apply the correction standard threshold to determine whether the participant's account needs to be adjusted.

- A rollover is submitted but never gets traded: again, the trade still needs to be executed, but review the trade to see if there is a significant enough difference between the shares purchased and what would have been purchased to warrant an adjustment. The standard threshold for an adjustment should be applied to this situation.
- Elective deferrals are deducted from a sponsor's payroll and the cash forwarded to the trading partner for deposit, but the sponsor doesn't provide the recordkeeper with the deposit breakdown. If the recordkeeper is diligent in following up for the breakdown, there shouldn't be a need for any corrective trades.

[C] Trades That Should Not Have Been Executed

When it is discovered that a trade was executed when it should have not been executed, the trades need to be adjusted as necessary as if the trades had never occurred.

Here are some examples of how to correct trades that were executed when they shouldn't have been executed:

- Contributions were deposited into the wrong participant's account. Assuming investment elections are different, the shares purchased must be sold, with the full contribution deposited into the correct participant's account. The proceeds of the sale may be more or less than the required deposit.
- A hardship withdrawal is submitted for a participant who is later determined not to be eligible for the hardship withdrawal. The shares sold must be repurchased. The amount required to repurchase may be more or less than the original proceeds of the sale.
- Ineligible participants begin making deferral contributions. The shares purchased must be sold. There may be differences in the dollar proceeds from the sale compared to the original amount deposited. Regardless of the dollar proceeds received from the shares redeemed, the entire contribution amount should be returned to the participant.
- A fee deducted from plan assets was to be billed to and paid by the plan sponsor. The shares sold must be repurchased to restore each participant's account. The dollars required to repurchase the shares may be more or less than the original dollar amount.

[D] Liability: Who Is Responsible for Paying for Trade Errors?

This is a difficult question of ethics, fair business decisions, good business practices, and the terms of a service agreement. There is no definitive answer.

As an administrator and business owner, it is important to treat customers (plan sponsors and participants) fairly and equitably. At the same time, some degree of protection is necessary to meet revenue and profit expectations. Reasonable and ethical common sense should prevail. In most cases, it is a matter of determining who is accountable for the error.

For example, if a contribution doesn't get invested when it should have due to the plan sponsor's delays in delivering a correct deposit breakdown, the recordkeeper should not be liable for investment losses that may have occurred due to the delay. The plan sponsor is accountable for the delay. This assumes the recordkeeper acted responsibly in the process. For example, did the recordkeeper promptly notify the plan sponsor of the deficiency and resulting delay?

If a trade does not get executed due to the procedural or systems failure of the recordkeeper, the recordkeeper is accountable. It is reasonable that the recordkeeper make the participant whole by making up any investment losses.

In other situations, it may be difficult to determine accountability. When contributions are received for ineligible employees, who is accountable for that determination? Since the sponsor allowed enrollment, it could be argued the sponsor is accountable. On the other hand, it could be argued the plan administrator didn't check eligibility and allowed the contributions to be accepted and invested and thus is accountable for the error.

In these situations, it is certainly helpful to have trading accountabilities outlined in a service agreement—agreed upon up front to avoid confrontational problems. This is also important if significant market losses occur as a result of an error. Who is liable can be an expensive question to answer. A predefined service agreement outlining accountabilities and expectations helps to determine liability. Service agreements are discussed later in this chapter.

Whoever is liable for the trading error may need to supply additional funds to correct the error. Alternately, if the correction results in a financial gain, there may be additional funds available. If the plan sponsor is liable, how the additional funds are provided, and what to do with any excess funds need to be determined. However, in no way should a service provider benefit from the transactions. It may be reasonable for the plan sponsor to keep gains available in the plan trust to pay for losses when the service agreement declares a plan sponsor liable for the loss. Note: This is an area in which judgment must be exercised because there is no guidance from any agency about what to do with gains.

Also, the result of a trading error may be nominal, with little or no financial impact on participant accounts. Market fluctuation may have been very minor. In these instances, it may cost more to correct the error than the error is worth.

Certainly, trading errors call for a reasonable review of the facts and circumstances of the situation to determine the best and most appropriate solution.

§12.07 Service Agreements

Generally, a **service agreement** designates the allocation of responsibilities between all of the parties involved in the operation of the plan. The terms of these service agreements vary based upon the nature of the services provided. Sometimes it may be necessary to have more than one service agreement depending on the manner in which services are provided.

Recent case law has made retirement plan administration firms and other service providers more vulnerable to litigation and claims. Unfavorable market returns and news of questionable business practices leave many plan participants and sponsors ready to seek redress from any available party. One effective way to manage expectations and control a service provider's liability is through a carefully drafted service agreement.

A majority of the service claims are for breach of contract or negligence. These claims are ordinarily brought by a plan sponsor and resolved in state court by a jury trial. Remedies may include any loss actually sustained by the plan, the plan sponsor, or a participant and any additional damages in the unlikely event that fraud or bad faith is established. Equitable remedies, such as injunction or specific performance, also may be available.

In addition to state law, a service provider can be liable under ERISA (either based upon its status as a fiduciary or as a result of participation in a prohibited transaction or similar action). These claims can be brought by a plan sponsor, another plan fiduciary, or by plan participants.

A fiduciary breach or similar ERISA claim must be resolved in federal court by a judge trial. An arbitration clause in a service agreement does not govern the resolution of these matters. Damages are not available. Instead, recovery is limited to equitable relief, which may include the return of any profit or fees obtained from the plan, or non-monetary relief, such as an injunction or specific performance.

[A] Special Daily Valuation Concerns under a Service Agreement

Plans using daily valuation have a number of special issues that can create additional liability for a retirement plan administration firm. These issues need to be addressed in the service agreement to minimize liability and clearly designate responsibility.

<u>1. ERISA §404(c) Liability</u>

Participant directed defined contribution plans are frequently designed to comply with ERISA §404(c), in order to shift the risk of loss for investment performance from the plan fiduciary to participants. There are both plan design issues that are incorporated in the plan document as well as operational issues that must be followed to shift the risk.

A service agreement should include an appropriate disclosure that services provided by the retirement plan administration firm alone cannot guarantee compliance with the ERISA §404(c) requirements.

Compliance with ERISA §404(c) does not relieve the plan sponsor or other fiduciary from liability arising from the selection and monitoring of available investment options. Again, the Service Agreement should clearly specify that the service provider has no liability for the performance of these functions and does not provide investment advice.

2. Fees Paid to Service Provider

If a service provider is to be paid, in whole or in part, by 12b-1 fees, shareholder servicing fees or sub-transfer agent fees, great care must be exercised to avoid a prohibited transaction. The reason for this is twofold: (1) all fees charged to plan participants must be reasonable, and (2) participants must not be charged for settlor functions. If fee amounts paid to a service provider are too high relative to the amount of work involved, then the fees charged to participant accounts are not reasonable. In the same manner, if participants absorb all plan expenses (i.e. the plan sponsor has no charges) then the participants are, in effect, absorbing the settlor expenses.

One method that may avoid the prohibition is to obtain the approval of an independent fiduciary after disclosure of the fee amounts and the manner in which the fees are paid. Even if not a prohibited transaction, ethics and good business practice may require the disclosure of such fees. The service agreement should be used to disclose the amount and source of the fees and charges to provide authority for the increase or modification of fees and charges with advance written notice and to establish the independence, authority, and fiduciary status of the plan sponsor or other signatory.

3. Trading Responsibilities

The daily valuation process relies heavily on electronic links between the retirement plan administration firm, the trading partner, and the transfer agent. Service agreements should address who is responsible for loss due to inaccuracy, incompleteness, or lack of timeliness of information received from the participant, plan sponsor, trading partner or transfer agent. In addition, it should address who is responsible if the links fail to transmit from one party to another.

4. Trade Settlement

Trades can occur every business day in daily valuation. Thus the transfer of cash from one fund to another may occur frequently. Service agreements should spell out:

- Who is responsible should a trade occur in which there is not sufficient cash in the account to cover the buy; or
- Who is responsible for a trade that has not resulted in collected funds at the time the trade took place.

5. Circumstances Outside the Control of the Service Provider

A "force majeure," "act of war," or "act of God" clause prohibits liability in the event the promised services cannot be performed on account of a failure outside the control of the service provider. For example, under this type of clause, no liability arises when investment directions are not timely implemented on account of the failure of a voice response unit due to circumstances outside the control of the service provider.

In conclusion, service agreements can minimize a service provider's liability. The provisions described address the most common daily valuation issues. There are many other provisions that are included in service agreements that are beyond the scope of this course.

Please refer to Appendix G, Sample Service Agreement, for an illustration of a sample service agreement.

§12.08 Key Terms

Service Agreement: An agreement that designates the allocation of responsibilities among all of the parties involved in the operation of the plan.

§12.09 Review of Key Concepts

- Trading problems can be categorized into three areas:
    1. Trades that are executed incorrectly;
    2. Trades that should have been executed but were not; and
    3. Trades that should not have been executed but were.

- It is important to establish internal procedures to track trades to validate, confirm, and if necessary, correct trading errors.

- Daily reconciliation identifies many trading errors and allows the recordkeeper or administrator to correct errors in a timely manner.

- Not all trading errors can be identified through daily reconciliation. Some errors can only be identified by data validation efforts and reports to the plan sponsor.

- The end result of the correction process is to have the participant made whole and the trade position adjusted.

- There are several methods for correcting trading errors and no industry-wide recommended practice.

- In most cases it is a matter of determining who is accountable for the error when determining who should pay if a fee is required to correct the error or if a market loss needs to be made up to make a participant whole. However, it may be difficult to determine who is responsible for the trading error, thus the importance of a service agreement outlining accountabilities.

- A service agreement spells out who is liable among the partners involved in the inaccurate or incomplete electronic processing of trades. It also may spell out the fee structure for a service provider.

§12.10 Review Questions

[A] True or False

______ 1. A service agreement should make the plan administrator responsible for all trading errors.

______ 2. Participant's should be able to keep any contribution made in error to his or her account.

[B] Multiple Choice

3. All of the following statements regarding correcting trading errors are **TRUE, EXCEPT**:

   A. Participants should be notified of all trading errors and the subsequent correction.
   B. Participants should be made whole.
   C. Corrections should be made as if the trades were executed as intended.
   D. Lost market gains should be restored to participants if applicable.
   E. Plan fund positions should be adjusted.

4. All of the following issues may be covered in a service agreement, **EXCEPT**:

   A. The amount and sources of the fees and charges
   B. Responsibility for loss due to electronic link failures
   C. Responsibility for a trade for which funds were not collected
   D. Responsibility for a prohibited transaction by the fiduciary
   E. No service provider responsibility for selecting investment options in compliance with ERISA §404(c)

5. All of the following are examples of trading errors, **EXCEPT**:

   A. An investment was priced incorrectly and then a transfer was processed for a participant with that investment.
   B. A loan request was processed for more than the maximum allowed by law.
   C. A profit sharing contribution was processed for an eligible participant who had terminated two months before.
   D. A QDRO processing fee was deducted pro rata from participants' accounts and should have been billed to one participant.
   E. An employer contribution was made to a participant who was ineligible due to a hardship withdrawal.

6. All of the following are ways to avoid trading errors, **EXCEPT**:

   A. Oversee the voice response unit and the web to be sure all trade requests are processed
   B. Check any pending trades on a daily basis
   C. Audit fund prices before applying them
   D. Process all distributions twice and compare the results
   E. Reconcile contributions and participant allocation instructions daily

§12.11 Answers

1. **False.** A service agreement should not make all trading errors the responsibility of the plan administrator since they are not all the plan administrator's fault. §12.07

2. **False.** Trading errors should be corrected. §12.03

3. The correct answer is **A.** §12.05 [C]

   A. Correct. This statement is false since some trading errors are nominal in value and are not corrected.
   B. Incorrect. This statement is true because when correcting trading errors participants should be made whole.
   C. Incorrect. This statement is true because when correcting trading errors corrections should be made as if the trades were executed as intended.
   D. Incorrect. This statement is true because when correcting trading errors lost market gains should be restored to participants if applicable.
   E. Incorrect. This statement is true because when correcting trading errors plan fund positions should be adjusted.

4. The correct answer is **D.** §12.07

   A. Incorrect. This statement is true because the amount and sources of the fees and charges are outlined in a service agreement.
   B. Incorrect. This statement is true because responsibility for loss due to electronic link failures is outlined in a service agreement.
   C. Incorrect. This statement is true because responsibility for a trade for which funds were not collected is outlined in a service agreement.
   D. Correct. This statement is false because responsibility for a prohibited transaction by the fiduciary is not an issue addressed by a service agreement.
   E. Incorrect. This statement is true because service provider responsibility for selecting investment options in compliance with ERISA §404(c) is an issue addressed by a service agreement.

5. The correct answer is **C.** §12.04

A. Incorrect. This statement is true because an investment that was priced incorrectly and then a transfer that was processed for a participant with that investment is an example of a trading error.

B. Incorrect. This statement is true because a loan request that was processed for more than the maximum allowed by law is an example of a trading error.

C. Correct. This statement is false because a profit sharing contribution that was processed for an eligible participant who had terminated two months before is not a trading error.

D. Incorrect. This statement is true because a QDRO processing fee that was deducted pro rata from participants' accounts and should have been billed to one participant is an example of a trading error.

E. Incorrect. This statement is true because an employer contribution that was made to a participant who was ineligible due to a hardship withdrawal is an example of a trading error.

6. The correct answer is **D.** §12.05

A. Incorrect. This statement is true because overseeing the voice response unit and the web to be sure all trade requests are processed is a way to avoid trading errors.

B. Incorrect. This statement is true because checking any pending trades on a daily basis is a way to avoid trading errors.

C. Incorrect. This statement is true because auditing fund prices before applying them is a way to avoid trading errors.

D. Correct. This statement is false because processing all distributions twice and comparing the results is not a way to avoid trading errors.

E. Incorrect. This statement is true because reconciling contributions and participant allocation instructions daily is a way to avoid trading errors.

Chapter 13:
Conversion Decisions and Issues

§13.01 Learning Objectives

- Discuss data gathering and the time frame involved when converting from one retirement plan administration firm to another.
- Define and discuss the various decisions that are involved when converting from balance-forward to daily valuation.
- Describe a blackout notice and to whom and when it is provided.
- Summarize the blackout rules during a plan conversion.
- Define required disclosures to plan participants relating to blackout period notices.
- Explain the impact a conversion has on various transactions types, e.g. contributions, transfers, withdrawals, both during and after conversion.

§13.02 Introduction

Defined contribution plans—especially 401(k) plans—are flocking to daily valuation. The investment manager welcomes the dollars that flow to them; however, it is the retirement plan administration firm that comes under pressure to get the conversion of plan records to the daily software accomplished quickly.

The transfer of participant data from its previous format into daily can be a difficult process that may take many months to complete. If the same firm continues to perform the recordkeeping responsibilities for the plan, the conversion from balance-forward to daily valuation may involve less time, but many of the issues remain the same.

A plan that is currently performing daily valuation but is changing retirement plan administration firms also encounters conversion decisions and issues, although not as many as when the conversion involves changing from balance-forward to daily valuation.

This chapter identifies many of the questions that must be asked and answered before a plan conversion is complete. The next chapter focuses on the different types of conversions and conversion methods. In all cases, it is important to thoroughly document the conversion process, leave a good audit trail and be sure assets reconcile after the conversion.

§13.03 Conversion Decisions and Setting Expectations

When a plan sponsor decides to engage a retirement plan administration firm or other entity to provide daily valuation services for its retirement plan, the process of transferring existing plan records to the new system marks the first real opportunity for the employer to see if the firm lives up to the promises made during the sales presentations. Many recordkeeping units have conversion teams whose duties focus solely on accurate and efficient set-up of the plan on its systems. The industry often views the day on which the plan goes live on the automated response systems as the benchmark for evaluating the effectiveness of a firm's conversion process.

Recordkeepers assigned to conversion teams must understand basic retirement plan operations and know the difference between daily and balance-forward processing. It goes without saying that these recordkeepers are well acquainted with their firm's recordkeeping software and its requirements. As they work with different plan conversions, they often become familiar with the nuances of other recordkeeping systems, and that can translate into even greater efficiencies in future plan conversions.

Effective and adequate communication between the parties involved in the conversion process can eliminate the anxiety and confusion that often accompany such changes. Whether the daily valuation is offered as part of a bundled or unbundled package, the following details must be worked out before data and asset transfers begin. Some of these issues affect how long the conversion process takes (the conversion period), while others affect the general operation of the plan in the daily valuation environment.

[A] Data Gathering

It is important that the new retirement plan administration firm learn as much as possible about the plan's operation before it comes to them. Some information is provided electronically, such as the participant's dates of birth and hire, salary, contribution amounts, transfer balances and amounts available for hardship withdrawal. Other items are more appropriately provided in hard copy, including the plan document, summary plan description, current participant loan documents, asset statements and Form 5500 reports filed by the plan sponsor.

A sample electronic information request and a hard copy request are included Appendix L of this course. It is critical to the success of the conversion and on-going operation of the plan that all of the information be provided by the former retirement plan administration firm to the new firm responsible for recordkeeping.

[B] Timelines

There are many tasks that must be performed by the plan sponsor, as well as the new and prior retirement plan administration firms, to make a conversion successful. A timeline is helpful to keep all parties on the same track, to ensure the process stays organized and to set reasonable expectations. Please refer to Appendix H for a sample timeline for a plan that is liquidating all of its assets and converting from one daily system to another.

[C] Plan Documents

Many providers of daily valuation services require employers to use only the prototype documents that are supported by their recordkeeping system, although some providers remain flexible enough to accommodate individually designed plan documents. When a plan converts from balance-forward to daily valuation, the document needs to be reviewed to determine if any amendments are needed to reflect the features offered by daily valuation.

Some features that may need to be amended and communicated to the participants are:

- The earnings allocation methods in many balance-forward plan documents describe a weighted-average approach. Daily plans typically use the weighted-average approach only for money market or other dollar par funds. Mutual fund earnings tend to be allocated proportionately, based on the number of shares held on behalf of the participant as of the dividend or distribution record date.

- Distributions in a balance-forward plan tend to occur as soon as administratively feasible after the valuation is completed. Daily plans make distributions more frequently using a current value.
- Balance-forward valuation dates generally are defined as one to four specific times during the year. Since daily plans value every business day, the plan document needs to be appropriately worded.
- Balance-forward plans tend to restrict the frequency of investment transfers. Daily plans can offer transfers every business day.
- The date on which allocations of forfeitures, matching and profit sharing contributions occur must reflect the timing of the daily environment.

[D] Installation and Administration Manuals

Standard procedures with all clients of the retirement plan administration firm are an absolute necessity for the operation to be efficient. This is especially true in the daily valuation environment. Many firms have created manuals for their clients (i.e., plan sponsors) to help educate them about the conversion process. Following suggestions in the installation manual, the retirement plan administration firm's conversion team and plan sponsor are able to review data requirements, as well as the responsibilities of each of the parties involved and establish a conversion timeline.

Administration manuals, on the other hand, present guidelines and procedures to be followed after the plan is fully under the control of the new retirement plan administration firm. These manuals contain forms to initiate various types of transactions, such as distributions and loans, as well as processing timelines.

[E] Effects of Cash Versus Accrual Accounting

Plan sponsors and participants alike often come to the daily valuation environment only with experience of a balance-forward accounting method. It is important that all parties understand how visible every transaction becomes in the daily environment.

Some examples:

- Participants in a balance-forward plan always receive year-end statements that include the amount of profit sharing contribution allocated to them, although the profit sharing funds may not be physically transferred to the trust until as much as 8½ months after the end of the plan year. In the daily environment, the actual timing of every deposit is there in black and white for all to see.
- Elective deferrals or loan repayments reported on daily valuation participant statements may appear to be one or more pay periods short when compared to payroll records or pay stubs for the same period because of cash basis reporting.
- Participants often question why the dividend and capital gains distributions declared at year-end by the mutual funds do not appear on their daily valuation participant statements. It is common for capital gain distributions to be paid a

few days later in the next valuation (or reporting) period. For example, one or more of the mutual funds offered by a plan declares a capital gains distribution on December 31, the end of a reporting period. The price of a share of the fund is reduced due to the distribution. Looking at the December 31 statement, the participant thinks a loss has occurred in the asset, without any offsetting income being paid. When the distributions are paid and reinvested on January 2, the loss "vanishes" because shares from the capital gains distribution are then reflected in that day's valuation.

[F] Voice Response and Website Capabilities

The conversion team explains the options available under the voice or other automated response systems, as well as the website capabilities they can offer to participants. The plan sponsor must decide which options to make available.

Systems vary, but most automated voice response systems have the following features from which the employer may choose.

Participants can:

- Hear the current market value of their account balances in dollars and in shares;
- Make changes to future investment elections;
- Initiate transfers of existing assets;
- Use modeling features to project account balances to retirement age using various assumptions;
- Monitor the value of any outstanding loan;
- Inquire about the amount available for a loan or hardship withdrawal;
- Request loans, hardship withdrawals or distributions due on account of termination of employment; and
- Elect to talk to a live operator or hear other announcements about the plan.

The plan sponsor may not want to offer all of these features. Sometimes, the retirement plan administration firm is not given enough data to have the recordkeeping system accurately determine the amount available for hardship or the highest loan balance in the past twelve months. This gap in reliable data compromises the accuracy of the information that could be spoken, so the plan sponsor may want these options turned off.

There may be an additional cost to offer live operators, so the plan sponsor may reject this option. The plan sponsor must understand how frequently the data heard is updated (or refreshed) and when transfer requests or election changes are processed. The plan sponsor should review the brochure describing how to use the voice response system and agree upon when and how personal identification numbers (PINs) are issued. Depending on the sophistication of the participants, the plan sponsor also may want to offer these same options through a website.

[G] Participant Statement Format

The plan sponsor may be curious about what the participant statement looks like and what information is provided.

Many decisions must be made, including:

- Should the statement show both shares and dollars?
- Should the statement show each transaction or just present a summary of activity similar to a balance-forward type statement?
- Should the statement show life-to-date (or inception-to-date) contributions made by the participant and employer?
- Does the plan sponsor want compensation, beneficiary designations, investment elections, vesting schedule and/or current deferral percentages printed?
- Should the plan sponsor's logo be added to the statement, and should it be printed on special paper, with a special color?
- Where are statements to be mailed? Do they go directly to the participant's home? If so, what format are addresses to be received by the retirement plan administration firm and how frequently are updates transmitted?
- Should the rate of return be included on the statement? If so, should it be based on published fund rate of return or individually calculated by fund and total return for each participant?

Participant benefit statements now commonly include published rates of return for the various investment funds in which they participate. Published returns are calculated by fund companies for the entire fund. These really represent a close approximation for the participant and are a good measure of performance, but they don't represent the actual rate of return for the participant.

Many service providers are now beginning to provide specific, individualized return data based on the actual activity that occurs in a participant's account, taking into consideration actual cash flow (such as contributions or transfers in and out). This is called a time-weighted rate of return. The most accurate time-weighted calculation is called the daily valuation method. This is a valuation method whereby a valuation occurs each time cash flow occurs. The calculation actually values the account every time cash flows in or out to arrive at a true rate of return for the participant. Even with little activity, this calculation can get very complex. It's also important for participants to understand that these calculations are complex and not easily recreated.

Individualized calculations may be provided for the overall account (all funds and sources combined), for each individual fund, or for each source/fund combination. As well, they may be provided in conjunction with published rates of return.

Regardless of the performance information being provided, the goal is to provide the participant with a good, accurate measurement of performance to:

- Assess how well their selected funds are meeting their investment objectives; and
- Assist in selecting the most appropriate investments to suit their particular needs.

[H] Investment Decisions

Before any data or assets are transferred to the new retirement plan administration firm, the plan sponsor must decide whether or not to sell the existing investments and replace them with new options. Plans converting from balance-forward accounting or other types of investment arrangements may be unable to liquidate all investments at the time of conversion. This might occur, for example, if real property or limited partnerships are owned by the plan. Sometimes the only solution is for that investment to be allocated to one or more of the participants' accounts in addition to whatever core options are available for other plan accounts.

Recordkeeping for these investments probably frustrate the conversion and ongoing processing for the plan. The retirement plan administration firm establishes procedures for handling investments that are not publicly traded or not otherwise valued on a daily basis.

Decisions also must be made on how to label the funds on the participant statements. Is it easier to use generic fund names or the official fund family name and name of the fund? What fund names are to be used on the voice or other automated response systems? How are the funds to be traded? Does the retirement plan administration firm have electronic links that can be used for trading or is trading done by fax or phone? The trading deadlines must be communicated.

[I] Calculation of Matching Contributions

If the plan sponsor intends to make matching contributions, the retirement plan administration firm must know how often the match is contributed and who is responsible for computing the amount. Some payroll services calculate the matching contributions, although many plan sponsors have the retirement plan administration firms prepare the computation. It is important to assign responsibility and to anticipate data collection associated with these contributions. Usually, the plan document provisions vary in this regard, and true-up calculations may be needed at year-end.

True-up refers to the adjustment needed when the method of computation has been less precise than required. For example, a plan document provides a matching contribution formula that matches some, but not necessarily all, of an employee's contributions. Payroll systems often calculate these matching contributions on a pay period basis, rather than looking at year-to-date values. At year-end, the matching contributions deposited throughout the year must be compared to the amount calculated by the formula stated in the plan document. Any difference must be trued-up, or adjusted, in the participant's account.

[J] Fees

Trustee and recordkeeping fees can be paid directly by the plan sponsor or from the plan's assets. Discussions should be held between the retirement plan administration firm and the plan sponsor to determine who pays the fees. It is important also to determine whether or not fees are paid in advance, how frequently fees are invoiced and to have a written service agreement stating the specific fees that are to be charged by the retirement plan administration firm.

[K] Loans to Participants

The plan sponsor must decide if participant loans are to be offered. Here are some questions that must be answered:

- How are loans initiated? Does the participant complete a written loan request form, call the IVR, log onto the website or verbally communicate with the plan sponsor?
- Who checks the loan limits and who prepares the promissory note, collateral agreement, and amortization schedule?
- Who drafts the loan check?
- Is the loan check to be mailed directly to the participant or to the plan sponsor for distribution?
- Is there a written loan policy that spells out the minimum loan amount available, the maximum term of a loan, what reasons are acceptable for a loan, whether or not mortgage loans are offered, how the interest rate is set and how frequently loans are processed?
- Are there limits on how many loans a participant can have outstanding at one time, and is there a waiting period between loans?
- How are assets to be liquidated for the loans? Which contribution source do they come from, and which funds and in what order? The retirement plan administration firm usually refers to this set of rules as the hierarchy for loans.
- How are loan repayments reinvested? Must loan repayments be made through payroll deduction?
- Are loans limited to 50% of the vested account balance, or are participants allowed to take up to $10,000, regardless of the vested account balance?
- Is interest charged from the loan issue date until the date of the first loan payment?
- Are there loan fees? If so, are they charged to the plan sponsor, the plan or the individual participant who initiated the loan?

§13.04 Issues during the Conversion Period and Ongoing

The following issues affect both the plan sponsor and the participants during the conversion period and need to be addressed well in advance of the actual conversion date.

[A] Blackout Period

A blackout is traditionally a period of time during which records are not yet on the new daily valuation recordkeeper's system. The blackout period normally runs from the start of the valuation (or accounting) period the conversion began on up through the time when the account balance information from the prior retirement plan administration firm is loaded onto the daily system and data is reconciled to their reports.

The blackout period may run from as little as a day or two to as much as thirty to sixty days depending upon the extent of the changes being made. The length of the blackout period depends also on how quickly the change can be made, i.e., how quickly the prior retirement plan administration firm can provide complete data and how quickly the new retirement plan administration firm can load and reconcile the data.

For example, suppose a plan sponsor wants to move its plan from a balance-forward environment to daily valuation after the end of the second calendar quarter. The blackout period would begin on July 1. The length of the blackout period depends in large part on how quickly the prior retirement plan administration firm completes the valuation work and provides the data to the new retirement plan administration firm.

During this blackout period no participant level sale transactions are processed because the full amount to the credit of each participant is unknown. For example, no loans, hardship withdrawals, or other distributions to terminated participants are processed. Similarly, participants may not request fund transfers or participant loans.

While the new retirement plan administration firm may begin processing deferrals/contributions from current payrolls, current loan repayments are not posted because the transfer loan balance does not yet appear in the new retirement plan administration firm's system. Loan repayments are deposited to a money market fund or a non-interest bearing account until such time as the new retirement plan administration firm receives the transfer data, can process the repayments and the monies can be invested based on the participant investment elections. Consequently, there is a lot of pressure put on the plan sponsor and old and new service-providers to complete the transition as quickly as possible.

Since the passing of the Sarbanes-Oxley Act of 2002, effective January 24, 2003, employers are required to provide participants and beneficiaries affected by a blackout period with an advance notice prior to the upcoming blackout period. Based on this

Act, the DOL has issued final rules that clarify and incorporate many of the interim rules to assist employers in meeting the requirements of the blackout period notices. Should a plan sponsor fail to provide this notice in a timely manner, a civil penalty was added by the Act.

A **blackout period** is now defined as any period of more than three consecutive business days during which the ability of participants or beneficiaries to direct or diversify assets credited to their accounts or to obtain loans or distributions from the plan is temporarily suspended, limited or restricted. There are some situations that do not require a blackout period notice, such as a blackout period that is as a result of a QDRO. A blackout can occur during a conversion from one retirement plan administration firm to another or as a result of circumstances and changes other than conversion to a new retirement plan administration firm, such as during a fund liquidation.

If a blackout period is to occur, a blackout notice must be furnished to all affected participants at least 30 calendar days, but no more than 60 calendar days, in advance of the last day on which affected participants and beneficiaries could exercise their affected rights immediately before the blackout period begins. Several exceptions do exist (*e.g.,* a blackout in connection with becoming or ceasing to be a participant or beneficiary by reason of a merger, acquisition or similar transaction).

Here are the highlights of the DOL's Blackout Notice Rules:

- The notice beginning and ending dates have been made more flexible in that the sponsor may use the calendar week that the blackout begins and ends rather than the specific day. However, if this option is used, the sponsor must provide affected participants and beneficiaries with a toll-free number or a free website that may be accessed to get the specific beginning and ending date.
- Furnishing a notice to the last known address of a participant or beneficiary is sufficient to comply with the notice requirements.
- The interim blackout notice rules mandated that a person's name must be provided to the participant to contact for further information. The final rule modified this to allow the substitution of a contact which may be a department that is responsible for answering questions.
- Calendar days, and not business days, are to be used when counting days regarding a blackout period.
- The notice should only include language about the specific rights that are suspended under the plan. For example, if a plan does not permit individual investments, the notice need not include investment change language but may include language about suspended rights such as loans or withdrawals.
- The same blackout notice may be provided to address different restrictions. For example, a 25-day blackout for withdrawals and a 20-day blackout for investment changes may be addressed in the same notice.

- The notice may be provided by electronic means, first class mail, certified mail, express mail, designated private delivery service or hand delivery, including interoffice mail.
- Blackout notices are only required for plan level suspension of rights. Thus, the suspension of an individual's rights due to a QDRO would not trigger the requirement for a blackout notice.
- Part of the Sarbanes-Oxley Act of 2002 also prohibits directors and executive officers from dealing in employer securities (outside of the plan) during a blackout period in which participants and beneficiaries are also restricted. The prohibition generally does not apply to small, privately held companies.

[B] Turnaround Times

The time it takes to process—or turn around—transactions, including new contributions, or to generate and deliver reports during the conversion period, tends to be longer than after the plan is fully up and running on the new retirement plan administration firm's systems. The new retirement plan administration firm must have full control of the plan's records before it can be in total control of processes, including participant reporting.

It is important, therefore, to set the plan sponsor's expectations about what happens and how quickly things happen both during the transition phase and on an ongoing basis. Benchmarks are set for such things as contribution and other transaction processing, as well as for delivery of reports to the participants and plan sponsor.

[C] Contribution Processing

Plan contributions do not come to a halt just because a plan's recordkeeping is in transition from one service provider to another. During the conversion period, new contributions are sent from the plan sponsor to the trustee in the normal fashion. The plan sponsor provides the new retirement plan administration firm with an electronic file that tells their system how much each participant is contributing for the period. The recordkeeper calculates how much money should be invested in each fund based on the participant investment elections.

The timing of this calculation is affected by how quickly the plan sponsor provides the participant investment elections to the recordkeeper. Getting new investment election forms from all participants can be one of the more difficult chores associated with a change in retirement plan administration firms. It also can cause unanticipated delays, resulting in longer blackout periods than originally promised. Ideally, this information is delivered to the retirement plan administration firm prior to their receipt of the first contribution file. It is a common practice to have the plan sponsor submit a test contribution file to the retirement plan administration firm to enable them to make sure the format of the data is one that can be used by the retirement plan administration firm and that the information includes all relevant data elements.

Turnaround time for ongoing contribution processing varies from one to five business days. Procedures should be established with regard to transfer of contributions to the trustee as well as how and when the electronic file is sent to the retirement plan administration firm. Some retirement plan administration firms want the data file first in order to confirm the data. Once accomplished, the plan sponsor wires or mails the contributions to the trustee, custodian or directly to the investment house/mutual fund. Other firms prefer to have the funds and the electronic file sent at the same time.

[D] Investment Elections

Changes to future investment elections can be received and put into effect during the blackout period. The plan sponsor must decide in advance of the conversion period how frequently changes can be made, as well as when the changes are effective, and if there is a waiting period before the next change can be made. Other decisions include whether or not elections can be made in increments of fractional percentages, whole percentages or only in five-percent or ten-percent increments per fund.

[E] Timing and Preparation of Periodic Reports

The plan sponsor often wants to know when the first participant statement and valuation report after the conversion is to be completed and mailed so participant questions can accurately be addressed.

These activities depend in large part on:

- The date the retirement plan administration firm receives the electronic file from the prior retirement plan administration firm with the account balance information;
- The date the retirement plan administration firm receives other takeover information from the plan sponsor;
- The balance-forward valuation being prepared on a cash basis rather than an accrual basis;
- The balance-forward valuation reconciling to the assets;
- The account balance information provided in an electronic file rather than on paper;
- Enforcement of the blackout period; and
- The date of the asset liquidation, if applicable, and transfer of the assets to the new trustee or custodian.

The plan sponsor should be told if the turnaround time is different for the first reporting period compared to future periods. Some plan sponsors prefer reports be delivered on paper as well as electronically. In addition, the plan sponsor may want the reports produced showing participant information in a certain order; for instance, alphabetically, by division or status code.

[F] Distribution Processing

After the blackout period is over, distributions may be one of the first activities given attention. The plan sponsor must establish procedures with the retirement plan administration firm to determine how frequently distributions are made and who prepares the distribution checks. Sometimes, the plan sponsor writes checks, but the task may be handed off to a bank trustee or other trust company, which also is responsible for preparing the Form 1099-R and Form 945 governmental reporting forms.

The time to turn around distributions must be made clear to the plan sponsor and forms to request a distribution must be agreed upon. Other matters, such as where distribution checks are sent—does it go directly to the participant or is it sent to the plan sponsor for distribution—and assigning responsibility for determining vesting or the amount available for a hardship withdrawal must also be worked out.

[G] Processing Transfer Requests

Participant transfers can be processed after the blackout period has ended. The retirement plan administration firm should discuss with the plan sponsor whether transfers are made using paper forms, the voice response system, an electronic website or all three. How frequently a transfer may be made is contingent on a number of factors, including: How long does it take for the process to be completed? Are there a minimum number of days that must pass before another transfer can be requested? Can each source of funds be transferred separately?

For instance, can the 401(k) assets be transferred separately from the match assets or must they all be transferred in the same ratios? When does a transfer occur after the request has been made? For many daily valuation activities, timing is everything.

The time spent with plan sponsors and participants in developing procedures and explaining processes is never wasted. The better prepared each party is for what happens before, during and after the conversion process, the less time the retirement plan administration firm is required to spend later dealing with dissatisfaction or confusion on the part of either the plan sponsor or the participants.

§13.05 Key Terms

Blackout Period: Any period of more than three consecutive business days during which the ability of participants or beneficiaries to direct or diversify assets credited to their accounts or obtain loans or distributions is temporarily suspended, limited or restricted.

True-Up: An adjustment needed when the method of computation for calculating matching contributions has been less than precise.

§13.06 Review of Key Concepts

- A balance-forward plan converting to daily valuation usually encounters discrepancies in the plan document that must be addressed prior to completing the conversion process.

- Plans moving from balance-forward to daily valuation must change from accrual to cash accounting and understand how visible every transaction becomes.

- Issues regarding voice response units and websites, participant statement format, investment decisions, calculations of matching contributions, fee issues and loan issues must be decided in advance of the conversion.

- Communication to participants regarding the blackout period—the time during which records are being transferred onto the new daily valuation recordkeeper's system—is imperative for a smooth conversion.

- Some transactions are suspended during the conversion process; others are not.

- A blackout notice is required for plan level suspension of rights for three or more consecutive business days.

- Employers are required to provide participants and beneficiaries affected by the blackout period with at least 30-calendar days advance notice prior to the upcoming blackout period.

- The blackout notice must specify the beginning and ending dates of the blackout or the calendar week that the blackout begins and ends. If the calendar week is used, the sponsor must provide a toll-free number or a free website that participants may access to get the specific beginning and ending dates.

§13.07 Review Questions

[A] True or False

______ 1. The blackout period during a conversion normally runs from the start of the accounting period when the conversion begins through the time the account balance information is loaded onto the new system and reconciled.

______ 2. Generally, if a blackout period is to occur, a notice must be furnished to all affected participants or beneficiaries at least ten days before the blackout period begins.

[B] Multiple Choice

3. All of the following should be provided to the new administration firm when moving the plan from one administration firm to another, **EXCEPT**:

   A. Electronic files regarding participant information
   B. Hard copies of plan documents
   C. A copy of the script for the former ARU
   D. A timeline to keep all parties on the same track
   E. Form 5500 reports

4. All of the following employer matching contribution issues must be decided by the plan sponsor and communicated to the new administration firm, **EXCEPT**:

   A. Has the plan always had matching contributions?
   B. How often is the match contributed?
   C. Who is responsible for calculating the match?
   D. Will true up calculations be need?
   E. What is the match formula stated in the plan document?

5. All of the following must be included in a blackout notice to participants, **EXCEPT**:

   A. The notice beginning and ending dates
   B. A place to check the exact dates if calendar weeks are used as dates
   C. The contact that is responsible for answering questions
   D. The names of the directors and officers who cannot deal in employer securities outside the plan during the blackout time
   E. The specific rights that are suspended

6. All of the following need to be considered when moving from one retirement plan administration firm to another, **EXCEPT**:

   A. Participant statement format
   B. Investments to offer
   C. Plan document language that may need to be amended
   D. Voice response and website capabilities to offer
   E. The distance of the firm from the plan sponsor

§13.08 Answers

1. **True.** The blackout period during a conversion normally runs from the start of the accounting period when the conversion begins through the time the account balance information is loaded onto the new system and reconciled. §13.04 [A]

2. **False.** The blackout notice should be provided at least 30 calendar days, but no more than 60 calendar days in advance of the blackout period. §13.04 [A]

3. The correct answer is **C.** §13.03

   A. Incorrect. This statement is true because electronic files regarding participant information should be furnished to the new administration firm.
   B. Incorrect. This statement is true because hard copies of plan documents should be furnished to the new administration firm.
   C. Correct. This statement is false because there is no need to furnish a copy of the script for the former ARU to the new administration firm.
   D. Incorrect. This statement is true because a timeline to keep all parties on the same track should be furnished to the new administration firm.
   E. Incorrect. This statement is true because Form 5500 reports should be furnished to the new administration firm.

4. The correct answer is **A.** §13.03 [I]

   A. Correct. This statement is false because whether the plan has always had matching contributions is not material to the new administration firm.
   B. Incorrect. This statement is true because how often the match is contributed should be communicated to the new administration firm.
   C. Incorrect. This statement is true because it is important for the new administration firm to know who is responsible for calculating the match.
   D. Incorrect. This statement is true because it is important for the new administration firm to know if true up calculations are needed.
   E. Incorrect. This statement is true because it is important for the new administration firm to know the match formula stated in the plan document.

5. The correct answer is **D.** §13.04 [A]

   A. Incorrect. This statement is true because the notice beginning and ending dates must be included in the blackout notice.
   B. Incorrect. This statement is true because a place to check the exact dates if calendar weeks are used as dates must be included in the blackout notice.
   C. Incorrect. This statement is true because the contact that is responsible for answering questions must be included in the blackout notice.
   D. Correct. This statement is false because the names of the directors and officers who cannot deal in employer securities outside the plan during the blackout time need not be included in the blackout notice.
   E. Incorrect. This statement is true because the specific rights that are suspended must be included in the blackout notice.

6. The correct answer is **E.** §13.03

   A. Incorrect. This statement is true because participant statement format is an important consideration when changing administrative firms.
   B. Incorrect. This statement is true because which investments to offer is an important consideration when changing administrative firms.
   C. Incorrect. This statement is true because plan document language that may need to be amended is an important consideration when changing administrative firms.
   D. Incorrect. This statement is true because voice response and website capabilities to offer are important considerations when changing administrative firms.
   E. Correct. This statement is false because the distance of the firm from the plan sponsor is generally not an important consideration when changing administrative firms.

Chapter 14:
Conversion Types and Methods

§14.01 Learning Objectives

- Discuss the three types of investment strategies used during daily to daily conversions as well as the two types of accounting methods that effect the conversions.
- Explain common reasons for a gap between the ending balance from the prior trustee and the amount of assets received by the new trustee during a conversion.
- List the five major reasons that balance-forward to daily conversions are the most challenging to complete.
- Explain the additional challenges of converting from a trustee-directed to a participant-directed plan.

§14.02 Introduction

The two most critical factors affecting the transition to a new service provider are the accounting method used and the investment strategy employed. The two accounting methods are daily valuation and balance-forward. The three types of investment strategies used during conversion are: total asset liquidation, mapping and transition recordkeeping while maintaining current investments.

The challenging aspect of the conversion of plans already maintained in a daily valuation setting is dealing with the transfer of investments. All three types of investment strategies are discussed in detail in this chapter.

In a balance-forward to daily conversion, the accounting method is converted and the investment strategy is decided. In addition, plans converting from balance-forward to daily often involve the transition to participant direction.

§14.03 Types of Conversions

When a plan sponsor decides to engage a retirement plan administration firm or other entity to provide daily valuation services for its retirement plan, the process of transferring existing plan records to the new system marks the first real opportunity for the employer to see if the firm lives up to the promises made during the sales presentations. Many recordkeeping units have conversion teams whose duties focus solely on accurate and efficient set-up of the plan on its systems. The industry often views the day on which the plan goes live on the automated response systems as the benchmark for evaluating the effectiveness of a firm's conversion processes.

Persons assigned to conversion teams must understand basic retirement plan operations and know the difference between daily and balance-forward processing. It goes without saying that these individuals are well acquainted with their firm's recordkeeping software and its requirements. As they work with different plan conversions, they often become familiar with the nuances of other recordkeeping systems and that can translate into even greater efficiencies in future plan conversions.

Certain elements of the current plan's operation must be understood before the conversion can proceed. The most critical factors affecting transition to a new service provider involve the accounting method currently being used and the investment strategy employed.

[A] Accounting

Inasmuch as there are two types of recordkeeping systems, there are two types of plans to convert:

1. One already in a daily recordkeeping format; or
2. A plan with balance-forward accounting.

A plan already using daily valuation must, by its very operation, be maintained on an automated system. All professional recordkeeping systems track participant balances in a matrix that matches two attributes to each account. Money types, or sources of money, identify whether the dollars are elective deferrals, employer matching contributions, profit sharing contributions, rollover money and so forth. The fund reflects the investment choice recorded in the account.

Saying a plan uses balance-forward accounting covers a lot of territory and does not necessarily mean the records are automated. Balance-forward plans include any plan that values participants' accounts less frequently than daily, which could mean records are kept on a monthly, quarterly, semiannual or annual basis. Furthermore, the records may be kept on a professional recordkeeping system or may be maintained by the plan sponsor using an electronic spreadsheet package, such as Lotus or Excel. In very small plans, records may be maintained with pencil and paper on ledgers purchased at the local office supply store.

An employer using less automated methods to maintain records generally needs more handholding during the transition to daily. If another retirement plan administration firm is maintaining the balance-forward plan, however, the transfer of data can be accomplished electronically.

Whatever the recordkeeping method, it is this accounting aspect of a plan's operation that involves maintenance of information about each participant. Basic participant data elements are the same whether the plan is a balance-forward plan or already uses daily valuation. For our purposes, basic participant data includes name, address, Social Security Number, dates of birth, hire and plan entry, as well as years of service for vesting purposes, and so forth. Other participant data, specifically the account balances, must be reported by source or money type and tied to the dollars transferred.

The conversion process, in total, must be tailored to the type of transition needed whether it involves simply moving from another daily valuation system or the transfer of data is from a balance-forward accounting method to the daily valuation environment. A balance-forward conversion often involves the introduction—for the first time—of participant direction of investments.

[B] Investments

There are three types of investment strategies during conversions. They are total asset liquidation, mapping of funds and recordkeeping only conversions.

<u>1. Total Asset Liquidation</u>

This investment conversion involves liquidation of all assets, or total asset liquidation; transfer of the resulting cash to the new trustee or custodian; and the deposit of the cash to a money market fund. The funds are held in the money market until such time as the new retirement plan administration firm has reconciled all data and is ready to invest in the new funds based on participant elections. The money market is used as a temporary holding account.

When plans offer a money market fund as an investment choice to participants and also use the money market as a "holding" account for transferred balances, it is important to be able to separately track the income that is attributable to the [new] ongoing contributions from that which is attributable to the conversion assets. Income must be allocated to the type of money that generated the income.

To assist in the tracking of this income, it is preferable to keep the money market fund for new contributions separate from the conversion money market fund. It also provides an easier way to track residual income that may have been due to the conversion of assets but was paid after those assets were liquidated. Keeping the new and conversion money market funds separate also facilitates balancing the plan assets to the daily system during the conversion period.

2. Mapping of Funds

This investment conversion method liquidates all assets and immediately invests the proceeds into new funds using a technique called mapping. Some retirement plan administration firms refer to mapping as like funds transfers. For example, a long term bond fund is mapped to the new long term bond fund with similar risk and return characteristics. Mapping can be used without regard to the accounting method used by the plan, although there must be participant direction of investments before the conversion. Mapping is best explained by an example.

Example 14-1. Mapping. Suppose a plan has permitted participants to direct investments to six mutual funds. We will call these A Funds. Coincident with the transition to the new retirement plan administration firm, the plan sponsor chooses six new funds, and these B Funds have risk/return characteristics very similar to those presently being used. Mapping of investments means that the A Funds are liquidated and the dollars are immediately invested in the corresponding B Fund (equity fund to equity fund and so forth). There is no transfer of the cash to an interim investment or holding account.

3. Recordkeeping only Conversions

This investment conversion method does not involve any liquidation of assets but merely a transition of the actual recordkeeping function. This type of conversion does not occur often when transitioning from one retirement plan administration firm to another. However, it is used extensively when balance-forward plans are internally converted to daily with the same retirement plan administration firm. Assets may be re-registered with a different custodian, but not liquidated.

Preparing a plan sponsor and the participants for the recordkeeping conversion starts with lengthy discussions with representatives from the retirement plan administration firm. Although practices vary throughout the industry, a consultant, administrator and recordkeeper—at a minimum—are usually part of the conversion team and participate in these discussions with the plan sponsor. Often, the service agreement—and there may be more than one depending on the manner in which services are provided—helps all of the parties focus on certain issues.

§14.04 Daily to Daily Conversions

Conversion of plans already maintained in a daily valuation setting is easier and more quickly accomplished than plans using balance-forward recordkeeping. This is due not only to the plan sponsor and the participants already being educated and comfortable with daily valuation, but also because the valuation is available almost immediately from the prior retirement plan administration firm. In addition, the old retirement plan administration firm's valuation balances without accruals.

The more challenging aspect of the daily to daily conversion is dealing with the transfer of investments.

[A] Total Asset Liquidation

The first type of investment conversion is where all assets are liquidated and deposited to a money market fund. The following steps are involved in this type of asset conversion process.

Step 1. The trustee liquidates all assets a few days prior to the end of the conversion date.

Step 2. The cash is wired to the new trustee or custodian, who then deposits the cash into a conversion money market fund.

Step 3. The old retirement plan administration firm completes its valuation work and sends the electronic valuation file to the new retirement plan administration firm.

Step 4. The new retirement plan administration firm uploads the account balances onto their daily software.

Step 5. The conversion money market funds are liquidated and invested based on the participants' new investment directions.

This investment conversion method is one of the easiest to use in terms of reconciling the assets to the value of participants' accounts on the recordkeeping system. The plan sponsor and participants, however, may not share that perspective, because the funds may sit in a money market fund for as long as 30 to 90 days while the data and investment transfers are arranged. The length of time the assets remain in the conversion money market fund is a function of how long it takes the old retirement plan administration firm to complete the valuation work together with the length of time it takes the new retirement plan administration firm to set up their systems.

While waiting on the prior retirement plan administration firm to send the transfer balance information, ongoing participant contributions must be invested. The contributions can be processed on the daily system when the cash is received by the trustee/custodian. The cash is then invested into funds based on the participant investment elections.

The fiduciaries of plans whose assets are not invested according to the participants' elections do not enjoy ERISA §404(c) protection from fiduciary liability. This includes investments in money market funds that are intended to ease the transfer of recordkeeping responsibilities from one service provider to another.

Balancing the mutual fund shares reflected on the daily system to those held by the trustee should be a routine daily activity. It is just as important to do this during the conversion period, as it is when the plan is "live." To assist in this balancing process, it is helpful to create a separate conversion management account on the daily system to track the total assets that are deposited into the conversion money market fund while waiting for the prior retirement plan administration firm to provide the transfer account balance information. This allows the daily software to reflect the total assets held by the trustee even though the conversion assets have not yet been allocated to specific participants.

Upon receipt of the prior valuation, the ending balance reflected on the valuation should equal the amount of assets received from the prior trustee and deposited into the conversion management account. However, even on daily to daily conversions, sometimes this does not happen.

There are several common reasons for this gap:

- The prior trustee deducted their fees from the assets before transfer yet did not reflect the expense on their report. Thus, fewer assets were actually received by the new trustee than shown on the prior trustee's report.
- A mutual fund declared a dividend before the fund was liquidated, but paid the dividend after the valuation date. This caused more assets to be received than allocated on the valuation.
- The conversion money market may have paid income. This income must be allocated to the conversion assets.
- In some cases, the asset liquidation may not have occurred by the end of the valuation period, so the full realized gain or loss on the sale might not be recognized in the prior valuation. This could cause the assets to be higher or lower than what is reported on the valuation.
- Another difference results from the handling of forfeiture amounts. Some firms reflect the forfeiture amount as a participant on the valuation. Others track the amounts forfeited separately from the valuation report. If it is tracked separately, then the valuation report does not tie to the total assets received causing a balancing issue.
- Surrender Fees: Assets being liquidated may carry surrender fees or Contingent Deferred Sales Charges (CDSCs) that may reduce assets.
- The plan may have received loan payments from participants that have not been reflected in their account balances.

After reviewing the valuation report from the prior retirement plan administration firm and identifying the differences between the assets received and the ending account balance, the conversion balances are uploaded to the daily software, by source. How the conversion assets are to be presented on the participant statements affects how fund data is uploaded. There are three methods that can be used:

1. If participants have been directing the investment of their account balances before the conversion, some plan sponsors want participants to be able to follow their balances through the conversion process. In this case, it is necessary to create accounts with the old funds on the new retirement plan administration firm's system and upload the conversion balances to the old funds. These funds can be set up as dollar par funds so that adjustments for fees, income, and realized gains/losses can be made without having to deal with the corresponding shares associated with these transactions. When all transactions are posted so that the conversion assets reflected on the valuation equal the amount in the conversion money market fund, the assets in that money market can be liquidated and invested according to the new investment elections completed by the participants. The transfer appears on the participant statement in the transfer column.

2. A second way to upload fund data is to reflect the transfer balance in cash (i.e., money market fund). At the point of conversion, the assets are invested in a money market fund. Prior investment funds are not set up on the daily system. This could be extremely important if the software has a limitation on the number of funds that can be set up. After transactions are posted to make adjustments for the fees, income and realized gain/loss, trades are set up to liquidate the conversion money market fund and invest these conversion assets based on the investment elections of the participants.

3. A third way to report the transfer balances on the participant statement is to show the conversion assets as already invested in the new funds. The new retirement plan administration firm simply uploads the transfer balance amounts, by source, and lets its system invest those dollars based on the participant investment elections. This works best when there are no adjusting transactions such as those described earlier. The participant does not see any transfers from the old funds or from the conversion money market to the new funds. The participant statement does not reflect that the conversion assets were invested in a temporary money market fund.

In all three of these situations, a posting entry must be made on the daily software to reflect the sale of the money market fund from the conversion management account. The amount of this special system transaction equals the amount traded. The conversion money market account should have had all assets liquidated from it, so the trustee can close out the conversion money market account.

Some retirement plan administration firms allow participants to make investment elections for the conversion assets that are separate from elections applied to their future contributions. Other firms simply invest the conversion assets based on the investment elections the participants make with regard to their future contributions. Using the latter method to invest the conversion assets minimizes the amount of work required and reduces the time spent on the conversion process. Participants can realign their balances after the voice response system is turned on.

The last steps in the daily to daily conversion process are:

- Make sure the daily system is in balance with the assets reported by the trustee; and
- Turn on the voice or other automated response systems.

[B] Mapping of Funds

The second investment conversion method is the mapping method, where the old funds are sold and the funds immediately invested in the corresponding new funds. For example, the plan has investments in the ABC Index Fund. It is being replaced with a DEF Index Fund.

Upon liquidation of the ABC Index Fund, the money is immediately invested in the DEF Index Fund. Likewise, each of the other old funds is mapped to a fund with investment objectives similar to the old one. The mapping is communicated to the participants so they know what the new funds are and how their old monies are invested. The participants do not make new investment elections during the conversion process.

Some employers prefer this method because the assets do not sit in a money market fund for 30 to 90 days; they are always invested. Participants who want to change their investment mix can do so as soon as the voice or other automated response systems are up and running.

Let's analyze this process in more detail. The old trustee liquidates the funds prior to the end of the valuation period and wires the cash to the new trustee, together with a written report indicating the separate liquidation value of each fund. The new trustee invests the funds based on the mapping instructions from the plan sponsor.

A conversion managements account is set up on the daily system to reflect the purchase of the new funds. This allows the conversion assets to be tracked separately from the ongoing contributions that are being received and invested while awaiting the transfer balance information. Any dividends paid during this period are posted to the conversion assets as well as to the new contributions. Any trailing dividends paid on the old assets are reinvested and posted to the appropriate fund in the conversion management account. This allows the assets to be tracked and the plan balanced before the transfer balance information is received from the prior retirement plan administration firm. The plan can be updated and priced every day just as though it is already out of the conversion period.

When the transfer balance information is received, the reconciliation process starts. As with the cash investment conversion method described earlier, the valuation produced by the prior retirement plan administration firm may reflect greater or fewer assets than were transferred. Since the plan is coming from a daily environment, there really should not be any accruals but the retirement plan administration firm may still have to deal with trustee fees, trailing dividends and/or realized gains/losses on assets that were liquidated after the valuation period.

There are two possible solutions if fewer assets have been received than what is reported on the prior valuation:

1. Upload the old assets as dollar par funds, post transactions to reflect the fees or losses and then show purchases of the new funds. The purchase appears on the system as a transfer, reflecting the shares bought for each fund; or

2. Load the new funds at the dollar value shown on the prior valuation with the real shares purchased when the funds were mapped. This creates a "derived price" per share so that the price times shares equals the transfer balance dollars as reflected on the prior valuation. When the real price is loaded the next business day, there is an unrealized loss that is immediately reflected on the accounts, which looks like the new funds had a loss. In reality, it is the trustee fee and the loss from the sale of the old funds being accounted for.

After the balances are uploaded, a transaction can be posted to the conversion management account to reflect the transfer of assets to the participant level accounts. Dividends on the new mutual funds may have been paid and allocated to the conversion management account. If so, these dividends can now be allocated to the participants' account balances (based on the transfer balance for each participant) and then moved out of the conversion management account.

The daily system should be in balance with the mutual funds positions reported by the trustee. In other words, the shares reflected for each mutual fund on the daily system should equal the number of shares the trustee holds for each mutual fund. The voice or other automated response system can be turned on and participant statements created. The plan is "live."

If there is any reason to believe the conversion may not be straightforward in a mapping situation, it may be helpful to create separate trust level accounts for the mutual funds related to the conversion assets and for the new contributions being invested in the mutual funds. This may generate a lot of statements from the trustee or the broker, but it helps to balance the plan without having to do a lot of ancillary accounting. After the transfer balance information is received, uploaded and balanced, the accounts can be merged.

[C] Recordkeeping Only Conversion

A daily plan simply moving from one retirement plan administration firm to another with no change in investment options is the easiest of all conversions. It is even more manageable if the prior retirement plan administration firm uses the same software as that used by the new recordkeeping firm.

The prior trustee transfers the assets (in-kind) to the new trustee at the start of the new valuation period. Upon receipt of the prior retirement plan administration firm's report, the balances and shares for each fund are uploaded. If any differences exist between the numbers of shares reflected at the end of the valuation period and the number received by the new trustee, the discrepancies must be reconciled and the appropriate transactions posted. Again, the differences may be trustee fees or trailing dividends.

The plan is ready to go live after the new retirement plan administration firm:

- Allocates any dividends paid during the new valuation period; and
- Balances with the trustee records.

§14.05 Balance-Forward to Daily Conversions

[A] Balance-Forward to Daily

A balance-forward to daily conversion is the most challenging to complete.

Here are five major reasons:

1. The accounting methodology changes from accrual to cash.

    - Balance-forward valuations reflect contributions withheld from a participant's compensation during the valuation period but invested after the valuation period ends. Daily plans reflect only the contributions actually invested during the period.
    - Distributions on balance-forward valuations that occur shortly after the valuation period may appear on the valuation as if they had been made. Participants who received the distributions are reflected on the valuation with a zero account balance. Daily valuations reflect these distributions only if they actually occur during the valuation period.
    - Dividends and interest that are paid shortly after the valuation period ends may be reported on a balance-forward valuation. In a daily plan, it is only reported if actually paid to the trust during the valuation period.

- Year-end matching contributions and profit sharing contributions are reflected on the balance-forward valuation even if they were deposited many months after the valuation period ends. In the daily environment, these contributions are reflected when invested.

2. Dollar accounting changes to share accounting. Daily plans track the shares and determine the market value at any point in time by multiplying the price per share by the number of shares owned. This allows the value to be computed every day. Market value is reflected as of a specific point in time on balance-forward plans. Daily plans may reflect dollars and shares on participants' statements, while balance-forward plans present only dollars.

3. More time is spent with the plan sponsor and the participants to educate them about the differences between balance-forward and daily recordkeeping. Two very important concepts are the accrual versus cash accounting and the dollar versus share accounting. Daily recordkeeping can provide many features not available in the balance-forward environment, such as voice or other automated response systems, paperless transactions, faster distribution processing and participant statement preparation, more frequent transfers and current values of participant accounts.

4. The level of cooperation from the prior retirement plan administration firm affects the transfer of data. Instructions regarding data transfers have improved substantially over the past few years, resulting in better cooperation and less frustration. An appreciation for and better understanding of the differences between the two methodologies makes everyone's work go more smoothly.

5. A decision must be made about the handling of any assets not valued daily that continue to be an investment choice.

The actual conversion processes for a balance-forward plan moving to daily is similar to activities described for the daily to daily conversions, but the processes themselves may take at least 30 days longer. If the communication between the balance-forward retirement plan administration firm and the daily retirement plan administration firm goes well, the reconciliation process should not be any more difficult than in a daily environment.

It is important that the final balance-forward valuation be prepared on a cash basis, rather than accrual, so that any market values computed by the daily retirement plan administration firm (beginning balances) should agree with the values reflected on the final balance-forward valuation (ending balances). Typically, an accounting reconciliation is part of the final report. If a gap exists, the assets must be reconciled.

Depending on the nature of the discrepancies, decisions are made as to who makes the corrections.

Balance-forward to daily conversions follows the same investment conversion processes as described in the daily to daily conversions.

The assets in a balance-forward conversion are:

- Liquidated and deposited to a money market fund [Total Asset Liquidation];
- Liquidated and mapped to similar funds [Mapping]; or
- The assets are not liquidated [Recordkeeping Only].

[B] Transition to Participant Direction

A fourth investment conversion process that only occurs in a balance-forward to daily conversion is one where the trustee was making all investment decisions and has now decided to allow participants to make investment decisions using a specified group of mutual funds. This often occurs when a 401(k) feature is first introduced. Some plan sponsors feel an obligation to let participants direct the investment of dollars deducted from their paychecks. In this situation, in addition to explaining the daily concepts to participants, a lot of time is spent discussing investment options and educating participants about their choices.

A plan may hold assets that cannot be easily turned into cash or that incur substantial penalties if redeemed, so existing assets must be evaluated with an eye toward whether or not the securities can be liquidated on demand. A timetable must be worked out with the trustees so that all the assets are sold in a timely fashion. Decisions about the timing of asset liquidation may put the trustee in the position of dictating when the conversion period starts.

Once a decision is made to allow participant direction, the trustees are anxious to get plan assets invested based on the participant elections; however, it could be as much as 90 to 120 days before the money is reinvested. Even though the trustees may liquidate funds throughout the final balance-forward valuation period, the balance-forward retirement plan administration firm may not be able to perform the valuation until 30 to 45 days after the end of the valuation period.

Most daily firms avoid performing estimated transfers based on a percentage of the transfer account balance. This slows the conversion process and causes additional reconciliation work. Following the same steps as a daily to daily cash conversion minimizes the work and time involved.

Suppose a plan sponsor has been using an array of mutual funds for the balance-forward plan and decides to keep these assets and merely transfer to the participant the responsibility for investment direction. In this situation, it is not necessary to liquidate the funds held by the trustee.

The daily retirement plan administration firm starts the recordkeeping conversion by creating an asset on the daily system to reflect the pooled trustee-directed assets, showing this as a dollar par fund. Participant transfer balances are uploaded, by source, or money-type. As with other conversions, the recordkeeper makes adjustments necessary to deal with activity that occurred from the beginning of the valuation period to the current date. Dividends and other income paid, along with realized gains/losses as of the “live” date, are posted.

The recordkeeper creates transactions on the daily system to reflect a liquidation of the pooled fund. Next, transactions are posted to reflect these assets being reinvested based on the participant investment elections. The recordkeeper must compare the current market value of the mutual funds to the amount needed to be purchased based on the participant elections and place trade orders for the difference between the market value and what was calculated by the system.

The trades are settled using the shares that were held by the trustee, plus or minus the shares bought or sold for the difference. There may still be an adjustment necessary because the trading is processed on the next day’s price. After adjustments are traded, the system should be in balance and the voice or other automated response systems can be turned on.

The recordkeeper may encounter other ways to do conversions, but the methods described in this chapter are standard throughout the industry. In all cases, it is important to thoroughly document the process, leave a good audit trail and be sure assets reconcile after the conversion.

Now that the topic of conversions is complete, the next chapter turns to the discussion of auditing a retirement plan, including the use of the SAS 70 Report in the audit process.

§14.06 Review of Key Concepts

- There are two types of plans to convert:
    1. One already in a daily recordkeeping format; or
    2. A plan with balance-forward accounting.

- There are three types of investment conversions:
    1. Liquidate all assets and deposit the cash in a holding account;
    2. Mapping; and
    3. Reregister assets with a different custodian but do not liquidate.

- The more challenging aspects of a daily to daily conversion are dealing with the transfer of assets when there is a change of investment options as part of the conversion.

- Balance-forward to daily conversions are the most challenging to complete.

- There are several reasons why the ending balance reflected on the valuation may not equal the amount of assets received from the prior trustee including: fees deducted, mutual fund dividend received, forfeiture allocated, surrender fees taken and loan payments received.

- A plan sponsor has several possible methods to present conversion assets on a participant statement.

- Moving from a trustee-directed to a participant-directed investment plan may add as much as 90 to 120 days to the conversion process.

§14.07 Review Questions

[A] True or False

______ 1. One reason an ending balance from the prior administration firm may be lower than the assets received during conversion is due to dividends paid after the last valuation date.

______ 2. One reason an ending balance from the prior administration firm may be higher than the assets received during conversion is due to surrender charges that were assessed.

[B] Multiple Choice

3. All of the following need to be explained to the plan sponsor when converting a plan from balanced-forward to daily recordkeeping, **EXCEPT**:

   A. The need to reflect year-end profit sharing contributions on the last valuation even if they are not yet available for deposit
   B. Any assets not valued daily need to be considered for possible liquidation
   C. New options available in daily
   D. Statements that reflect both shares and dollars
   E. The movement from accrual accounting to cash accounting

4. All of the following are processes to change from a trustee-directed to a participant-directed recordkeeping plan, **EXCEPT**:

   A. Create a dollar-par fund on the daily system to reflect the pooled trustee-directed assets
   B. Upload participant transfer balances by type of money
   C. Create a transaction to liquidate the pooled fund
   D. Reinvest the assets based on participant investment elections
   E. Withdraw any differences between the pooled assets and participant accounts

5. All of the following are processes to change from a trustee-directed to a participant-directed recordkeeping plan, **EXCEPT**:

   A. Create a dollar-par fund on the daily system to reflect the pooled trustee-directed assets
   B. Upload participant transfer balances by type of money
   C. Create a transaction to liquidate the pooled fund
   D. Reinvest the assets based on participant investment elections
   E. Withdraw any differences between the pooled assets and participant accounts

§14.08 Answers

1. **True.** One reason an ending balance from the prior administration firm may be lower than the assets received during conversion is due to dividends paid after the last valuation date. §14.04 [A]

2. **True.** One reason an ending balance from the prior administration firm may be higher than the assets received during conversion is due to surrender charges that were assessed. §14.04 [A]

3. The correct answer is **A.** §14.05 [A]

   A. Correct. This statement is false because the need to reflect year-end profit sharing contributions on the last valuation is not relevant when converting to daily recordkeeping.
   B. Incorrect. This statement is true because any assets not valued daily need to be considered for possible liquidation when converting to daily recordkeeping.
   C. Incorrect. This statement is true because new options available in daily need to be explained to the plan sponsor when converting to daily recordkeeping.
   D. Incorrect. This statement is true because the fact that statements reflect both shares and dollars needs to be explained to plan sponsors converting to daily recordkeeping.
   E. Incorrect. This statement is true because the movement from accrual accounting to cash accounting needs to be explained to plan sponsors converting to daily recordkeeping.

4. The correct answer is **C.** §14.03

   A. Incorrect. This statement is true because total asset liquidation is a conversion investment strategy.
   B. Incorrect. This statement is true because cash is generally transferred to the new trustee or custodian in total asset liquidation.
   C. Correct. This statement is false because cash is usually held in a money market or non-interest bearing account until the administration firm reconciles all data.
   D. Incorrect. This statement is true because participants choose their new funds and assets are invested in them in a total asset liquidation.
   E. Incorrect. This statement is true because any income generated in the holding account is allocated to participants based on the type of money that generated the income.

5. The correct answer is **E.** §14.05 [B]

   A. Incorrect. This statement is true because participant-directed recordkeeping creates a dollar-par fund on the daily system to reflect the pooled trustee-directed assets
   B. Incorrect. This statement is true because uploading participant transfer balances by type of money is a process when moving to participant-directed recordkeeping.
   C. Incorrect. This statement is true because creating a transaction to liquidate the pooled fund is part of the process when moving to participant-directed recordkeeping.
   D. Incorrect. This statement is true because reinvesting the assets based on participant investment elections is part of the process when moving to participant-directed recordkeeping.
   E. Correct. This statement is false because withdrawing any differences between the pooled assets and participant accounts is not part of the conversion process.

Chapter 15:
Audits of Employee Benefit Plans

§15.01 Learning Objectives

- Discuss the purpose of a SAS 70 report for a service organization.
- Differentiate between a Type 1 and Type 2 SAS 70 report.
- List the transactions that auditors test when performing a plan audit and discuss the common problems encountered during the testing.
- List common reports prepared by service organizations for plan auditors.

§15.02 Introduction

Generally, retirement plans that cover 100 or more participants are typically required to include the report of an independent accountant along with their Form 5500 Series reports. These reports are provided each year to the Employee Benefits Security Administration (EBSA), which is part of the DOL. To facilitate the work that must be performed by the auditor that issues an opinion on a plan, a SAS 70 is commonly used. A SAS 70 assesses the internal controls that exist in service organizations (such as firms providing daily valuation recordkeeping) to help ensure that the controls result in accurate, quality service being provided to the plan, its sponsor and its participants. A SAS 70 may document these controls only (Type 1) or may actually test the effectiveness of the controls (Type 2).

Although the SAS 70 report is not required of the service organization, it is an effective means of distributing the cost of auditing retirement plans and can be marketed as a value-added service for its clients.

§15.03 Checks and Balances in Auditing a Retirement Plan

Part of the work of any retirement plan administration firm is to follow procedures that ensure the quality of the work product. This is true whether the accounts of participants are updated annually or if activity is recorded more frequently. Such checks and balances might involve comparing loan repayments reported by the employer to the payments shown on the amortization schedule, reconciling cash positions to fund balances, requiring higher level review for certain transactions, or other steps that are specific to the software being used to maintain records. Many retirement plan administration firms have detailed checklists that facilitate this quality control function, and also serve as a useful tool in training new recordkeepers.

To an accountant who audits the retirement plan, these procedures are known as controls. The control procedures are part of the internal control environment, which sets the tone of an organization, influencing the control consciousness of its people. The control procedures are the most tangible and visible components of internal control, providing discipline and structure. Control environment factors include integrity and ethical values, a firm's commitment to excellence, the organizational structure and resulting assignment of authority and responsibility, as well as human resource policies and practices.

Retirement plan administration firms may employ internal auditors or other personnel primarily for the purpose of evaluating the quality of and adherence to controls over time by monitoring ongoing activities, performing periodic evaluations or both. Customer complaints and communications from IRS, DOL or other regulatory agencies also may be an indicator of the lack of effectiveness of the controls established by the retirement plan administration firm.

A retirement plan's internal control is generally not limited to the controls in place within the plan sponsor's physical facility or internal operations. These additional issues result from the plan using another organization to perform services that affect the plan's ability to record, process, summarize, and report financial information in its financial statements. These service providers, for auditing purposes, are known as service organizations.

Common examples of service organizations include bank trust departments, insurance companies, retirement plan administration firms and similar entities. Service organizations may provide a wide range of services to an employee benefit plan. The trust department of a bank, for instance, could be given authority to make decisions about how a plan's assets are invested. It also may serve as custodian of the plan's assets, maintain records of each participant's account, allocate investment income to the participants as directed by the plan document, make distributions to participants, and prepare filings for the plan, such as the Form 5500 or Form 1099-R. If a retirement plan chooses to have the service organization perform some or all of these tasks, the service organization might be executing, recording, and maintaining the documentation for that portion of the plan's transactions. This activity could have a material effect on the plan's financial statements.

When a plan sponsor engages a service organization, transactions that affect the plan's financial statements are subjected to controls that may be physically and operationally removed from the plan sponsor. In effect, the plan sponsor shifts some control procedures to the service organization and must consider the service organization's control procedures as part of its overall internal control environment for the plan.

In the end, the accountant planning and performing the audit of the retirement plan must gain an understanding of the plan's control environment, including the controls at the service organization. Typically, this is the point at which a service auditor is engaged to perform a service audit. Throughout the industry, the service auditor's report is known as the SAS 70 report.

§15.04 Statement on Auditing Standards (SAS) No. 70

[A] Reports on the Processing of Transactions by Service Organizations

In the 1970s, computers became increasingly accessible to those businesses that had been keeping their records manually. Independent data processors, or service organizations, emerged to provide smaller businesses access to computing power that had previously been the privilege of large companies. While the arrival of the personal computer in the 1980s meant in-house computer access to almost anyone, data processors continued to provide valuable services for community banks, securities firms and, for many businesses, human resource functions such as payroll. The auditing profession found it increasingly difficult to audit around the computer as companies turned over more and more control to these outside service providers.

Auditors began to request access to those outside data centers to understand the organization's control procedures and gain some basis for reliance on the information that was being provided to them. Coincidentally, the auditing profession was shifting its focus to place more reliance on the internal controls of an enterprise. In September 1992, the Committee of Sponsoring Organizations (COSO) published a report that provided common definitions of internal control, control environment, and control objectives. As the number of businesses using service organizations grew, it became very inconvenient for these organizations to be visited by one audit firm after another.

From the conflict between the need for relief from the many audit requests on the part of the service organization and the need for information on the part of the auditor, came the Service Auditor's Report, today known as the SAS 70 report. The report was designed for use by the auditors of those entities using a service organization, but retirement plan auditors are probably the primary users of today's SAS 70 reports.

When auditing a retirement plan, the auditor is required to obtain an understanding of the plan's internal control structure to the extent necessary to assess the control risk and perform the audit. Internal control is defined in accounting literature as *"a process, effected by an entity's board of directors, management and personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories of: effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations."*"

The SAS 70 report, together with other information about the plan sponsor, helps the plan's auditor understand the aspects of the service organization's controls that may affect the processing of the plan's transactions and the flow of significant transactions through the service organization. In addition, the auditor is able to determine whether the service organization's controls are suitably designed to prevent or detect processing errors that could result in a material misstatement of the plan's financial statements.

A retirement plan administration firm that has its own in-house daily valuation operation is considered a "service organization" and may engage auditors to perform a SAS 70 audit. Those firms providing daily valuation through subcontractors or other alliances should expect the alliance partner to have its own SAS 70 audit. It is important for a daily environment to have the SAS 70 audit because the service provider initiates most of the transactions automatically.

A retirement plan administration firm that is directly involved in processing transactions and placing trades such as in daily valuation recordkeeping is likely to engage auditors to perform a SAS 70 audit and find it very helpful. Balance-forward retirement plan administration firms generally do not have a SAS 70 audit because the plan sponsor is usually directly involved in processing all transactions.

[B] SAS 70—Type 1 Report

Documenting, understanding, and testing the controls over the assets and records of the service organization are the primary activities of the service auditor. By means of inquiries, walk-through of transactions, tests of input, processing, output controls and even physical security, the service auditor is able to issue one of two types of reports.

The "Report on Policies and Procedures Placed in Operation," called a Type 1 report, is a description of the controls and activities in place.

The SAS 70 Type 1 report contains:

- A specific reference to the application, services, products, or other aspects of the service organization covered by the report. A service organization may have different reports for different services or products that they offer. The report being utilized covers the plan auditor's focus.
- A description of the scope and nature of the service auditor's procedures. This allows the plan's auditors to determine if the procedures performed are adequate for their purposes.
- Identification of the party specifying the control objectives.
- An indication of the purpose of the service auditor's engagement.
- A disclaimer of opinion on the operating effectiveness of the policies and procedures.
- The service auditor's opinion is strictly on the description and design of the organization's policies and procedures in a Type 1 report.
- A statement of the inherent limitation of the potential effectiveness of policies and procedures at the service organization and the risk of extrapolating into future periods any evaluation of the description.
- Identification of the parties for whom the report is intended.

The opinion expressed in a Type 1 report is on the suitability of the design of the control policies and procedures. It is intended to provide the reader with an understanding of the control environment. The service auditor's report explicitly identifies the factors that impact the application, service, or product that is the basis for the report. A Type 1 report does not give the plan's auditor a basis for reliance on controls, so its use is limited. It would, for example, be useful to a benefit plan auditor performing a limited scope audit.
ERISA §103(a)(3)(c) allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to investment information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency who acts as trustee or custodian. (The limited scope audit provision does not apply to information about investments held by a broker/dealer or an investment company.) This election is only available if the trustee or custodian certifies both the accuracy and completeness of the information submitted. Since the scope of testing

investments is limited and not required, the Type I report may be utilized to document the understanding of the control environment for processing investment transactions.

[C] SAS 70—Type 2 Report

The service auditor may issue a "Report on Policies and Procedures Placed in Operations and Tests of Operating Effectiveness." This is a Type 2 SAS 70 report.

This report enables the plan's auditor to rely on those controls without the need to visit the service organization. Generally, effectiveness must be assessed for at least six months of the full plan year for the report to be useful to the plan's auditors.

For the plan auditor performing a full scope audit or performing a limited scope audit where the service organization also provides services such as the processing of participant level transactions (i.e. contributions, benefit payments, income and expense allocations), a Type 2 SAS 70 report would reduce the work involved to perform the audit. The plan auditor would then have a basis to rely on the effective operation of the controls as identified and tested in the report and therefore reduce the extent of testing.

A Type 2 report is not intended to be a certification that computer software functions as designed or as promised by the management of a service provider. Rather, the report provides information about the effectiveness of the controls over the functioning of the software.

The SAS 70 Type 2 report contains all of the elements of the Type 1 report in addition to the following:

- A reference to a description of tests of the specified policies and procedures. The description should include the nature, time, and extent of the tests in sufficient detail to enable the plan's auditors to assess control risk.
- A statement of the period covered by the service auditor's report.
- An opinion on whether the policies and procedures that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives were achieved during the specified period.
- A statement on control objectives not covered.
- A statement that the service auditor has performed no procedures related to any specific individual user organizations. User organizations are the separate employee benefit plans or other entities for which the service auditor's report is being issued.

Service auditor's reports cover many areas. For custodians such as mutual funds, their work includes not only tests around asset custody and related investment record processing, but also tests of the controls surrounding participant directed interfund transfers, even those accomplished telephonically. For retirement plan administration firms, the report includes areas ranging from controls over daily valuation and daily balancing to the controls over recording of participant transactions and annual testing for ERISA compliance.

In summary, when using a Type 2 SAS 70 report, the plan auditor must read the entire report to obtain an understanding of the relevant controls at the service organization and to determine if there are any instances of noncompliance found during testing of such controls. When the Type 2 SAS 70 report identifies instances of noncompliance, the plan auditor may need to perform additional tests at the service organization. When no such instances are noted, the plan auditor may have a basis to rely on the effective operation of controls and accordingly reduce the extent of audit procedures.

§15.05 Testing of Controls

The service auditor uses his or her judgment on the tests to be performed and refers to published guidance on the application and evaluation of audit sampling in performing the tests of controls. The tests include observation of processes, sampling and selection of system generated reports, completed forms, transaction logs and records, as well as corroborative inquiry of management, supervisory and staff personnel. The plan's auditor sees the relationship between the control objective, the control procedure that addresses the objective, and the test of the control procedure.

A plan's auditor may identify the relevant service organization controls by reading a description of the service organization's controls in a service auditor's report. Information about the effectiveness of such controls may be obtained from such a report if the report includes tests of operating effectiveness. Tests of operating effectiveness address how controls are applied, how consistently they are applied, and who applies them.

Suppose the service auditor is performing tests of the operating effectiveness of controls at a trust organization. One of the services performed by the trust organization is recording transactions for user organizations.

Typically, the auditor's testing includes the following detail:

- <u>Control objective specified by the service organization</u>. Controls do/do not provide reasonable assurance that security purchase and sale transactions are recorded at the appropriate amounts and in the appropriate periods.
- <u>Controls described by the service organization for this objective</u>. Reconciliations are/are not performed daily and reconciling items are/are not identified and resolved within ten days and before the issuance of customer statements.
- <u>Tests of operating effectiveness performed by the service auditor.</u> The service auditor inspected a sample of *n* reconciliations covering the test period.

- Results of tests. Reconciling items for the reconciliations inspected appeared/did not appear to result from normal processing and ranged from n cents to n dollars. Reconciling items were/were not identified timely and were/were not always resolved within the ten-day period and before the issuance of customer statements.
- Reporting test results. The service auditor concluded that the service organization consistently solved/did not consistently solve all reconciling items within the required period. This could/could not affect user auditors' assessments of whether transactions are completely and accurately reflected in customers' statements. Accordingly, the service auditor concluded that this information would be included in the results of tests.

§15.06 Conditions Affecting Operating Effectiveness

Certain aspects of the operations at either the service organization or the plan sponsor may erode the effectiveness of a procedure over time. Rapid growth of a service organization's customer base or implementation of new software may require additional or revised controls. A change in ownership or an internal reorganization could affect reporting responsibilities or limit the resources available for routine activities between the service organization and the plan sponsor.

The most common condition affecting operating effectiveness on both sides of the equation is the introduction of new personnel. On the service organization side, new personnel who are responsible for executing manual controls that affect a plan may increase the risk that controls are not operated effectively. High turnover of employees, a change in management's attitude, or a reduction in the level of supervision on the part of either the service provider or the plan sponsor tends to make controls less effective.

Each year, auditors for both the service organization and the retirement plan must take these factors into consideration when planning the audit. It can directly impact the testing function during the audit fieldwork.

[A] Limitations of the Service Auditor's Work

Service auditors do not test the controls at the plan sponsor's place of business. The plan's auditor must still evaluate controls at this level.

The service auditor's report normally indicates the controls that are in place at the plan sponsor's office to enable the service organizations controls to function properly. For example, controls over access to remote terminals (passwords), information pertaining to a new hire, a termination, changes in and accuracy of compensation, and reviewing the reports generated by the service provider are often controls in place at the plan sponsor and, therefore, tested by the plan's auditors.

Retirement plan administration firms encourage plan sponsors to review the portion of the SAS 70 report that addresses user organization controls that are required for the service organization to achieve its stated control objectives. This review is undertaken prior to engaging a service organization and at least annually as updated SAS 70 reports are issued. It is important to identify user controls that are not possible or practical to perform and discuss such gaps with the service organization. In addition, SAS 70 reports may not cover issues such as disaster recovery and backup facilities, both of which are very important to any plan sponsor.

§15.07 Audit Considerations

[A] SAS 70 Reports are Not Mandatory

It is important to note that SAS 70 Reports are not mandatory. The lack of a SAS 70 report does not in and of itself mean the plan auditor will encounter a scope limitation during the audit. However, reliance on controls in a Type 2 SAS 70 Report is typically the efficient means of conducting an audit of a benefit plan.

When a Type 2 SAS 70 Report is not present, the auditor may need to audit information at the custodian or recordkeeper's offices. This is accomplished by visiting the service provider directly or contracting with the service provider's own auditors. In the event that is not feasible (or the service provider refuses access) the plan's auditors significantly expand the scope of their work in order to render an opinion. Auditors often attempt to accomplish this through extensive requests for account balance and transaction confirmations of participants and detailed analysis of investment information from asset custodians.

SAS 70 reports are a useful means of sharing the cost of auditing retirement plans, in terms of dollars and in hours of aggravation for both plan sponsors and service providers.

[B] Other Audit Considerations

Technology drives the activity associated with participant directed accounts. As systems become more automated, there is less written documentation of transactions which translates into less of an audit trail. This initially presents a potential problem for the plan's auditor, which eventually trickles down to the service provider and the plan sponsor, as the auditors of the paperless plans make special requests for data.

In anticipation of these requests, many service organizations have developed audit packages that include certain summary reports and schedules.

The following are common items assembled for an auditor's package:

- SAS 70 report for the trust department and/or retirement plan administration firm;
- Schedule of contributions to the plan for the year, segregated by participant and employer contributions. If there are contributions receivable at the end of the plan year, those are summarized with a notation of the date that the contributions were deposited in the subsequent plan year;
- Detail of realized gains and losses for the year;
- Details of unrealized gains or losses at year end;
- Schedule of expenses incurred by the plan;
- Trial balance of the plan for the year then ended;
- Draft of statements of net assets and changes in net assets;
- Schedules required for attachment to Form 5500, including assets held for investment, reportable transactions, etc.; and
- Summary of loan activity.

Service providers are able to improve their own efficiency by planning and developing a reporting system that facilitates the work of the plan's auditor. This presents a substantial benefit for plan sponsors who engage those service providers and creates goodwill with the plan's auditors.

§15.08 Common Problems Encountered During an Audit of a Plan Using Daily Valuation

The following issues are cited by auditors from a national accounting firm as the most common obstacles to completing their work and getting reports issued for plan sponsors. Many of these issues are common to all defined contribution plans, whether or not the plans are using daily valuation.

[A] Access to Information

Service organizations who provide a SAS 70 report often mistakenly advise plan sponsors that their plan's auditors should not need to request any detailed information from them (the service organization), suggesting the SAS 70 report takes the place of that process. This is not true.

As described above, the SAS 70 report does two things for auditors. First, it provides a description of the accounting and controls at the service organization. Professional auditing standards require that auditors document an understanding of the accounting and controls of a plan and the Type 1 report provides a convenient and efficient means of satisfying that requirement. Secondly, Type 2 reports may provide a basis for reliance on controls at the service organization. This allows the auditor to *reduce*, but not eliminate, the amount of audit testing.

[B] Testing Participant Records

Even in a limited scope audit where investment balances are not subject to audit, the plan's auditors are required to test the allocations to individual participant's accounts of employee and employer contributions, investment income, loans, transfers, and withdrawals or distributions. The auditor accesses all of the activity in a participant's account and confirms that the aggregate of all participants' contributions, investment income, loans, withdrawals, and distributions is equal to the total reported on the plan's financial statements.

[C] Employee Contributions

Auditors test whether the amount withheld and contributed is that which the participant has authorized. In a daily valuation plan, this authorization may occur by voice response unit or via the company's intranet or Internet and may change as frequently as each pay period. A documented audit trail for this authorized amount or percentage is often not available. The plan's auditors may confirm the deferral election directly with the participant, but they generally do not get a good response rate and need to get evidence elsewhere for participants who do not reply to the confirmation request. A copy of the written confirmation that the recordkeeper sends to the participant and any follow-up response from the participant may be sufficient. The plan's auditors also may request access to a participant complaint log to look for evidence of system reliability.

[D] Employer Contributions

Auditors test employer contributions to a participant's account and access details that allow them to recalculate the amount. This may include a history of the participant contribution percentages elected or the dollar amount contributed for the period.

[E] Investment Income

Whether the plan is valued at the end of each day, month, quarter, or only on an annual basis, the plan's auditor tests the allocation of investment income to a participant's account, even in a limited scope audit. A common audit approach is to estimate the allocation and compare it to the amount actually reported to the participant. To estimate a participant's investment income, the auditors need the following data:

- Participant's balance by investment fund and changes during the period;
- Investment fund's interest and distributions per share during the period; and
- Price per share at the beginning and end of the period.

[F] Transfers between Investment Funds

There typically is no audit trail to check authorization, accuracy, and timeliness of transfers, particularly when the transfer is initiated using an automated response unit of some sort. A plan's auditors may again be forced to rely on confirmation directly with the participant and the participant complaint log.

[G] Participant Loans

As with transfers, there typically is no audit trail when authorized by an automated response unit. Often the auditors find that there is no executed promissory note or amortization schedule. The promissory note is evidence of the plan asset and, as such, should be held in trust by the plan's trustee or asset custodian.

[H] Participant Understatement Testing

Auditors check to see if all eligible employees are, in fact, participating in the plan. The plan's auditor may select employees from the employer's payroll register and determine whether those employees who meet the plan's participation requirements are enrolled in the plan, or if not, whether they elected not to contribute. Since most plans with voice response systems do not document the fact that an employee elected not to participate, that fact is difficult to establish.

[I] Distributions

Canceled checks and distribution authorization forms are becoming more difficult to track down now that automated response units are used to initiate the distribution process and institutional trustees are writing the benefit payment checks. In the past, the plan sponsor often could produce these documents from their own files. The trend to daily valuation and bundled services usually takes away from the plan sponsor the task of maintaining these records.

§15.09 Conclusion

The SAS 70 report is one way that plan sponsors may evaluate the quality of service to expect from a service provider. The control objectives stated in the report are directly linked to the recordkeeper's daily tasks.

The recordkeeper is critical to the success of the firm providing daily valuation services. Their work requires constant attention to detail if plans are to be operated correctly and participant records accurately maintained. The recordkeeper who is aware of the full scope of plan administration and consulting services offered by his or her firm is truly a valued professional!

The final chapter focuses on plan mergers and plan terminations. It reviews the different situations during which a plan merger might take place. It also discusses plan terminations, including terminating a defined benefit plan.

§15.10 Review of Key Concepts

- An organization that sponsors a retirement plan may employ internal auditors to evaluate the quality of and adherence to controls over time, either by monitoring ongoing activities, periodic evaluations, or a combination of the two.

- A plan sponsor may use other organizations (e.g. retirement plan administration firm, custodian, or bank trustee) to perform services that affect the plan. These service organizations are also subject to control procedures.

- The SAS 70 report helps the plan's auditor understand the aspects of the service organization's controls that may affect the processing of the plan's transactions and the flow of significant transactions through the service organization. It also helps to determine whether the controls are suitable to prevent or detect processing errors.

- There are two types of SAS 70 reports:
    1. Type 1 - Report on controls placed in operation. This report helps a plan auditor gain an understanding of controls, but the plan auditor cannot rely on those controls as they have not been tested.
    2. Type 2 - Report on controls placed in operation and tests of operating effectiveness. This is the most useful report to a plan auditor. The plan auditor can use this report to not only gain an understanding of controls but also rely on those controls and reduce the plan auditor's testing.

- Aspects that may erode a service organization's procedural effectiveness may include rapid growth, implementation of new software, high turnover of employees, and change in management personnel.

- Generally, a plan that covers more than 100 participants is required to include the report of an independent accountant with the annual Form 5500 series report to the EBSA, which is part of the DOL. This report is known as the audit report.

- Many service organizations put together audit packages to facilitate the work of the plan's auditor.

- Auditors encounter many obstacles to completing their work and getting reports issued for plan sponsors. In a daily valuation plan, use of voice response system or Internet may limit the documented audit trail to confirm a deferral election, transfer, or participant loan. A plan's auditor may be forced to rely on confirmation directly with the participant and the participant complaint log.

§15.11 Review Questions

[A] True or False

______ 1. A Type 1 SAS 70 report tests the effectiveness of the controls at the service organization and a Type 2 report documents the design of the controls.

______ 2. An auditor is required to test the allocations to individual participant accounts for accuracy.

[B] Multiple Choice

3. All of the following statements regarding audit packages prepared by a service organization are **TRUE, EXCEPT**:

   A. An audit package anticipates requests from the plan auditor.
   B. A summary of loan activity is provided to the plan auditor.
   C. Attachments to Form 5500 are provided to the plan auditor.
   D. A CD of all recorded participant requests received by phone is provided to the plan auditor.
   E. Presenting the audit package to the plan auditor creates goodwill.

4. All of the following are reasons a service organization requests a SAS 70 report, **EXCEPT**:

   A. To reduce the amount of testing required by the plan auditor
   B. To offer a value-added service to plan sponsors
   C. To evaluate the quality of controls in their own organization
   D. To share the cost of auditing a plan with the plan sponsor
   E. To eliminate any requests for information from the plan auditor

§15.12 Answers

1. **False.** A Type 1 SAS 70 report documents the design of the controls and a Type 2 report tests effectiveness of the controls at the service organization. §15.04

2. True. An auditor is required to test the allocations to individual participant accounts. §15.08 [B]

3. The correct answer is **D.** §15.07 [B]

   A. Incorrect. This statement is true because an audit package anticipates requests from the plan auditor.
   B. Incorrect. This statement is true because a summary of loan activity is provided to the plan auditor.
   C. Incorrect. This statement is true because attachments to Form 5500 are provided to the plan auditor.
   D. Correct. This statement is false because a CD of all recorded participant requests received by phone is not usually provided to the plan auditor.
   E. Incorrect. This statement is true because presenting the audit package to the plan auditor creates goodwill.

4. The correct answer is **E.** §15.04

   A. Incorrect. This statement is true because a SAS 70 report reduces the amount of testing required by the plan auditor
   B. Incorrect. This statement is true because a SAS 70 report offers a value-added service to plan sponsors
   C. Incorrect. This statement is true because a SAS 70 report helps to evaluate the quality of controls in their own organization
   D. Incorrect. This statement is true because a SAS70 report shares the cost of auditing a plan with the plan sponsor
   E. Correct. This statement is false because a SAS 70 report will not eliminate other requests for information from the plan auditor

Chapter 16:
Mergers and Terminations

§16.01 Learning Objectives

- List the reasons plan sponsors might merge two retirement plans.
- Differentiate between rollover transactions and plan-to-plan transfers.
- Explain the difference between a frozen and a terminated qualified plan.
- Summarize the general requirements for terminating a qualified retirement plan.
- Explain the two types of voluntary defined benefit plan terminations.
- Explain under what circumstances a defined benefit plan may be terminated involuntarily.

§16.02 Introduction

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) raised the employer deductible limit for profit sharing plans from 15% of compensation to 25% of compensation, providing parity with money purchase plans and other defined contribution plans. With this change many employers decided to terminate, merge or convert their money purchase plan into a profit sharing plan. Plan sponsors also may decide to terminate or merge certain retirement plans in their companies as a result of an acquisition or merger with another company. The decision to terminate, merge or convert plans enables employers to eliminate expenses associated with multiple plans.

Plan termination is the final stage in the life of a qualified retirement plan. Whether voluntarily or involuntarily undertaken, the dissolution of a plan is a complex process. All of the steps must be handled in an orderly and comprehensive manner to ensure that the plan remains qualified until the departure of the last penny of assets. Although the termination date is defined by the plan amendment, until that last cent leaves the plan's trust and the last governmental reports are submitted, the plan is not technically considered terminated.

This chapter provides an overview of the various aspects of plan mergers and terminations.

§16.03 Plan Mergers

There are many reasons for plan mergers. Qualified retirement plans are relatively costly for companies and time-consuming for their human resource employees to administer, even when retirement plan administration firms do the bulk of the work. Therefore, companies that have more than one qualified retirement plan may decide to merge their plans. Other companies may choose to convert an existing plan into a new plan type (*e.g.,* a money purchase pension plan may be converted into a profit sharing plan). Doing so may enable employers to eliminate expenses associated with dated and often costly plans. Also, when companies are acquired and multiple qualified retirement plans exist between the selling company and the buyer, the buyer may be forced by law under the successor plan rules, to merge the plans rather than terminate one or more of them.

[A] Company Merger

The merger of companies and the subsequent impact on qualified retirement plans is a specialized area of pension practice. Most firms have only a few staff members qualified to handle the complexities of the issues that arise from corporate mergers. Many plan sponsors retain ERISA attorneys who specialize in mergers and acquisitions, in addition to retaining the services of a pension consultant, to ensure compliance with the limited guidance available from the government.

When two or more unrelated companies are involved in a merger, or a stock or asset sale, the decisions regarding the fate of the seller's plan must be carefully made with the advice of pension professionals who specialize in this area of pension law. Generally, the first step is to determine if this is a stock sale or an asset sale. The rules are substantially different for stock sales and asset sales.

In a **stock sale**, the buyer acquires some or all of the stock of the seller. The employees do not change employers. They continue to work for the seller's business. The business that was sold has different ownership now, but the employees still work for the same business. Next, the retirement plan professional needs to determine the amount of stock that was acquired and the nature of the relationship of the two businesses to determine if the resulting business structure is a related employer (a controlled group, affiliated service group or management group).

If it is determined that the two employers are now related, the buyer's plan is now a successor plan to the seller's plan. It may be necessary to maintain the two plans. If there is no 401(k) plan involved in the transaction, there is more flexibility in determining if the plans can be terminated. If the seller's plan is a 401(k) plan, the plan cannot be terminated but must be merged. If the two employers are not related employers, then merging the plans creates a multiple-employer plan with all of the complexity of this type of arrangement.

In the event of an **asset sale**, the seller negotiates whether or not to sell the plan (an asset of the business) to the buyer. If the seller chooses not to sell the plan, then the seller may continue the plan for its existing employees and simply show the employees sold as terminated. Alternatively, the seller can spin-off the portion of the plan attributable to the employees sold. The spin-off plan can then be merged into the buyer's plan. If the seller chooses to sell the plan, the buyer becomes the owner and new plan sponsor. In this case, the buyer can either maintain the two plans or merge them together, as the successor plan rules also apply in this situation.

The employer(s) sponsoring the plans involved may unilaterally decide to enter into one of the above transactions without the consent of the participants of the plan. If the buyer decides to merge the two plans and act as the continuation of the prior employer, generally the participants do not become 100% vested, and they are not eligible for a distribution from the merging plan.

[B] Plan Merger Concerns and Actions

The following concerns and actions result on the part of the plan sponsor in the event of a plan merger.

<u>1. Disqualifying Events</u>

Prior to merging two or more plans, potential disqualifying events may be identified. In the event that one of the two plans has a disqualifying event, upon merger the remaining plans (including the plan without any issues) would be considered to have that disqualifying event. To prevent this from occurring, careful due diligence of the plan being acquired by the buyer is normally performed prior to the buy/sell agreement being signed. If a disqualifying event is identified during the due diligence process, the sponsor of the merged plan may incur the cost of going through IRS resolution programs to maintain the plan's qualification.

2. Underfunded Defined Benefit Plans

Underfunded defined benefit plans may require a significant outlay of cash on the part of the buyer in order to terminate the plan. In any event, the past service liability should be negotiated as part of the purchase price of the seller's business, or the buyer may insist that the seller terminate the plan and fully fund it prior to the date of the actual business acquisition.

3. Overfunded Defined Benefit Plans

Overfunded defined benefit plans may incur excise taxes in the event of a reversion. These excise taxes and the amount of overfunding need to be considered in the negotiations for the future of the plans. Often the buyer requires their plan actuary to evaluate the funded status of the plan in order to make any determinations.

4. Plan Design

Some design issues include how to handle plan loans of the merged plan participants, which investments to offer and how to transfer existing plan assets. Also, how to handle future vesting needs to be decided. Since vested benefits may not be reduced but future benefits may be changed, participants who have three years of service or more have a choice of remaining under the old vesting schedule or moving to the new vesting schedule. Application of service crediting and other qualification issues need to be clarified as well. All of these issues are normally addressed in the plan amendments related to the merger.

Distribution restrictions and joint and survivor annuity and spousal consent rights required of pension plans must continue to apply even if the seller's plan is merged into a profit sharing plan that is exempt from such requirements. The plan sponsor has two options: (a) add joint and survivor requirements to the surviving plan, or (b) separately account for the money purchase plan assets and apply the rules only to those assets.

Protected benefits in the plan of the seller cannot be eliminated after the merger. For example, if the seller's plan provided for a lump sum distribution, the surviving plan would need to preserve that provision for the employees of the acquired company to the extent of the benefits accrued as of the date of the merger.

The surviving plan needs to be amended for any new tax laws (that have not already been included) prior to the plan merger. As long as the amendments are written to retroactively amend the new merged plan to comply with the new tax laws, only the surviving plan need be amended going forward.

Each participant in the new plan must have the same account balance or accrued benefits following the merger as immediately before the actions. Forfeitures must be allocated, usually by plan amendment, as of the merger date to avoid having to file a Form 5310-A. Certain nondiscrimination testing transition rules apply during periods following corporate business transactions. These transition rules can force plan sponsors to make decisions regarding the timing of plan mergers in order to ensure plan compliance.

5. Actions Prior to the Plan Merger

Good plan practice is to draft written merger/transfer documents executed by both plans involved in the transaction. The documents should include an effective date for the merger/transfer. Many plans accomplish this by writing a plan amendment for each plan that indicates exactly what will happen to that plan in the merger, how benefits will be protected and how the plans will be modified in the future as a result of the merger.

A notice of reduction in benefit accruals might be required depending on the benefits in the surviving plan. In the case of a merger of a money purchase pension plan into a profit sharing plan, the notice is required. Generally, the ERISA §204(h) notice must be communicated to all participants at least 45 days prior to the effective date of the amendment, although this is reduced to 15 days in some cases.

Plan compliance issues that remain unresolved; fiduciary breaches; and pending IRS, DOL or PBGC audits are all liabilities to the buyer of a retirement plan. Often a thorough review of the seller’s plan is required by the buyer in order to determine the potential cost for correction. The buyer needs to know this potential liability in order to negotiate the purchase price. Alternatively, the buyer may require the seller to terminate the plan prior to the corporate acquisition date to ensure that all of the liability remains with the seller.

The plan sponsor may request a compliance determination letter (using Form 5300) from the IRS on the qualified status of the plan for a merger or transfer. Although not required, some retirement plan administration firms suggest it as a prudent action for the plan sponsor, especially if the plan merger or spin-off has the effect of significantly modifying the surviving plan involved in the transaction. However, a determination letter is no guarantee of continued compliance.

Form 5310-A (Notice of Plan Merger or Consolidation, Spin-off or Transfer of Plan Assets or Liabilities: Notice of Qualified Separate Lines of Business) with the appropriate attachments, must be filed with the IRS at least 30 days prior to the transaction. Exception: An individual account defined contribution plan that is merging or spinning off another individual account defined contribution plan for which there is no unallocated money in either plan may not be required to file this form if certain additional conditions are met.

The intent to merge the plans should be communicated to the plan participants affected by the merger. There is no formal guidance as to what must be communicated or the format for communicating information about mergers to participants. Information briefly describing the merger, the effective date of the merger, as well as how the assets of their former plan are to be transferred to the surviving plan, how loans are to be handled and vesting issues are usually communicated to assist the participants to understand the impact of the merger.

Sarbanes-Oxley blackout notices are not required in a plan merger. A plan merger is a permanent cessation of all rights under the plan being merged. Sarbanes-Oxley applies to temporary cessations of rights.

6. Actions after the Plan Merger

Generally, revised summary plan descriptions (SPDs) or summaries of the material modifications (SMM) resulting from the transaction are furnished to all of the participants and beneficiaries of the surviving plan within 90 days after the merger. A separate statement must be included that briefly describes the merger and the provisions of the merged and successor plans that continue to apply to the affected participants and beneficiaries. The affected participants and beneficiaries must also receive notice that copies of the merged and successor plan documents, as well as the plan merger documents, are available for inspection and that copies may be obtained upon written request.

The merger is reported on the Form 5500. Nondiscrimination testing becomes significantly more complex in the year of a plan merger. Since little IRS guidance has been issued in this area, the retirement plan administration firm or the ERISA attorney retained by the client needs to provide guidance on how to ensure compliance in the year of the merger.

In spite of the extra expenses incurred in conducting due diligence when merging two or more plans, the merger can ultimately result in reduced costs for the company, and, for newly merged or acquired companies, harmony among employees with the same retirement plan and a smoother transition toward company unity.

[C] Plan-to-Plan Transfer Versus Rollover

Sometimes confusion exists between the terms direct rollover or elective transfer and plan-to-plan transfer. An eligible **rollover** distribution is available for direct rollover when a participant experiences a distributable event such as a plan termination or severance from employment. As a result of the event, the participant may elect to take a distribution from the plan and roll it over to another qualified retirement plan or IRA. The distribution is not a transfer of assets and liabilities that must satisfy the plan merger or consolidation requirements. The direct rollover is not a transfer of benefits, and the retirement plan that is eligible to receive the rollover is not required to provide the same optional forms of benefits that were provided under the qualified retirement plan that made the rollover.

Significantly, merging a plan into another plan, converting a plan from one plan type to another or replacing a plan with another comparable plan are not events that allow for distribution of assets to participants. A **plan-to-plan transfer** of assets is determined at the company level without first obtaining the consent of the affected participants. It does not constitute a distributable event for participants, and their account balances are not eligible rollover distributions. Spousal consent is not required, and the plan accepting the plan-to-plan transfer of assets is required to provide the same optional forms of benefits that were provided under to plan that transferred the assets.

A plan merger is an event that results in a plan-to-plan transfer. A plan termination is an event that creates the opportunity for direct rollovers.

§16.04 Freezing Versus Terminating a Plan

[A] Freezing a Plan

Freezing a plan principally means the plan continues to exist, but there has been a cessation of benefit accruals in a defined benefit plan or a discontinuance of contributions in a defined contribution plan other than a profit sharing plan. (A complete discontinuance of contributions under a profit sharing plan renders it automatically terminated. Profit sharing contributions must be substantial and recurring.)

Because the plan continues, all administrative actions such as maintenance of participant accounts and benefits, governmental filings, reporting and disclosure continue while participant rights remain unchanged. Generally, the only difference between a frozen plan and an active plan is that no future benefits or contributions accrue in a frozen plan.

[B] Plan Termination

While qualified plans must be established with the intent to be permanent, events sometimes happen which make it necessary to terminate the plan. Some of these events include the sale or acquisition of the employer, restructuring of the employee benefit program or the inability of the employer to afford the plan.

Plan termination means the complete cessation of the plan and the liquidation of the trust. All assets must be distributed from a terminated plan as soon as administratively feasible after the plan termination date. After the termination is complete, the plan no longer exists, and all assets have been distributed so that the trust has a zero balance thereby also ceasing to exist.

1. Partial Plan Termination

There does exist the concept of a partial plan termination under which a portion of the plan is considered to have been terminated. According to qualified plan regulations, if a significant group of employees are no longer covered under the plan due to discharge of employment or because a plan amendment changed the plan's eligibility provisions, the affected employees must have their vested percentages accelerated to 100% full vesting and be allowed to receive a distribution from the plan.

Determining whether or not a partial plan termination has taken place involves a study of the relevant facts and circumstances. No legislative rule dictates what constitutes a significant group; however, the IRS has indicated that a loss of less than 20% of the eligible employees is not a significant group, while the loss of more than 30% is most likely a significant group. Between 20% and 30% is a facts and circumstances determination.

As an example of the consequences of a partial plan termination, consider a group of employees who lose their jobs because their employer closes their division. Some of them are less than 100% vested due to the length of their service. If no partial plan termination is declared, the affected employees are entitled to distribution of their benefits to the extent vested, and forfeiture of nonvested benefits occurs. However, if a partial plan termination has taken place, the affected employees all become 100% vested in their account balances or accrued benefits, and no benefits are forfeited.

The concept of a partial plan termination precludes an employer's ability to close itself down slowly over a period of time and avoid the full vesting required by plan termination rules. The determination of whether or not a partial plan termination has occurred is determined by the IRS. Typically, a plan sponsor will consult with an ERISA attorney for advice about partial plan termination issues.

§16.05 General Requirements for Plan Termination

In the normal course of business, a company may decide to terminate its qualified plan. A number of actions must be taken by the plan sponsor or plan administrator during the termination of a plan. Some of the more important steps include:

- Adopt a resolution terminating the plan. In the case of a partnership or sole proprietorship, a resolution by the owner or owners is acceptable. Note that the existence of a profit sharing plan is predicated on regular and ongoing contributions: upon the complete discontinuance of those contributions, the plan may be considered terminated without action on the part of the employer. The IRS considers complete discontinuance of contributions when a profit sharing plan fails to make substantial contributions for at least three years in a five-year period.
- Review the plan document for compliance with all applicable laws and regulations, and if necessary, amend the plan to comply with all laws and

regulations in effect as of the plan termination date as required. This is important because the plan must be qualified upon termination in order for the participants to receive the favorable tax treatment available to distributions from qualified plans.

- Amend the plan to make all affected participants 100% vested. As a general rule, all affected participants must become 100% vested upon termination of the plan. This applies even if the participant has not completed the number of years required for full vesting under the plan's vesting schedule. Most prototype and volume submitter documents automatically include language for 100% vesting if the employer adopts a resolution to terminate; therefore, a separate amendment is not required. Consult the plan document to determine if this language is already in the plan.
- Plans subject to the minimum funding requirements (money purchase, target benefit and defined benefit plans) are usually amended to cease benefit accruals or discontinue contributions.
- Plans subject to the minimum funding requirements (money purchase, target benefit and defined benefit plans) must provide an ERISA §204(h) notice to affected parties before benefit accruals can be ceased or contributions discontinued. Participants, beneficiaries, QDRO alternate payees and employee organizations representing participants as affected parties must receive this plain language notice within a reasonable time (generally at least 45 days before the amendment ceasing accruals or contributions becomes effective). Since only participants affected by the reduction in benefits must be notified, terminated participants do not receive the ERISA §204(h) notice. The notice should clearly explain the amendment so that participants understand the effect of the amendment on their current and future benefits.
- If a plan sponsor is going to request a favorable determination letter upon termination, the sponsor must timely submit Form 5310, the application for a determination letter to the IRS. Additionally, a defined benefit plan must file Form 6088, which is a schedule of distributable benefits. Although an IRS determination letter is not required, it is commonly recommended, particularly since the IRS announced in 1993 that audit chances were increased if no determination letter is requested.
- A notice to interested parties must be issued to notify the participants, beneficiaries and alternate payees that the plan will be submitted to the IRS for a determination letter. This notice may be provided by any method that reasonably ensures that all interested parties receive the notice. This notice must be furnished to all interested parties no later than ten days and no earlier than 24 days before the date the determination letter application is filed with the IRS.
- Once an IRS favorable determination letter is received, employees must be provided distribution notices and election forms which explain the tax consequences resulting from the distribution of benefits and which allow affected participants to make the appropriate transfer, withholding, or rollover elections. Plan assets must be distributed within one year of the termination date. This period may be extended for administratively reasonable delays or if the plan is covered by the PBGC.

- The appropriate recordkeeping and administration also needs to be completed for the final plan year. This includes valuation of participant accounts and benefits, filing of Form 5500 and all the other reporting and disclosure duties of the plan administrator as supported by the retirement plan administration firm. Note that the appropriate Form 5500 must continue to be submitted to EBSA until all plan assets have been distributed.

[A] Distributions

It often happens during the course of a plan termination that participants initially misunderstand the taxation issues surrounding the distribution of all assets under the plan to its participants and beneficiaries. These in-service withdrawals of benefits are not accomplished tax and penalty-free.

The presence of participant loans or insurance policies as plan assets and the desire of participants to receive annuity payments also complicate the distribution process and potentially create additional taxation issues. To combat any potential misunderstanding, a host of communication and notification requirements are set in motion upon any declaration of intent to terminate a plan.

The following in-service distribution options may be available from terminated plans:

- Participants may be allowed to take their distributions in cash or as in-kind distributions. In addition to ordinary income tax and withholding, a 10 percent additional income tax on early distributions may be applicable. Other favorable tax treatments, such as income averaging or capital gains treatment, may be allowed under the Internal Revenue Code.
- Participants may roll over their benefits in whole or in part to an IRA or another retirement plan to preserve the tax-deferred status of the rolled funds.
- Participants who don't elect a lump sum distribution or rollover may have the option to purchase an annuity. For this reason, the terminating plan may need to purchase annuities from an insurance company.

§16.06 Termination of Defined Benefit Plans

The **Pension Benefit Guaranty Corporation (PBGC)** guarantees payment of benefits up to PBGC statutory limits for participants in certain defined benefit plans. As an example, the maximum PBGC guaranteed monthly payment for plans terminating in 2006 is $3,971.59, expressed as a single life annuity payable at age 65. In order to receive PBGC protection, defined benefit plans pay annual premiums to the PBGC based on the number of participants and the funded status of the plan. Should such a defined benefit plan subsequently seek to terminate, it is subject to PBGC rules for plan termination. Generally, most defined benefit plans are covered by the PBGC. Some of the plans that are exempt from PBGC coverage include:

- Plans which cover only owners and their spouses; and

- Plans sponsored by professional service employers such as physicians, accountants and architects that have never had more than 25 participants.

[A] Defined Benefit Plans Not Covered by the PBGC

The procedure to terminate a defined benefit plan that is not covered by the PBGC is the same procedure generally described in the previous section. In addition to the pension-related notices and any applicable amendment to cease benefit accruals, the essential difference between a terminating defined benefit plan and a terminating defined contribution plan is that the amounts paid to participants are based on accrued benefits instead of account balances. Some participants may elect to receive monthly benefits at retirement.

In that instance, the plan transfers assets out of the plan to purchase an annuity from an insurance company or other financial institution that pays the stated benefit to the participant in the chosen form. Other participants may elect to receive an immediate cash distribution that is equal in amount to the present value of their benefits under the terms of the plan. In either instance, whether paid in a stream of payments or paid in a lump sum, plan assets are reduced to zero, thus ending the trust.

[B] Defined Benefit Plans Covered by the PBGC

For plans covered by the PBGC, the termination process includes all the steps involved in terminating a non-PBGC defined benefit plan, with additional requirements and limitations imposed by the PBGC.

Defined benefit plans covered by the PBGC may be terminated either:

1. Voluntarily by the employer; or
2. Involuntarily by the PBGC.

[C] Voluntary Defined Benefit Plan Terminations

There are two types of voluntary terminations approved by the PBGC:

<u>1. Standard Termination</u>

A **standard termination** is by far the most common type of voluntary defined benefit plan termination. Standard terminations require that the plan is fully funded: that is, the assets in the plan are sufficient to pay all benefits as of the date of plan termination for participants and their beneficiaries under the plan without PBGC involvement. If the assets are not sufficient, the plan sponsor may make a written commitment to the plan to contribute the amount necessary to make the assets in the plan sufficient before distributions are completed. Alternately, majority owners, those individuals owning 50% or more of the interest of the employer, may agree to accept less than their accrued plan benefits so that the benefits of all other plan participants can be paid in full.

2. Distress Termination

A **distress termination** may apply if the employer is in liquidation or reorganization proceedings under bankruptcy law or the plan can prove to the PBGC that plan termination is necessary to pay debts or to avoid burdensome pension costs. The plan must apply to the PBGC to request a distress termination. The PBGC criteria for distress terminations are strict. If the PBGC grants a distress termination, various PBGC regulations and procedures then govern the benefit amount calculations and how those benefits are paid.

[D] Involuntary Defined Benefit Plan Terminations

In order to protect the interests of plan participants, the PBGC may decide to initiate action to terminate a defined benefit plan. When the PBGC initiates an action to terminate a defined benefit plan, it is known as an **involuntary termination**.

The PBGC may terminate a plan for a number of reasons including:

- The plan is not able to pay benefits when due;
- The plan has not met the minimum funding standards; or
- PBGC losses will increase unreasonably if the plan is not terminated.

The PBGC contacts a plan sponsor long before it initiates steps to involuntarily terminate a plan in an attempt to ensure that the plan is able to terminate in a standard termination.

§16.07 Notice Requirements upon Termination of a Defined Benefit Plan

Various notices to plan participants, as well as to the IRS and PBGC, are required for both standard and distress terminations of PBGC covered defined benefit plans.

[A] Notice of Intent to Terminate

A Notice of Intent to Terminate (sometimes called a NOIT) must be given to all affected parties advising them of the proposed plan termination. It must include substantive and explanatory information such as a statement regarding the sufficiency of plan assets, explanations on how to get a copy of the plan's SPD, the date that benefits cease to accrue and advise that a Notice of Plan Benefits is forthcoming. The NOIT must be issued at least 60 days but no more than 90 days before the proposed date of plan termination. For this purpose, the date of plan termination is the date specified in the Notice of Intent to Terminate or, if later, in the Standard Termination Notice described below.

[B] Notice of Plan Benefits

A Notice of Plan Benefits must be issued to each participant and beneficiary describing his or her plan benefits. This notice must be provided no later than the date the Standard Termination Notice is filed with the PBGC and includes:

- The date of plan termination;
- The accrued and vested benefit;
- The employee data used to calculate the benefits, such as service years and compensation;
- The availability of other payment options; and
- The relative value of the optional forms.

[C] Standard Termination Notice (Form 500)

The Standard Termination Notice (Form 500) notifies the PBGC of the proposed standard termination and provides supporting information in the form and manner required by the PBGC. As an example, the filing must include a Schedule EA-S, the actuarial certification that the plan assets are sufficient to pay all benefits. Notice to the PBGC must occur on or before the 180th day after the proposed termination date. Failure to file on time nullifies the termination. After notification, the PBGC issues a notice that it will take 60 days to review the termination for compliance with the law and regulations.

If, within the 60-day period after the filing of Form 500, the PBGC does not issue a Notice of Noncompliance stating that the termination does not satisfy the requirements for a standard termination, the plan sponsor may assume the termination to be in compliance. Alternately, the PBGC and the plan sponsor can negotiate in writing for an extension of this 60-day period.

Assets must be distributed to pay all benefits due within 180 days after the end of the PBGC's 60-day review period, that is, within 240 days after the PBGC's receipt of a complete and valid filing. If the plan sponsor filed a request for determination letter upon plan termination with the IRS on or before the date the Form 500 was filed with the PBGC, the asset distribution deadline is automatically extended to 120 days after receipt of the IRS determination letter. Often, the plan sponsor wishes to wait for the IRS approval of the plan termination prior to distributing assets. Note that failure to complete the distributions in a timely fashion may nullify the termination.

Under certain circumstances, the PBGC may extend the deadline for distribution of benefits upon written application by the plan sponsor.

[D] Notice of Annuity Information and Notice of Annuity Contract

If the defined benefit plan is to distribute benefits in the form of an annuity, it must provide to participants and beneficiaries a Notice of Annuity Information at least 45 days prior to distribution date. Later, upon completion of the annuity purchases, the plan issues a Notice of Annuity Contract to annuitants no later than 30 days after the annuity contracts have been purchased. Neither notice is required to be filed with the PBGC.

[E] Post-Distribution Certification (Form 501)

The Post-Distribution Certification (Form 501) must be filed with the PBGC within 30 days after the completion of the distribution of plan assets. Failure to file the Form 501 on time subjects the plan administrator to possible penalties and may invalidate the termination.

§16.08 Key Terms

Asset Sale: The buyer acquires some of all of the assets of the seller, including the retirement plans.

Distress Termination: A voluntary plan termination whereby the plan under financial duress is terminated according to strict regulations governed by the PBGC.

Freezing: The plan continues to exist absent any benefit accruals or contributions.

Involuntary Termination: A plan termination that is initiated by the PBGC.

Pension Benefit Guaranty Corporation (PBGC): A nonprofit corporation, functioning under the jurisdiction of the Department of Labor, responsible for insuring benefits to participants of certain defined benefit plans.

Plan-to-Plan Transfer: A transfer determined at the company level without first obtaining the consent of the affected participants.

Plan Termination: A complete cessation of the plan and liquidation of the trust.

Rollover: A tax-free transfer of cash or other assets from one retirement plan to another. Certain payouts from a qualified plan may also be rolled over to an IRA or to another employer's plan.

Standard Termination: A voluntary plan termination whereby the plan is fully funded.

Stock Sale: The buyer acquires some or all of the stock of the seller but employees do not change employers.

§16.09 Review of Key Concepts

- Plans may be merged for various reasons, including administrative cost savings, conversion of one plan type to another or company mergers and acquisitions.

- A plan merger is an event that results in a plan-to-plan transfer.

- A plan termination is an event that results in a plan distribution.

- Freezing a defined contribution plan means no additional contributions are made. In the case of a defined benefit plan, no additional benefits accrue. Otherwise, the plan continues to exist as an active plan.

- Termination of a plan means complete discontinuance of the plan, including distribution of all assets. All administrative actions must continue until the balance in the trust is zero.

- The procedure for plan terminations includes:
    - A resolution terminating the plan;
    - A possible amendment to bring the plan document into compliance with current regulations;
    - A vesting increase to 100% full vesting for all affected participants if not already included in the plan document;
    - A Notice of Intent to Terminate to all participants of a plan subject to minimum funding standards, which includes information regarding the cessation of benefit accruals;
    - Additional requirements for defined benefit plans covered by the PBGC;
    - Additional requirements for plans wishing to file for a determination letter from the IRS.
    - Calculation of final benefit amounts;
    - Preparation of distribution paperwork for all participants and beneficiaries of the plan; and
    - Distribution to all participants and beneficiaries.

- There are two types of voluntary plan terminations approved by the PBGC: a standard termination, where the plan is fully funded or will be fully funded by the time assets are to be distributed, and a distress termination, where there are certain extenuating financial circumstances for the plan sponsor that necessitate terminating the plan.

- An involuntary termination is one initiated by the PBGC where a plan is not able to pay benefits when due or has not met minimum funding requirements, or the PBGC will incur increasing losses if the plan is not terminated.

§16.10 Review Questions

[A] True or False

______ 1. Freezing a defined benefit plan results in participants not accruing any future plan benefits but participant rights to benefits already accrued remain unchanged.

______ 2. Employers who sponsor a defined benefit plan may voluntarily apply to the PBGC for a standard termination if the plan is fully funded.

______ 3. A plan sponsor of a defined benefit plan may voluntarily apply to the PBGC for a distress termination if the employer is in liquidation or reorganization under bankruptcy law.

[B] Multiple Choice

4. All of the following statements regarding a PBGC standard plan termination of a defined benefit plan are **TRUE, EXCEPT**:

   A. The assets in the plan must be able to pay all benefits as of the termination date.
   B. The PBGC may initiate this termination.
   C. If the plan is not fully funded, the plan sponsor may commit to make the assets sufficient before distributions are complete.
   D. The process is a voluntary termination.
   E. If the plan is not fully funded, the majority owners of the plan may agree to accept less in benefits.

5. All of the following statements are differences between a direct rollover and a plan-to-plan transfer, **EXCEPT**:

   A. A plan merger creates the opportunity for a direct rollover; a plan termination results in a plan-to-plan transfer.
   B. Spousal consent may be required in a direct rollover; plan-to-plan transfers do not require spousal consent.
   C. Participants may request a direct rollover; plan-to-plan transfers are determined at the company level.
   D. A direct rollover is not a transfer of benefits; a plan-to-plan transfer requires the new plan to provide the same optional forms of benefits as the former plan.
   E. A direct rollover is a distributable event; a plan-to-plan transfer is not.

6. All of the following are provided to participants when a plan is terminating, **EXCEPT**:

   A. An ERISA §204(h) notice if the plan is subject to minimum funding
   B. A copy of the amended plan document
   C. A notice informing participants when the plan termination will be submitted to the IRS for a determination
   D. In-service distribution options available
   E. Distribution taxation notices

7. All of the following statements regarding an involuntary defined benefit plan termination are **TRUE, EXCEPT**:

   A. The PBGC may initiate an involuntary plan termination.
   B. It protects the interests of plan participants.
   C. Participants may initiate an involuntary termination.
   D. It minimizes losses that the PBGC would need to pay.
   E. It may be the result of a plan not meeting its minimum funding.

8. All of the following actions must be taken to terminate a plan, **EXCEPT**:

   A. Amend the plan
   B. Immediately cease filing 5500 returns
   C. Adopt a resolution to terminate
   D. Notify the participants
   E. Distribute plan assets

§16.11 Answers

1. **True.** Freezing a defined benefit plan results in participants not accruing any future plan benefits but participant rights to benefits already accrued remain unchanged. §16.04 [B}

2. **True.** Employers who sponsor a defined benefit plan may voluntarily apply to the PBGC for a standard termination if the plan is fully funded. §16.06 [C]

3. **True.** A plan sponsor of a defined benefit plan may voluntarily apply to the PBGC for a distress termination if the employer is in liquidation or reorganization under bankruptcy law. §16.06 [C]

4. The correct answer is **B.** §16.06

   A. Incorrect. This statement is true because the assets in the plan must be able to pay all benefits as of the termination date.
   B. Correct. This statement is false because the plan sponsor initiates a standard plan termination.
   C. Incorrect. This statement is true because if the plan is not fully funded, the plan sponsor may commit to make the assets sufficient before distributions are complete.
   D. Incorrect. This statement is true because a standard plan termination is voluntary.
   E. Incorrect. This statement is true because if the plan is not fully funded, the majority owners of the plan may agree to accept less in benefits.

5. The correct answer is **A.** §16.03 [C]

   A. Correct. This statement is false because a plan merger creates a plan-to-plan transfer while a plan termination provides the opportunity for direct rollover.
   B. Incorrect. This statement is true because spousal consent may be required in a direct rollover; plan-to-plan transfers do not require spousal consent.
   C. Incorrect. This statement is true because participants may request a direct rollover; plan-to-plan transfers are determined at the company level.
   D. Incorrect. This statement is true because a direct rollover is not a transfer of benefits; a plan-to-plan transfer requires the new plan to provide the same optional forms of benefits as the former plan.
   E. Incorrect. This statement is true because a direct rollover is a distributable event; a plan-to-plan transfer is not.

6. The correct answer is **B.** §16.05

   A. Incorrect. This statement is true because an ERISA §204(h) notice is provided to participants in a terminated plan subject to minimum funding requirements.
   B. Correct. This statement is false because a copy of the amended plan document is not usually provided to participants in a terminating plan.
   C. Incorrect. This statement is true because a notice informing participants when the plan termination will be submitted to the IRS for a determination is provided to participants in a plan that is terminating.
   D. Incorrect. This statement is true because in-service distribution options available is provided to participants in a terminated plan.
   E. Incorrect. This statement is true because distribution taxation notices are provided to participants in a terminating plan.

7. The correct answer is **C.** §16.06 [D]

   A. Incorrect. This statement is true because the PBGC may initiate an involuntary plan termination.
   B. Incorrect. This statement is true because an involuntary plan termination protects the interests of plan participants.
   C. Correct. This statement is false because the PBGC initiates an involuntary termination.
   D. Incorrect. This statement is true because an involuntary plan termination minimizes losses that the PBGC would need to pay.
   E. Incorrect. This statement is true because an involuntary plan termination may be the result of a plan not meeting its minimum funding requirements.

8. The correct answer is **B.** §16.05

   A. Incorrect. This statement is true because to terminate a plan it must be amended.
   B. Correct. This statement is false because a terminated plan does not trigger a final Form 5500, the liquidation of the trust does.
   C. Incorrect. This statement is true because to terminate a plan it must adopt a resolution to terminate.
   D. Incorrect. This statement is true because to terminate a plan the participants must be notified.
   E. Incorrect. This statement is true because a terminated plan distributes plan assets.

Chapter 17:
ASPPA Code of Professional Conduct

§17.01 Learning Objectives

- Recognize the action required of an ASPPA member in situations requiring ethical standards.

§17.02 Introduction

This chapter contains the ASPPA Code of Professional Conduct by which ASPPA members must abide in all of their professional undertakings. This code serves the public interest.

§17.03 ASPPA Code of Professional Conduct

The reliance of the public, the business community and pension plan participants and beneficiaries upon the quality of advice and services provided by actuaries and other benefits professionals imposes upon them a duty to maintain the highest level of technical competence and integrity. To this end, a member of ASPPA shall:

- Maintain independence of thought and action,
- Observe the highest standards of practice, and
- Uphold the dignity and honor of the profession.

This Code of Professional Conduct (Code) identifies the professional and ethical standards by which all benefits professionals must abide and thereby serve the public interest.

1. COMPLIANCE

An ASPPA member shall be knowledgeable about this Code of Professional Conduct, keep current with Code revisions, and abide by its provisions.

Laws and regulations may impose binding obligations on a benefits professional. Where the requirements of law or regulation conflict with this Code, the requirements of law or regulation take precedence.

2. PROFESSIONAL INTEGRITY

An ASPPA member shall perform professional services with honesty, integrity, skill, and care. A member has an obligation to observe standards of professional conduct in the course of providing advice, recommendations, and other services performed for a principal. For purposes of this Code, the term "principal" means any present or prospective client or employer.

A member who pleads guilty to or is found guilty of any misdemeanor related to financial matters or any felony shall be presumed to have contravened this Code and shall be subject to ASPPA's counseling and disciplinary procedures.
A member's relationship with a third party shall not be used to obtain illegal or improper treatment from such third party on behalf of a principal.

3. QUALIFICATION STANDARDS

An ASPPA member shall render opinions or advice, or perform professional services only when qualified to do so based on education, training or experience.

4. DISCLOSURE

An ASPPA member shall make full and timely disclosure to a principal of all sources of compensation or other material consideration that the member or the member's firm may receive in relation to an assignment for such principal.

A member who is not financially and organizationally independent concerning any matter related to the performance of professional services shall disclose to the principal any pertinent relationship that is not apparent.

5. CONFLICTS OF INTEREST

An ASPPA member shall not perform professional services involving an actual or potential conflict of interest unless:

(a) The member's ability to act fairly is unimpaired;
(b) There has been full disclosure of the conflict to the principal(s); and
(c) All principals have expressly agreed to the performance of the services by the member.

If the member is aware of any significant conflict between the interests of a principal and the interests of another party, the member should advise the principal of the conflict and also should include appropriate qualifications or disclosures in any related communication.

6. CONTROL OF WORK PRODUCT

An ASPPA member shall not perform professional services when the member has reason to believe that they may be used to mislead or to violate or evade the law.

Material prepared by a member could be used by another party to influence the actions of a third party. The member should recognize the risks of misquotation, misinterpretation or other misuse of such material and should take reasonable steps to ensure that the material is clear and presented fairly and that the sources of the material are clearly identified.

7. CONFIDENTIALITY

An ASPPA member shall not disclose to another party any confidential information obtained through a professional assignment performed for a principal unless authorized to do so by the principal or required to do so by law.

“Confidential information” refers to information not in the public domain of which the member becomes aware during the course of rendering professional services to a principal. It may include information of a proprietary nature, information that is legally restricted from circulation, or information which the member has reason to believe that the principal would not wish to be divulged.

8. COURTESY AND COOPERATION

An ASPPA member shall perform professional services with courtesy and shall cooperate with others in the principal’s interest.

Differences of opinion among benefits professionals may arise. Discussion of such differences, whether directly between benefits professionals or in observations made to a client by one benefits professional on the work of another, should be conducted objectively and with courtesy.

A member in the course of an engagement or employment may encounter a situation such that the best interest of the principal would be served by the member’s setting out a differing opinion to one expressed by another benefits professional, together with an explanation of the factors which lend support to the differing opinion. Nothing in this Code should be construed as preventing the member from expressing such differing opinion to the principal.

A principal has an indisputable right to choose a professional advisor. A member may provide service to any principal who requests it even though such principal is being or has been served by another benefits professional in the same matter.
If a member is invited to advise a principal for whom the member knows, or has

reasonable grounds to believe, that another benefits professional is already acting in a professional capacity with respect to the same matter or has recently so acted, it would normally be prudent to consult the other benefits professional both to prepare adequately for the assignment and to make an informed judgment whether there are circumstances as to potential violations of this Code which might affect acceptance of the assignment. The prospective new or additional benefits professional should request the principal’s consent to such consultation.

9. ADVERTISING

An ASPPA member shall not engage in any advertising or business solicitation activities with respect to professional services that the member knows or should know are false or misleading.

“Advertising” encompasses all communications by whatever medium, including oral communications, which may directly or indirectly influence any person or organization to decide whether there is a need for professional services or to select a specific person or firm to perform such services.

10. TITLES AND DESIGNATIONS

An ASPPA member shall make use of the membership titles and designations of ASPPA only where that use conforms to the practices authorized by ASPPA.

11. COLLATERAL OBLIGATIONS

An ASPPA member who is an actuary shall also abide by the Code of Professional Conduct for Actuaries.

A member or representative shall respond promptly in writing to any letter received from a person duly authorized by ASPPA to obtain information or assistance regarding possible violations of this Code.

§17.04 Review Questions

[A] True or False

______ 1. An ASPPA member shall not disclose to another party any confidential information obtained through a professional assignment unless authorized to do so.

______ 2. ASPPA members are prohibited from performing professional services involving an actual or potential conflict of interest.

§17.05 Answers

1. **True.** Confidential information may not be disclosed by an ASPPA member unless authorized to do so by the principal or required by law. §17.03

2. **False.** ASPPA members may perform services involving an actual or potential conflict of interest if 1) the member's ability to act fairly is unimpaired, 2) there has been full disclosure of the conflict to the principal(s) and 3) all principals have expressly agreed to the performance of services by the member. §17.03

Appendix A:
Sample Request Forms

Periodic Information Request

General Information

Review information pre-printed in the blanks. If the information is incorrect, please indicate.

Plan Sponsor: ___________________________

Plan Name: ___________________________

Business Address: ___________________________

Street Address: ___________________________
(If above is a P.O. Box)

____

Person to Contact: ___________________________

Telephone No.: ___________________________

Fax Number: ___________________________

Employer I.D. No.: ___________________________

Trust I.D. No.: ___________________________

Three Digit Plan No.: ___________________________

Effective Date of Plan: ___________________________

Plan Fiscal Year Ends: ___________________________

Six Digit Business Code: ___________________________

**Date Business Began/
Incorporation Date:** ___________________________

Company Information

1. Company fiscal year ends: ______________________
   If the Company has changed its fiscal year, the new fiscal year ends: __________________

2. Entity type is: _____________________
   If the entity type has changed during the Plan Year, the new entity type is: _____________
   New Employer Identification Number, if applicable: _______________________________

The information contained in this report is correct to the best of my knowledge and was compiled and submitted by:

____________________________________ ______________________

Preparer Signature Date

Professional Advisor Information

Please review the following information regarding your advisors for the Plan as of the period end date, making corrections, additions and deletions where necessary. **Please check the box for each advisor shown if you want us to send a copy of the reports for the period.**

Accountant [ ]

Attorney [ ]

Insurance Agent [ ]

Financial Planner [ ]

Banker [ ]

Broker [ ]

Plan Information

		Yes	No
1.	Have any amendments been made to the Plan during the past period OTHER than those prepared by our office? If so, please enclose an executed copy.	☐	☐
2.	During the last period, were there any changes of persons who served the Plan in any of the following positions:		
	Trustee	☐	☐
	Accountant	☐	☐
	Insurance Carrier	☐	☐
	Plan Administrator	☐	☐
	Investment Manager or Custodian	☐	☐

If so, please explain and include the name, position, address and telephone number of the individuals who were removed from the Plan, as well as their replacement(s).

____

____

		Yes	No
3.	Does the Employer maintain any retirement or other employee benefit plans <u>NOT</u> administered by our office? If yes, please verify and/or complete the following:	☐	☐

PLAN TYPE	PLAN NUMBER	CONTRIBUTION FOR PLAN YEAR	ADMINISTRATOR NAME/ COMPANY/PHONE NUMBER

		Yes	No
4.	Have you ever had any other plans that are no longer active (including frozen Keoghs)? If yes, please verify and/or complete the following:	☐	☐

PLAN NAME	IS PLAN TERMINATED (Y/N)?	ARE ASSETS DISTRIBUTED (Y/N)?

		Yes	No
5.	In order to help us complete the Form 5500 Annual Return/Report please indicate if your trust has participated in any of the following transactions during the last period:		
	Loans to Plan Sponsors	☐	☐
	Loans to Participants, Employees, or family members of Employees	☐	☐
	Lease contracts with any of the above	☐	☐
	Sales contracts with any of the above	☐	☐

Please Attach Copies of All Supporting Documentation

Plan Sponsor Information

Ownership – Please verify and/or complete the following list of owners of the Plan Sponsor and percentage of ownership for each owner. Also indicate the names of any family members who work for the Plan Sponsor and the relationship to the owner.

OWNERS	DID PERCENTAGE OF OWNERSHIP CHANGE SINCE LAST PERIOD (Y/N)?	PERCENTAGE OWNERSHIP
		%
		%
		%

Controlled Groups – Please verify and/or update the following table. Under "Business Name," please list the names of all businesses owned at least partially by any or all of the following:

- Owners of the Plan Sponsor
- Spouses of owners of the Plan Sponsor
- Direct descendants or ascendants of either of the above

Under "Percentage of Ownership," please list the percentage of ownership of the business listed in "Business Name" that would be attributable to any of the parties listed above.

Under "Number of Employees," please provide the number of non-owner employees employed by the business listed under "Business Name."

BUSINESS NAME	PERCENTAGE OF OWNERSHIP	NUMBER OF EMPLOYEES
	%	
	%	
	%	
	%	
	%	

Officers – Please update the following list of the officers of the Plan Sponsor:

NAME	TITLE	CHANGED SINCE LAST PERIOD (Y/N)?

Union Employee Information Request

Employer: Self Study, Inc.

Plan Name: Employees Retirement Plan and Trust

Plan Year End: ____________________

	YES	NO
During the Plan Year, did you employ any individuals who were represented by a collective bargaining unit and who are not covered under the above-named Plan?	☐	☐

> If NO, do not complete the remainder of this form. Return it with your Census Request form.

If YES, please answer the following questions:

1. Were retirement benefits for your union employees the subject of good faith bargaining? ☐ ☐

2. How many union employees did you employ during this Plan year, including terminated union employees? ___________

3. What is the 6-digit “LM Number,” which is the Labor-Management disclosure number entered by the sponsoring labor organization in item 1 of the Form LM-2 or LM-3 filed with the Department of Labor? ___________

ASPPA asap
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10-Year COLA Summary

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Qualified Plan Limits										
401(k), 403(b) and SARSEP maximum deferral [402(g)]	$15,000	$14,000	$13,000	$12,000	$11,000	$10,500	$10,500	$10,000	$10,000	$9,500
457 maximum deferral	15,000	14,000	13,000	12,000	11,000	8,500	8,000	8,000	8,000	7,500
Catch-Up for 401(k), 403(b), SARSEP, and 457	5,000	4,000	3,000	2,000	1,000	–	–	–	–	–
SIMPLE election maximum deferral	10,000	10,000	9,000	8,000	7,000	6,500	6,000	6,000	6,000	6,000
Catch-Up for SIMPLE	2,500	2,000	1,500	1,000	500	–	–	–	–	–
DB – annual benefit	175,000	170,000	165,000	160,000	160,000	140,000	135,000	130,000	130,000	125,000
DC – annual contributions	44,000	42,000	41,000	40,000	40,000	35,000	30,000	30,000	30,000	30,000
Compensation Limits										
Maximum compensation	220,000	210,000	205,000	200,000	200,000	170,000	170,000	160,000	160,000	160,000
SEP annual compensation floor	450	450	450	450	450	450	450	400	400	400
Highly Compensated Employees										
Any employee compensation	100,000	95,000	90,000	90,000	90,000	85,000	85,000	80,000	80,000	80,000
Key Employees										
Officer compensation	140,000	135,000	130,000	130,000	130,000	70,000	67,500	65,000	65,000	62,500
10 largest owners	–	–	–	–	–	35,000	30,000	30,000	30,000	30,000
1% owner	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000
Covered Compensation Limits										
Social Security	94,200	90,000	87,900	87,000	84,900	80,400	76,200	72,600	68,400	65,400
Medicare	no limit	no limit	no limit	no limit	no limit	no limit	no limit	no limit	no limit	no limit

ASPPA
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10-Year COLA Summary (continued)

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Self-Employment Tax										
Self-employment rate	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%
Medicare rate	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%
Combined rate	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%
Social Security Tax										
Social Security rate	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%
Medicare rate	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%
Combined rate	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%
ESOP Distribution										
Normal dist. period (years)	5	5	5	5	5	5	5	5	5	5
Threshold account balance IRC 409(o)(1)(C)	885,000	850,000	830,000	810,000	800,000	780,000	755,000	735,000	725,000	710,000
One year extension threshold IRC 409(o)(1)(C)(ii)	175,000	170,000	165,000	160,000	160,000	155,000	150,000	145,000	145,000	140,000
Max. additional distribution periods allowable (years)	5	5	5	5	5	5	5	5	5	5
Maximum PBGC-Insured Annuity										
ERISA Reg. 4022.23(c)										
Age 65 / 100% Paid	3,971.59	3,801.14	3,698.86	3,664.77	3,579.55	3,392.05	3,221.59	3,051.44	2,880.68	2,761.36
Age 64 / 93%	3,639.58	3,535.06	3,439.94							
Age 63 / 86%	3,415.57	3,268.98	3,181.02							
Age 62 / 79%	3,137.56	3,002.90	2,922.10	2,895.17	2,827.85	2,679.72	2,545.06	2,410.40	2,275.74	2,181.47
Age 61 / 72%	2,859.54	2,736.82	2,663.18							
Age 60 / 65%	2,581.53	2,470.74	2,404.26	2,382.10	2,326.71	2,204.83	2,094.03	1,983.24	1,872.44	1,794.88
Age 59 / 61%	2,422.67	2,318.70	2,256.30							
Age 58 / 57%	2,263.81	2,166.65	2,108.35							
Age 57 / 53%	2,104.94	2,014.60	1,960.40							
Age 56 / 49%	1,946.08	1,862.56	1,812.44							
Age 55 / 45%	1,787.22	1,710.51	1,664.49	1,649.15	1,610.80	1,526.42	1,449.72	1,373.01	1,296.31	1,242.61

Appendix C:
Sample ERISA §404(c) Administrative Procedures

Name of Plan: ____
Name of Employer: ____
Name of Plan Administrator: ____
Name of Trustee: ____
Date these procedures are effective:____

THESE ADMINISTRATIVE PROCEDURES (the "Procedures") are made and entered into by the employer and plan administrator named above (respectively, the "Employer" and the "Plan Administrator"), to be first effective as of _____________ , _________.

1. **Purpose**. These Procedures are intended to form a part of and to be incorporated into the plan named above (the "Plan") and are intended to amplify the terms and conditions of the Plan that are applicable to the investment of participant-directed accounts (referred to as "Directed Investment Accounts"). These Procedures are intended to comply with the provisions of § 404(c) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and should be interpreted and construed in a manner consistent with the regulations promulgated thereunder.

The parties hereto acknowledge that the protection afforded under ERISA §404(c) may not be available for all investments. The Employer shall designate the portion of the Plan, if any, which is not subject to the provisions of these procedures.

2. **Duties and Powers of the Employer.** Subject to the limitations of Paragraph 6 hereof, the Employer shall designate one or more open or closed-end mutual funds, common or collective trust funds, group or master trusts, deposit funds, insurance contracts or guaranteed insurance contracts (GICs), separate investment accounts or other collective or pooled arrangements for the investment of Directed Investment Accounts hereunder. The Employer shall review the performance of such funds or arrangements, from time to time, and shall have the power and authority to modify the designation of such funds or arrangements, in its sole discretion.

3. **Designation of ERISA §404(c) Fiduciary**. The Plan Administrator shall be the fiduciary required to be identified within the meaning of ERISA §404(c) and the regulations promulgated hereunder (the "Investment Administrator"), to act as the person who, among other things, is responsible for the execution of investment instructions in accordance with Paragraph 6 hereof.

4. **Form of Instructions.** Investment instructions may be communicated to the Investment Administrator orally, in writing or by other means acceptable to the Investment Administrator, including, without limitation, instructions transmitted through voice response or similar systems or instructions transmitted through electronic media or technology, such as Internet and intranet systems. The Investment Administrator shall generally oversee the proper execution of such instructions, but the Employer may appoint one or more agents for the purpose

of transmitting, receiving, and executing such instructions.

5. **Information.** The Investment Administrator shall furnish (or cause to be furnished) to each participant the following information: (a) a disclosure that the Plan is intended to comply with ERISA §404(c); (b) a description of the investment options available under the Plan; (c) a description of the procedures applicable to investment instructions; (d) a summary of any fees or charges applicable to purchases or sales of investment options deducted from participants accounts; and (e) the name, address and telephone number of the Investment Administrator. If a prospectus is available with respect to an investment option hereunder, the Investment Administrator must furnish (or cause to be furnished) such prospectus to a participant not later than the time of his or her initial investment in such option.

Information may be delivered in accordance with this Paragraph 5 in writing or by other means acceptable to the Investment Administrator, including, without limitation, voice response or similar systems or other forms of electronic media or technology, such as via a website or other Internet and intranet systems. Information shall be deemed furnished by the Investment Administrator if furnished or made available by an agent appointed by the Employer or the Investment Administrator.

6. **Investment of Directed Investment Accounts**. The Investment Administrator (or an agent appointed by the Employer for such purposes) shall cause the Trustee to invest amounts allocated to each participant's Directed Investment Account in accordance with the instructions of said participant. Such accounts may be invested in the following:

a. An equity fund, which fund shall consist primarily of shares of common or preferred stock issued by companies other than the Employer or an affiliate of the Employer;

b. A money market fund, which fund shall consist primarily of high quality money market instruments such as, but not limited to, interest-bearing securities issued by companies other than the Employer or its affiliates, commercial paper, interest bearing securities issued by the United States government or agencies thereof with varying maturity dates, certificates of deposit and time deposits, banker's acceptances, investment contracts and repurchase agreements; and

c. At least one other investment option designated by the Employer.

Investment directions shall be expressed as a whole percentage of the total amount credited to a participant's accounts. A participant shall be permitted to change his or her investment instructions with respect to at least three investment alternatives at least as frequently as once each three-month period.

The Investment Administrator may establish additional uniform procedures concerning the investment of Directed Investment Accounts, which procedures shall include, but shall not be limited to, the times at which investment changes can be made, the circumstances under which investment directions can otherwise be revoked and the designation of one or more default investments to be used in the event investment instructions are ambiguous or not received in a timely manner from any participant.

7. **Open Option Arrangement.** In addition to, or in lieu of, the designated investment arrangement described in Paragraph 6 hereof, the Employer may permit each participant to invest all or a portion of his or her Directed Investment Account in an open option, brokerage or similar arrangement. With respect to any such arrangement:

a. Available investments may be limited, at the discretion of Employer; such limitations may be expressed by group or classification.

b. In addition to any fees or expenses ordinarily charged to a Directed Investment Account, such account may be charged a fee reasonably related to the maintenance and use of the arrangement.

c. The Investment Administrator (or its designee) shall provide to each participant investing through such an arrangement the information described in (a) through (e) of Paragraph 5 hereof. The Investment Administrator shall take reasonable actions to ensure that prospectuses are delivered or made available to each such participant in accordance with Paragraph 5 hereof; provided, however, that the Investment Administrator may delegate such delivery obligation to the broker or other third party providing services in connection with such arrangement.

8. **Liability for Investment Decisions**. Each participant shall have exclusive responsibility for and control over the investment of amounts allocated to his or her Directed Investment Account. Neither the Employer, the Trustee, the Investment Administrator nor the Plan Administrator shall have any duty, responsibility or right to aid or give investment advice concerning the investment of a Directed Investment Account hereunder. To the maximum extent permitted by law, neither the Employer, the Trustee, the Investment Administrator nor the Plan Administrator shall be responsible for any loss that may result from a participant's exercise of control hereunder.

9. **Termination of Employment**. If a Directed Investment Account is maintained for a participant who has terminated his or her employment with the Employer, such participant shall be entitled to exercise investment authority over such accounts in accordance with the terms of the Plan and these procedures; provided, however, that if the Plan Administrator is unable to locate such participant after exercising reasonable efforts, the Trustee shall have full discretion over the investment of such participant’s accounts. Such discretion shall include the right to invest the accounts in accordance with the last investment instructions of the participant or to invest the accounts in any other investment then available under the Plan. The Trustee shall exercise the power afforded under this Paragraph 9 in a manner intended to preserve the principal of any such account. To the extent the exercise of such power results in a diminution of income or earnings, neither the Plan Administrator, the Employer, nor the Trustee shall have any liability for such diminution.

10. **Fees and Expenses**. One or more of the investment options designated by the Employer may require participants to bear all or a portion of the management or other fees charged thereunder and transaction costs may be assessed with respect to any such investment. The Employer shall not be required to ensure that all such fees and costs are uniform among investment options. Further, the Employer shall not be prohibited from deducting from each participant's Direct Investment Account such additional fees and expenses as may be directly attributable to the participant's exercise of investment discretion with respect to such account. The provisions of this Paragraph Ten shall be in addition to any provision in the Plan concerning the treatment of fees and expenses.

THESE PROCEDURES shall be executed in multiple counterparts, each of which shall be deemed an original as of the dates set forth below, but to first be effective as provided above.

PLAN ADMINISTRATOR/ INVESTMENT ADMINISTRATOR:	**EMPLOYER:**
______________________________________	______________________________________
Date: ________________________________	**Date**: ______________________________

Appendix D: Mutual Fund Trading Through the NSCC

Diagram 1

Mutual Fund Trading Through the NSCC

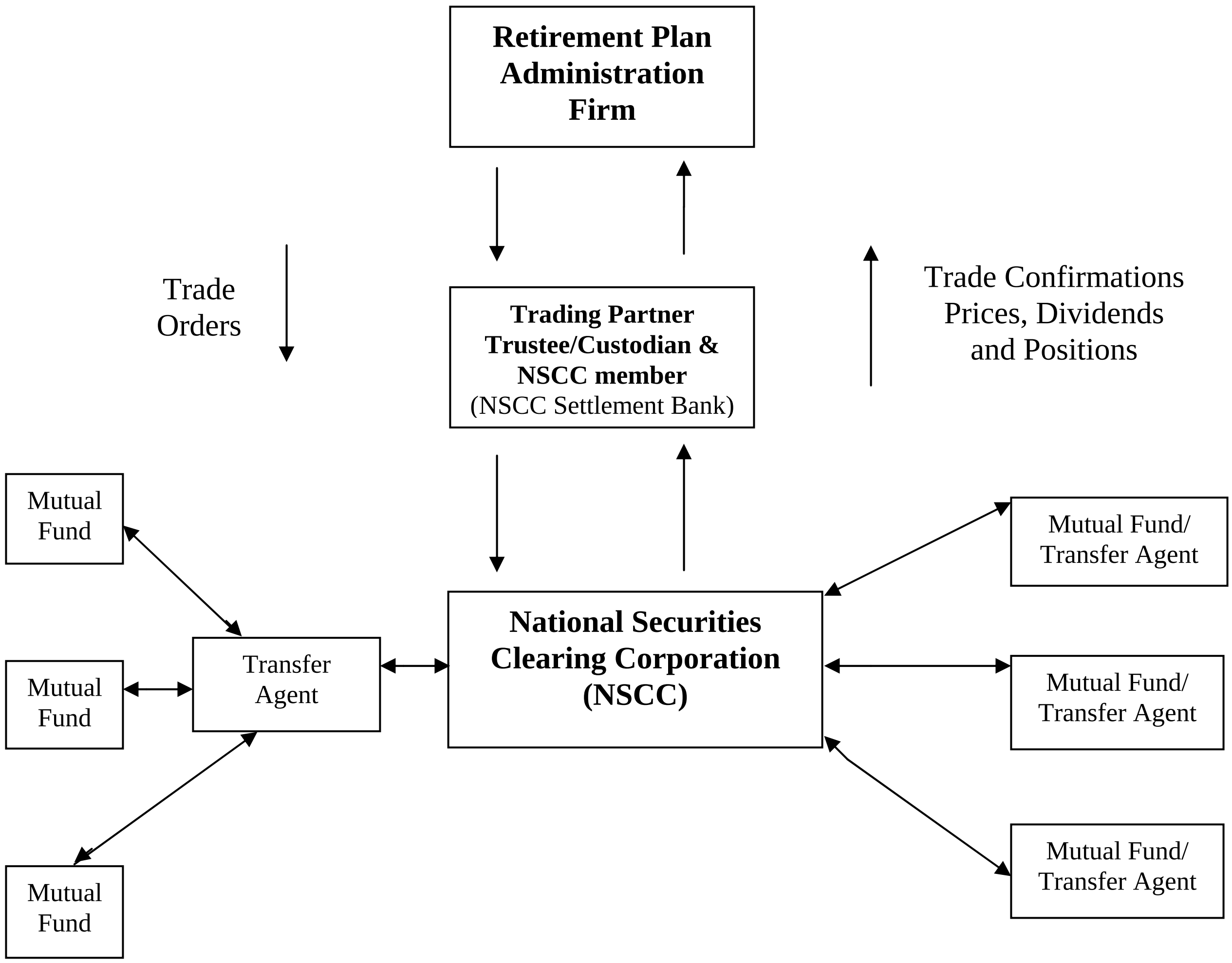
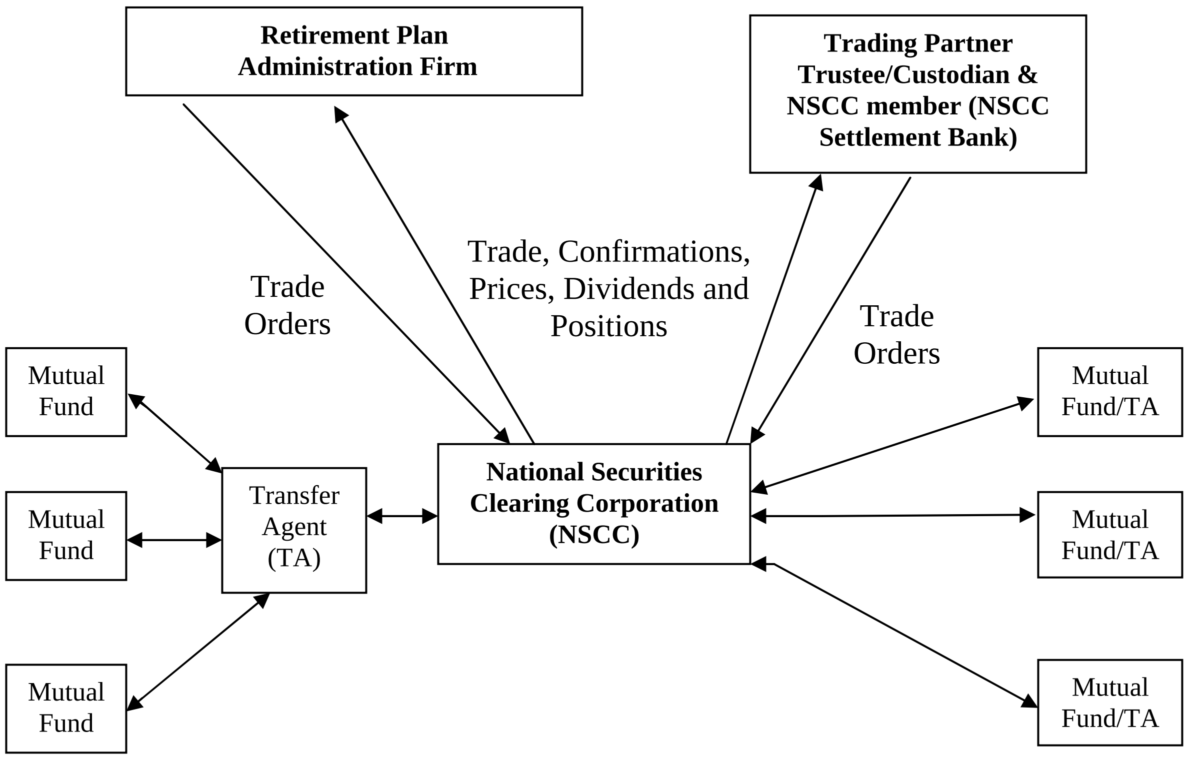


Diagram 2

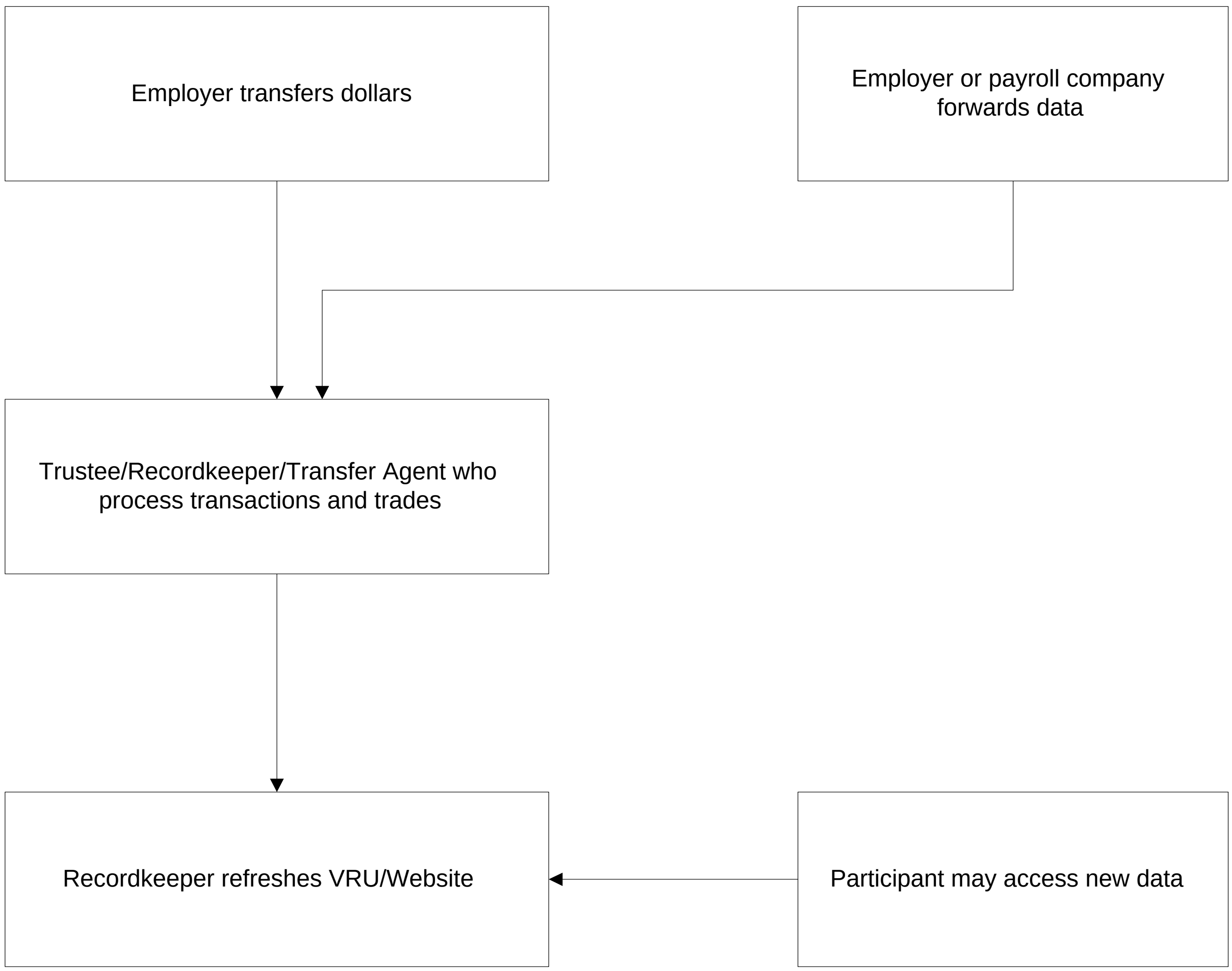
Mutual Fund Trading Through the NSCC



Appendix E:
Contribution Processing

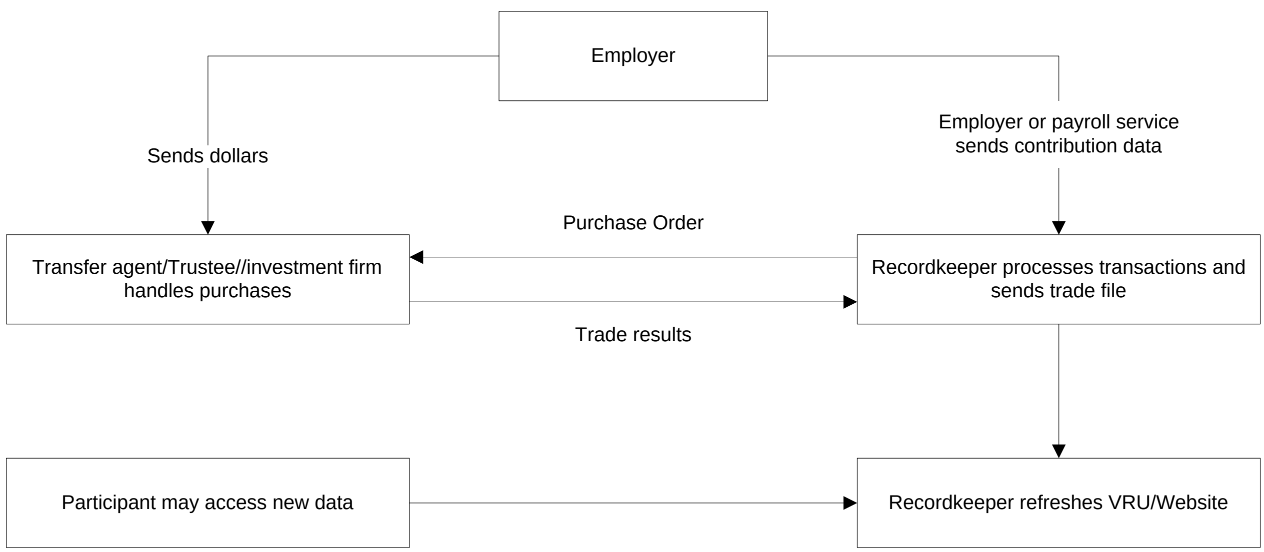
Contribution Processing
Example #1

Employer uses outside payroll service. Recordkeeper, trustee, and transfer agent are a single entity.



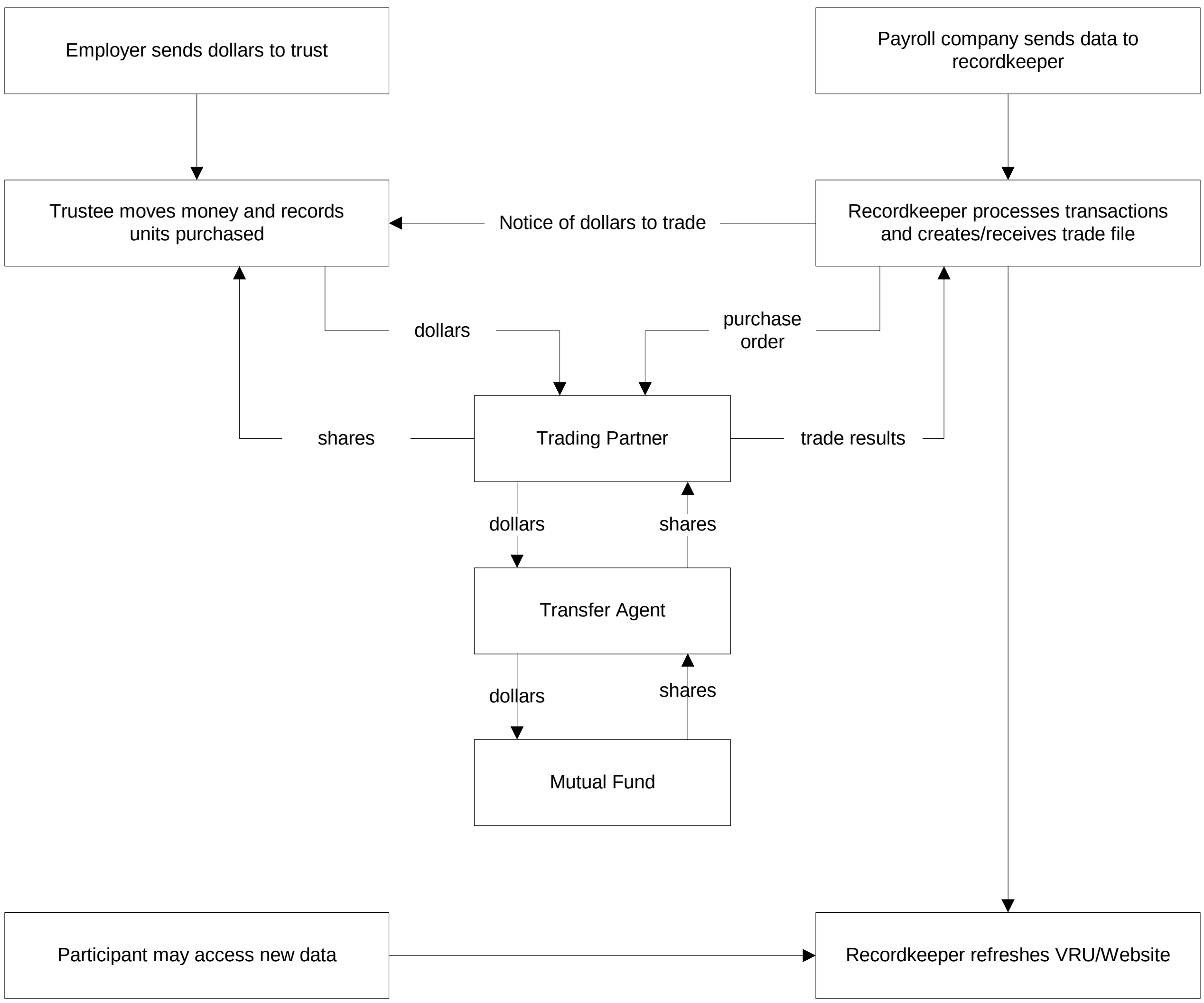
Contribution Processing
Example #2 (Money sent to transfer agent/Trustee)

Employer has internal payroll function or external payroll service. An outside recordkeeper is engaged, and the transfer agent/Trustee is another separate entity. Several fund families are selected as investment options in the plan.



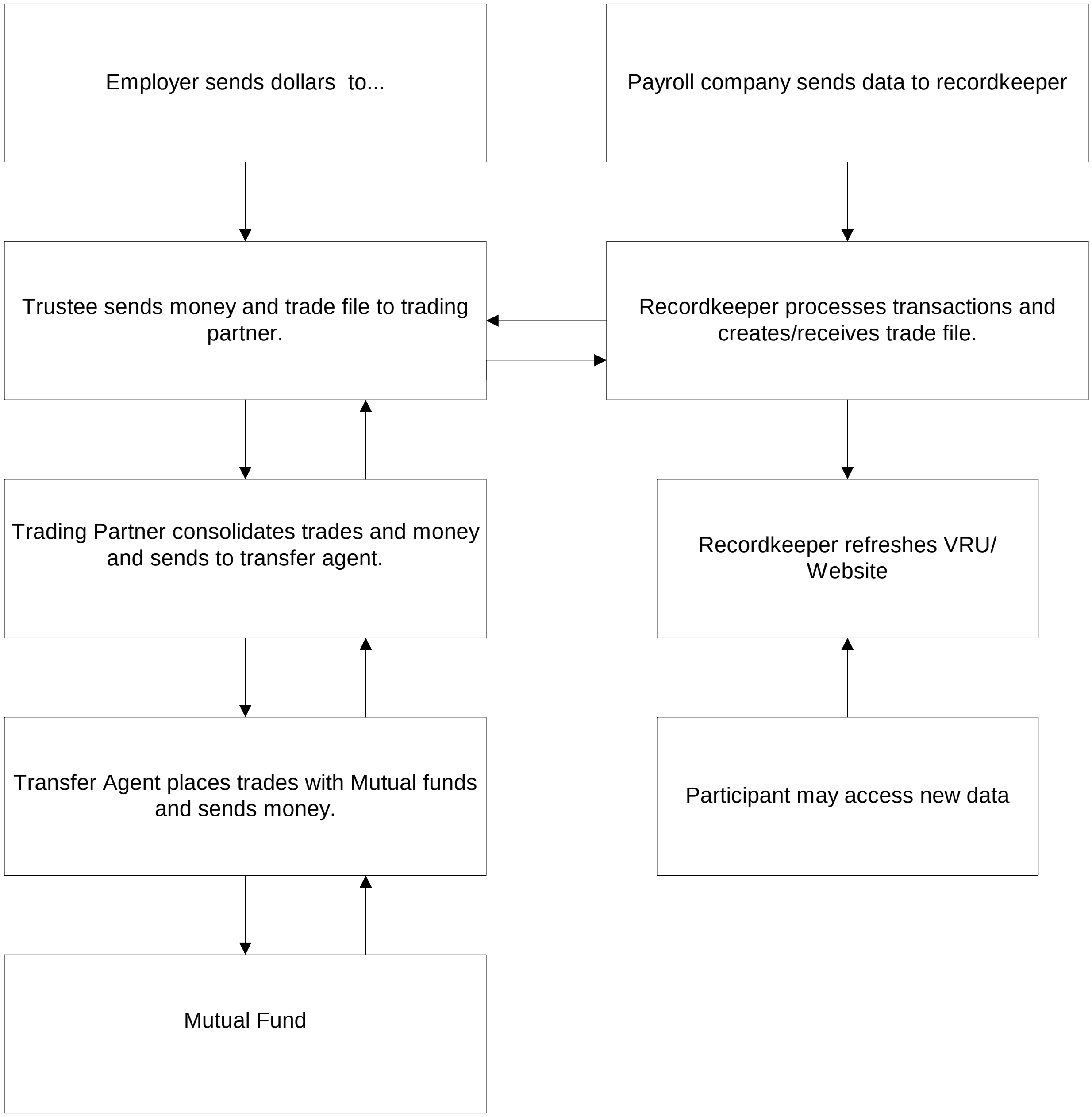
Contribution Processing
Example #3

This example has a separate trading partner who contracts with the transfer agent.



Contribution Processing **Example #4**

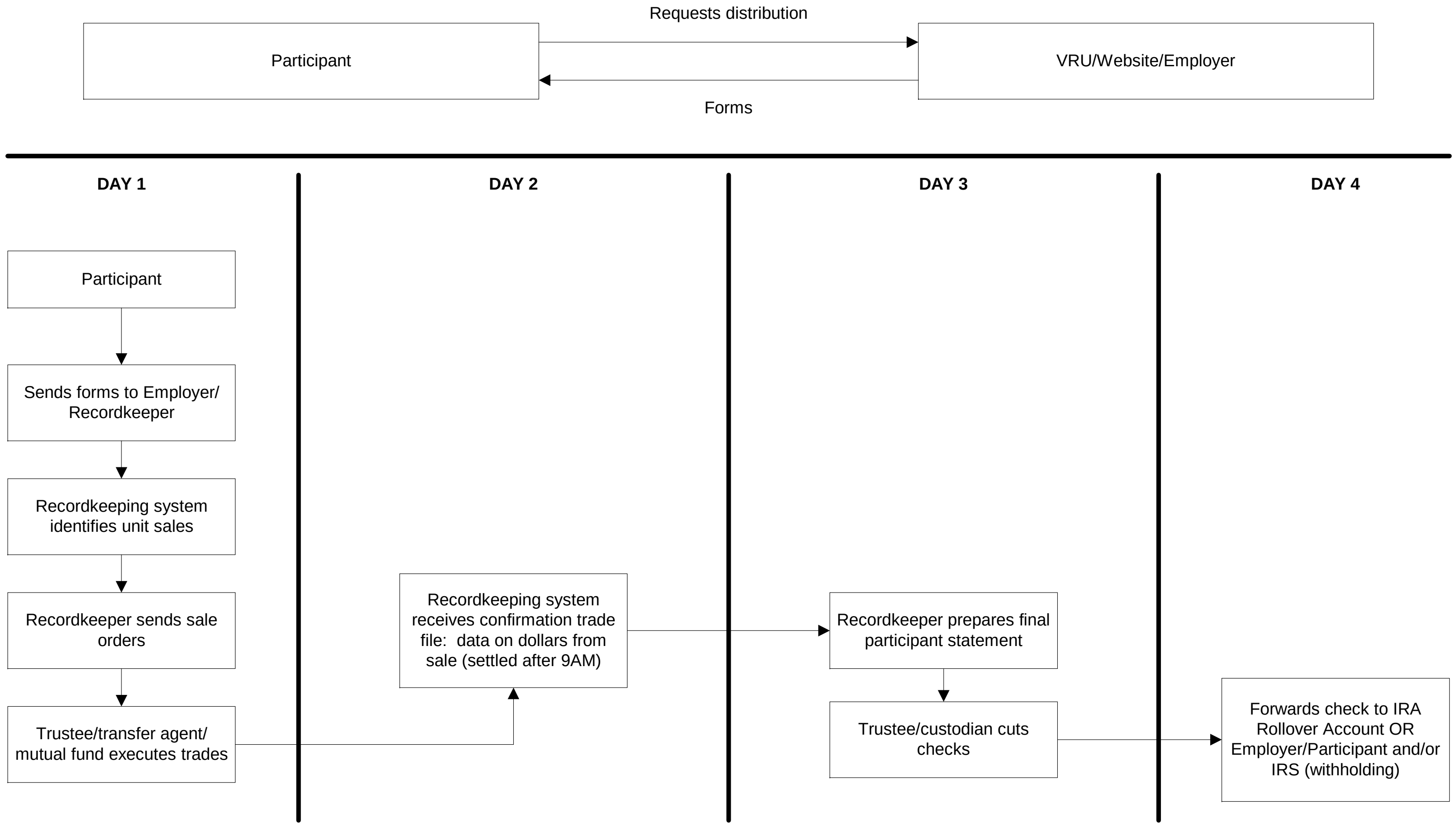
Employer has external payroll function. Recordkeeper, trustee, trading partner and transfer agent are all separate entities. All information from recordkeeper goes through Trustee.



Appendix F:
Distribution Processing

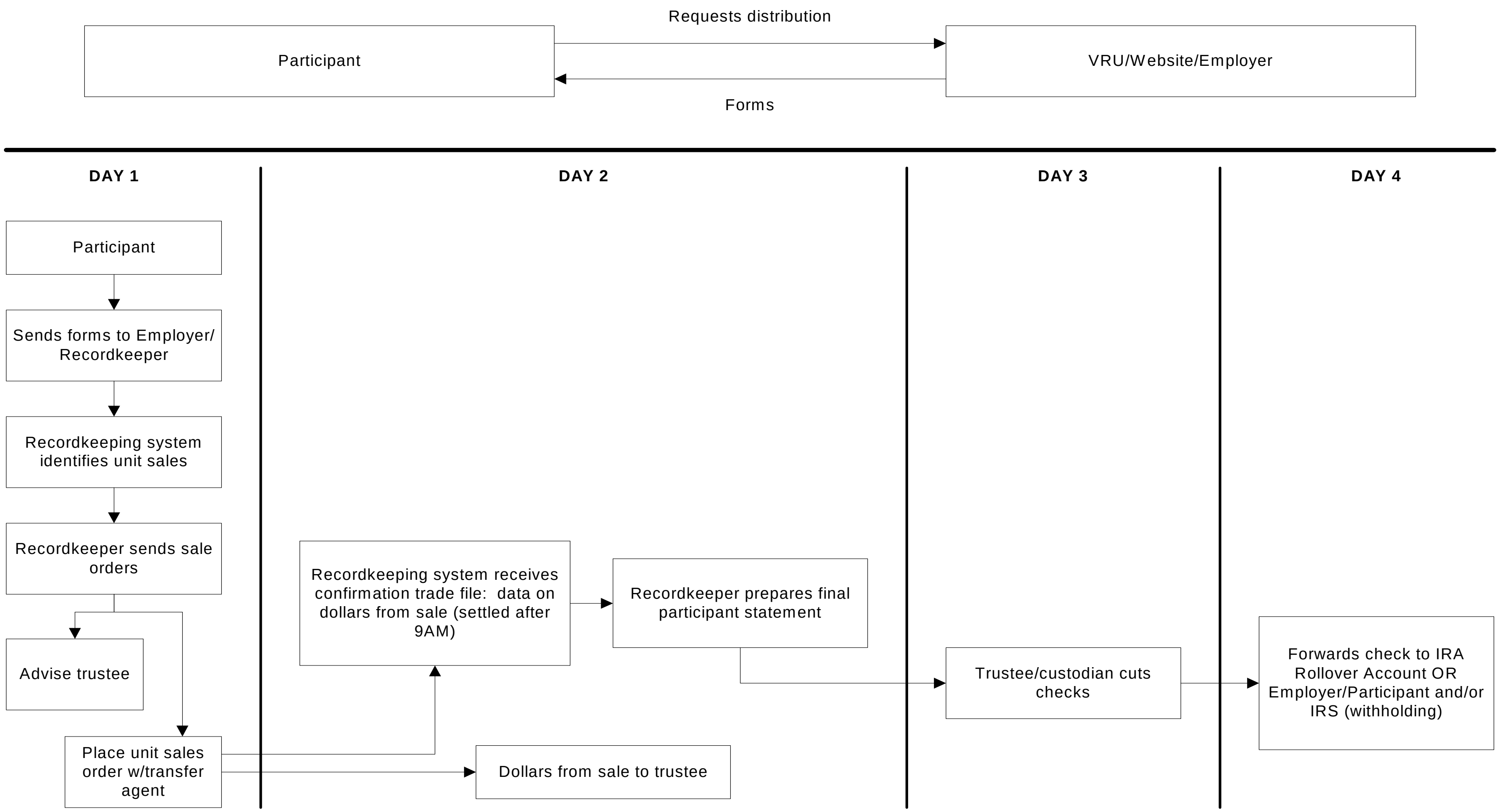
Distribution Processing
Example #1

A participant requests a total distribution, that results in unit certain sales. The funds are from the same fund family and settle next day. The trustee is the transfer agent, as well as the fund sponsor.



Distribution Processing
Example #2

A participant requests a total distribution, that results in unit certain sales. The funds are from a single fund family and settle the next day. The trustee, transfer agent, and fund sponsor are each separate entities.



Appendix G:
Sample Service Agreement

ADMINISTRATIVE SERVICES AGREEMENT

AGREEMENT entered into by and between ABC Pension Planning Corp. (**"APPC"**) and Dewey, Cheatham & Howe, LLC (**"Customer"**) effective as of the ____ day of ___________, 2003 (the **"Effective Date"**).

APPC is in the business of providing recordkeeping and consulting services relating to qualified and non-qualified retirement plans.

Customer maintains the Dewey, Cheatham & Howe, LLC Retirement Savings Plan (the **"Plan"**).

Customer desires to retain APPC to provide certain services, described more fully below, with respect to the Plan.

THEREFORE, the parties agree as follows:

<u>Section 1 - Definitions</u>

A. **Authorized Representative** means any person designated by Customer in writing who is authorized to provide instructions or information relating to the Plan to APPC, including the authority to approve benefit payments and, if the Plan permits participant loans, to authorize loans. If more than one person is designated as an Authorized Representative, APPC may rely on any one person to authorize a transaction unless Customer directs otherwise in writing. Instructions and information may be provided orally, in writing or in any electronic medium as APPC may require to perform its services under this Agreement.

B. **Code** means the Internal Revenue Code of 1986, as amended, including any relevant regulations.

C. **Employer** means Customer and any affiliate which has adopted the Plan.

D. **ERISA** means the Employee Retirement Income Security Act of 1974, as amended, including any relevant regulations.

E. **Plan Administrator** means Customer or the person(s) appointed by Customer to administer the Plan on behalf of Customer.

<u>Section 2 - Recordkeeping Services</u>

A. **Setup Services.** The Plan trustees have selected the following mutual funds as Plan investment options (collectively, the **"Mutual Funds"**). [list funds, including share class]

All Plan assets shall be invested in ______________________________ until APPC receives copies of the executed Plan documents, employee census data, properly completed enrollment forms for all participants, an executed agreement appointing State Capital Bank Trust Services (**"SCBTS"**) custodian of the Plan assets and such other information as it reasonably shall request. As soon as administratively feasible after receipt of all of the information described above, the assets of the Plan shall be invested according to participant elections in the Mutual Funds.

APPC has prepared Plan enrollment materials and reviewed them with Customer. Customer agrees to purchase, and APPC agrees to provide, ___ enrollment kits, which APPC agrees to provide at its cost of approximately ten dollars ($10.00) each. Additional materials shall be provided upon request after reasonable notice to APPC. APPC shall not be responsible for the consequences of any changes or modifications to any such materials made by the Customer, its employees, agents or any other third party without the prior written consent of APPC.

B. **Charges Associated With Taking Over the Plan.** APPC waives the fees associated with setting up the Plan on its daily valuation system, provided that this Agreement remains in effect for at least three (3) years. If Customer terminates this Agreement before the end of that three (3) year period for any reason other than a material breach of its terms by APPC, APPC shall be entitled to charge a reasonable set-up fee, which shall be substantiated by time records.

C. **Ongoing Plan Services.** Subject to the terms, conditions and limitations set forth below, Customer agrees to pay APPC an annual fee equal to_____________________________________ for the Plan Services described in this Subsection C. Customer acknowledges that APPC may receive sub-transfer agent and similar revenue sharing payments relative to one or more of the Mutual Funds and that those payments have been factored into the pricing of the services to be performed by APPC under this Agreement. Any such payments, together with the annual fees described in C4 and C6, are referred to collectively as the **"Administrative Services Fee."**

The amount of the Administrative Services Fee is based on approximately _____ Plan participants and on the following assumptions:

- the assets of the Plan shall be invested in the Mutual Funds (or such other funds as may be set forth on any properly executed, written amendment to this Agreement);
- SCBTS shall act as custodian of the Plan assets pursuant to the terms of a separate agreement, attached as Exhibit A;
- the number of employees participating in the Plan shall remain approximately the same;
- APPC receives timely, accurate data from the plan sponsor or the Trustee, as appropriate, relative to compensation, contributions and any Trust transactions relating to assets not

custodied by SCBTS. Such information shall be delivered in a format consistent with the remaining provisions of this Agreement.

APPC reserves the right to change its fees, upon written notice to Customer, in the event of a material change in the number of covered employees, the available mutual funds or the terms of the Plan or if any other condition identified above is not met.

The parties acknowledge that APPC will perform certain Plan recordkeeping functions using daily valuation software authored by Daily Valuation Corporation, Inc. (**"DVC"**), which uses an electronic trading link to the National Securities Clearing Corporation trading platform, made available through SCBTS. The electronic trading functions on the system require that SCBTS have custody of any plan assets for which daily valuation, trading and access to information (**"Daily Valuation Services"**) are required.

1. Plan Participant-Level Recordkeeping. APPC will provide the following participant-level recordkeeping services for the Plan:

a. Calculate vesting and provide quarterly participant statements;

b. Participant access to their account balances daily, by phone and through the Internet, including both local and 800 phone numbers, which will permit participants to inquire about their plan balances and investments, change investment elections for future contributions, change investments of prior balances and project balances to retirement based on rate of return assumptions they establish;

c. Investment changes and elections shall be subject to the following rules and limitations:

   i. Trade instructions must be by phone (local or 800 phone numbers) or through the Internet,

   ii. Trade instructions received by 2:00 P.M. on any day the relevant securities exchanges are open for business (a **"Business Day"**) will be forwarded to SCBTS on that day, and those received after 2:00 P.M. will be forwarded on the next Business Day;

   iii. Transactions involving only the purchase of mutual fund shares generally will settle based on the closing share price, determined as of the market close on the first Business Day on which SCBTS has received the purchase instructions;

   iv. The sell phase of an exchange transaction (*i.e.,* one involving the sale of the shares of one or more funds and the purchase, with the sales proceeds, of shares of one or more different funds) generally will settle based on the closing share price, determined as of the market close on the first Business Day on which SCBTS has received the sell instructions, and the purchase phase of the exchange generally will settle on the next Business Day; and

v. The turnaround times described above for Plan asset transactions apply under normal circumstances, but, as indicated below in this Agreement, APPC cannot and shall not be responsible for delays in executing trades that are caused by circumstances beyond its control.

The parties acknowledge that the time of activation of the Daily Valuation Services depends on the transfer of information and assets from existing service providers to SCBTS and APPC, as appropriate. APPC agrees to use its best efforts to have the Daily Valuation Services functional by February 28, 2004; however, because it is dependent on the timeliness and accuracy of information it has not yet received, APPC cannot guarantee that the Daily Valuation Services will be fully functional on that date.

2. Plan-Level Recordkeeping and Compliance Functions. Except as otherwise expressly provided below, APPC will perform the following Plan-level services for the Plan:

a. Preparation of the appropriate 5500 series form, including any required schedules, but excluding any independent auditor's report required by Title I of ERISA;

b. Preparation of an annual Plan valuation report, which includes:

- a balance sheet for the Plan trust account;
- a detailed list of Plan assets, to the extent of available information;
- a listing of Party-in-Interest transactions, if any;
- an investment summary Plan only; and
- a census data listing;

c. Testing of the Plan for compliance with the following Internal Revenue Code (**Code**) requirements:

- the Actual Deferral Percentage Test described in Code §401(k);
- the Actual Contribution Percentage Test described in Code §401(m);
- the limit on elective deferrals set forth in Code §402(g); and
- the annual addition limitations set forth in Code §415;

d. Testing for compliance with the following Code requirements:

- the top heavy rules set forth in Code §416;
- the coverage requirements set forth in Code §410(b);
- the non-discrimination requirements under Code §401(a)(4), including cross-testing, which is required with respect to the current Plan document; and
- the limit on deductible contributions under Code §404;

e. Responding to operational and administrative questions relating to the Plan; and

f. Meeting with the Trustee/Plan Administrator to review the annual valuation report.

3. Form of Information Provided. All information, data and other materials furnished to APPC by Customer, the Plan, Plan Administrator or their agents must be in an electronic medium (such as diskettes, tapes or Internet transmissions) in a file format acceptable to APPC. This requirement does not apply to requests for distributions or loans or to any Employer instructions, which must be in writing. Customer, the Plan, the Plan Administrator and their agents agree to use all necessary and appropriate security measures to safeguard the confidentiality of any information, data or other material transmitted to APPC (including, without limitation, any transmissions over the Internet) and to comply with such reasonable requirements as may be established from time to time by APPC. To the extent Customer is unable to comply with the requirements of this Section 3, APPC reserves the right to increase its fees to cover the resulting extra time required to perform its duties under this Agreement.

4. SCBTS Fees. In addition to the fees described elsewhere in this Agreement:

(i) SCBTS charges, and Customer agrees to pay, a fee of ten (10) basis points or one tenth of one percent of the value of the Plan assets, for access to the NSCC trading platform and

(ii) SCBTS charges, and Customer agrees to pay, an annual fee of three hundred fifty dollars ($350) for custody of the Plan assets and the production for quarterly trust statements.

The fees described above may be paid by the Plan or by Customer. Pending receipt of contrary instructions from an Authorized Representative, APPC is authorized to pay those fees from Plan assets as they become due.

5. Time of Payment. All amounts billed to and payable by Customer or the Plan are due and payable upon receipt.

6. Miscellaneous Expenses and Special Services. Customer may request that APPC perform services not specified in this Agreement. APPC will provide only those additional services as may be agreed to by APPC and Customer in writing for a mutually agreed upon fee.

a. Charges for preparation of distribution forms, loan papers and Forms 1099-R are not included in the Administrative Services Fee and are as follows:

   Preparation of distribution papers and processing of distributions:

   i. There is no charge for processing lump-sum distributions in amounts less than two hundred dollars ($200.00).

   ii. The charge for hardship distributions (regardless of the amount) and Plan distributions in excess of two hundred dollars ($200.00) is ___________dollars ($___________).

iii. SCBTS charges a fee of twenty dollars ($20.00) per distribution to prepare a distribution check and Form 1099-R for any Plan distribution. This includes any required withholding deposit and preparation of a Form 945 for all distributions processed by SCBTS.

b. The charge for initiating a loan, which includes determination of the maximum loan amount under §72(p) of the Code and applicable Department of Labor Regulations, and preparation of a note, security agreement and amortization schedule, is one hundred dollars ($100.00). There is an additional charge of twenty-five dollars ($25.00) per year to monitor and record loan payments for each outstanding loan. These fees will be assessed against the account of the participant taking out the loan, unless APPC is advised by an Authorized Representative that they will be paid by Customer.

c. Additional custom enrollment kits will be provided by APPC for approximately ten dollars ($10.00) each.

d. As indicated in Section 2, clause C(2)(f), the fees quoted above include an annual meeting with the Trustee/Plan Administrator to review the annual report. There is an additional charge for attendance by a APPC representative at any other meeting, which will be quoted on a case-by-case basis. As provided in Subsection 8, Customer is responsible for all enrollment and employee meetings.

e. SCBTS charges a nominal fee of approximately twenty-five cents ($.25) for each purchase or sale of a mutual fund, which shall be paid from the assets of the Plan unless and until APPC receives instructions from an Authorized Representative that Customer will pay those charges.

7. **Employer Representations and Responsibilities.** Customer represents that it is authorized to enter into this Agreement on behalf of the Plan and that all Authorized Representatives have capacity to act on behalf of the Plan. Customer acknowledges that it is solely responsible for promptly furnishing any required instructions or information to APPC as may be required by APPC to perform its services under this Agreement. APPC shall be fully protected in relying on instructions from Customer or an Authorized Representative which appear proper on their face and shall have no responsibility to ascertain the accuracy or genuineness of any such instructions or information. Instructions shall be sent to APPC either in writing (an original and/or faxed copy of the original as required by APPC) or in an electronic medium (such as diskettes or e-mail) in a file format acceptable to APPC. All written instructions shall be signed by an Authorized Representative. Customer shall provide APPC with a written update from time to time of all persons who are Authorized Representatives. If it is necessary for APPC to repeat any portion of its services due to incorrect or incomplete information or instructions furnished by Customer, the Plan Administrator or their respective agents, APPC will be entitled to charge an additional fee, which will be due upon receipt of the invoice.

Customer shall be responsible for enrollment and all employee education meetings.

Section 3 - General Provisions

A. Limitation of Liability. The provisions of this subsection A shall survive the termination of this Agreement. Nothing in this Agreement will be deemed to impose any obligation on APPC to monitor, control or in any way exercise any powers or discretion in the handling of any Plan assets, including but not limited to disposition of any funds, securities or other assets under the Plan. All recordkeeping services performed by APPC shall be as an independent contractor to Customer and not as an employee or agent of Customer, the Plan, the Plan Administrator, their agents or any trustee or other named fiduciary. APPC is not responsible for electronic transmissions sent over the Internet by Customer, the Plan, any trustee or other named fiduciary or their agents or the acts or omissions of Internet service providers.

It is understood that APPC does not provide investment advice and will not advise Customer concerning the nature, potential value or suitability for the Plan of any particular security, transaction or investment strategy nor make, recommend or review investment decisions. APPC will not act as Trustee or Custodian of the Plan assets. However, Customer will provide APPC with a limited Power of Attorney to place investment trades as requested by the Participants and or Customer. The Customer will indemnify APPC and each of its officers, directors, employee and agents from, and hold such persons harmless against, any claims, judgments, surcharges, settlement amounts or other liabilities or cost of defense or settlement (including attorney's fees) arising out of or related to any actual or alleged improper or unsuitable action taken due to Customer or its Plan Participants' instructions in connection with the placing of investment trades.

APPC is not responsible and Customer will be responsible, for any losses due to trades placed by APPC, which have been communicated by Customer or its Plan Participant for which there is not sufficient cash held in the account with the trading partner or transfer agent to settle the trade.

APPC is not responsible and Customer will be responsible, for collecting and paying any loss which results from effecting a trade with funds paid by Customer which have not resulted in collected funds at the time the trade is effected.

Customer will notify APPC within 24 hours after the settlement date with respect to any errors made or allegedly made by APPC in connection with any requested trade. If Customer fails to notify APPC within such time, the trade will be conclusively presumed to have been effected in accordance with the request, and Customer will indemnify APPC with respect to any loss resulting from such trade.

In no event will APPC be liable for any loss to Customer or its Plan Participants or anyone for the refusal or failure of the trading partner transfer agent or any investment sponsor to act on instructions from APPC

APPC in no way will be responsible for any loss incurred due to the inaccuracy, incompleteness or lack of timeliness of information received from the trading partner, transfer agent or any investment sponsor.

APPC will in no way be responsible for or liable for the internal procedures of the trading partner or transfer agent or any investment sponsor or any loss resulting from a change in these procedures.

APPC is not responsible, and Customer will be responsible, for alterations of information made by Customer after APPC has transmitted such information via electronic mail, facsimile or regular mail to the trading partner or transfer agent.

APPC and its affiliates shall be liable only for direct damages (the aggregate amount of which shall not exceed the sum of the fees paid to it during the term of and pursuant to this Agreement) solely and directly caused by the negligent acts of APPC and its affiliates. APPC shall not be liable for any other direct damages or for any indirect, special, incidental or consequential damages suffered or incurred by Customer, the Plan, the Plan Administrator, their agents, the Trustee(s) or any other person. Customer agrees to notify APPC promptly in writing of any alleged negligence, and APPC shall not be responsible for any negligent act or omission unless it receives such notice within twelve (12) months of the termination of this Agreement

Neither Customer nor APPC will be responsible for delays or failures in performances resulting from acts beyond its reasonable control. Such acts will include, but not be limited to, acts of God, strikes, lockouts, riots, acts of war, epidemics, governmental regulations, power outages, fire, interruption or malfunction of communication facilities or equipment, earthquakes, other natural disasters and extraordinary trading volume or any other event affecting any stock exchange which disrupts trading on the exchange or delays execution of any transaction involving Plan assets.

Nothing in this Agreement shall be construed to limit the liability of APPC for intentional misconduct or fraud or to make APPC: (i) the "administrator", as that term is defined in Section 3(16) of ERISA, of either Plan or (ii) responsible for any acts or omissions by a prior recordkeeper or other entity which provided services relating to the Plan, regardless of whether those services were provided to any Customer or directly to the Plan.

C. Confidentiality of Plan Information. APPC agrees that all Plan information and data, including any instructions provided to APPC by Customer, the Plan Administrator or their agents, is the confidential information of Customer or the Plan. APPC agrees not to disclose such confidential information to third parties (except in any administrative or judicial forum involving a dispute under this Agreement or as may be required by law or by order of any government agency, regulatory body or court of competent jurisdiction) for purposes other than specified in this Agreement without the prior consent of Customer or the Plan Administrator.

D. Amendment and Assignment. This Agreement may be amended or modified at any time by an instrument executed by Customer and APPC. This Agreement may not be assigned by either party without the prior express written consent of the other party.

E. Term of Agreement and Insurance. The Agreement will continue in effect and automatically will be renewed from Plan Year to Plan Year, but may be terminated at any time with or without cause by Customer or APPC upon thirty (30) days written notice. APPC represents that it now has, and agrees to maintain throughout the term of this Agreement, errors and omissions insurance with a minimum face amount of one million dollars ($1,000,000.00).

F. Notices. All notices to APPC shall be addressed to the President, ABC Pension Planning Corp. and sent by regular mail to 123 ABC Drive, Arlington, VA 22203-1648 unless Customer is otherwise notified in writing of any change. All notices to Customer shall be sent to the address appearing below unless APPC is otherwise notified in writing of any change.

Howard Lewis Dewer
Dewer & Howe, LLC
Orlando, Florida

G. Effect of Agreement. This Agreement (including any Exhibits and as amended from time to time) supersedes all written and oral agreements, communications or negotiations between the parties, and it constitutes the complete and full understanding and agreement of the parties with regard to the services to be provided pursuant to it. This Agreement may be executed in any number of counterparts, each of which shall be deemed to be an original, but all counterparts together, constitute only one Agreement. No waiver by any party of any failure or refusal to comply with an obligation hereunder shall be deemed a waiver of any other subsequent failure or refusal to so comply. This Agreement shall inure to the benefit of, and shall be binding upon, the successors and assigns of the respective parties. If any term or provision of this Agreement or the application thereof to any person or circumstances shall, to any extent be invalid or unenforceable, the remainder of this Agreement or the application of such term or provision to persons or circumstances other than those as to which it is held invalid or unenforceable, shall not be affected thereby. Each term and provision of this Agreement shall be valid and enforceable to the fullest extent permitted by law. This Agreement shall be governed by the laws of the State of Ohio, except to the extent such laws are superseded by ERISA. Any claim, dispute, controversy or other matter arising under or related to this Agreement shall be subject to the sole and exclusive jurisdiction of the federal and state courts located in Dayton, Ohio, and all parties hereby waive any claims of forum non conveniences or lack of personal jurisdiction with respect to such courts.

TO EVIDENCE THEIR AGREEMENT, the parties, by their duly authorized representative, have executed this document on the date first set forth above.

Dewer & Howe, LLC	**ABC Pension Planning Corp.**
By:______________________________	By:______________________________ President

Appendix H:
Sample Paperwork for a Conversion

<u>Sample Electronic Information Request</u>

A typical ***electronic information*** request may look like this:

Electronic Information to be provided by Current Recordkeeper

We appreciate your assistance in making the transition of the client's recordkeeping services from your firm to our firm go as smoothly and quickly as possible. In order to maintain high quality data transfer, we request the data be provided to us electronically. The following provides information on formatting and a listing of the data.

File Format - Flat ASCII Text File:

- Records cannot contain more than 1024 characters.
- Files should not contain headings or totals.
- The participant's Social Security Number must be on each participant record.
- Fields in variable length files must be delimited by a single printable character (e.g., tilde or slash). The delimiter should be one that is not found within the file as text. Non-printing characters, such as tabs and multiple characters (*e.g.*, pairs of quotation marks) are not valid delimiters.
- Fields in fixed length files must have no delimiters.
- Multiple records for participants must contain unique record identifiers.

Field Format:

Date Fields	must be zero filled and in one of the following formats: mmddyy, yyyymmdd, yymmdd, mmddyyyy, mm-dd-yyyy, mm-dd-yy, mm/dd/yyyy or mm/dd/yy
Soc Sec No	xxx-xx-xxxx dashes are optional
Negative Number	Place negative sign at beginning of the number
Participant Name	Names should not have commas. The field should be only 30 characters and a single field for first, middle and last names. The name should be in one of the following formats: Last name First name Middle initial or First name Middle initial Last name

Numeric Fields	All amount fields are 12 characters including decimals and negative sign, if applicable. Do not include commas. Do not include dollar signs. Decimals are optional. If a decimal is not included, the last two positions are treated as cents.

Electronic Media - M/S DOS Formatted Diskettes

Please label each diskette with the client name and send a hard copy of the file layout with the diskette.

Data to Transmit Electronically

Please provide the following file as soon as possible.

Employee Census Data

Name	Social Security Number	Date of Birth	Status Code
Date of Hire	Date of Participation	Date of Retirement	Address
Date of Termination	Date of Rehire	Division or Location	

Please provide hard copy documentation describing what the division, location, and status codes mean.

In addition, please electronically provide the participant investment election percentages per source if they are different for each source. Define the source and the investment funds and the order in which they are presented on the electronic file.

Please provide the following after the final valuation has been completed.

Current Account Balance Information

Please provide a hard copy of the valuation report reflecting the account balances so that we have reconciliation numbers to tie to the electronic transmission.

- For each source of contributions (elective deferral, after-tax employee contribution, profit sharing, match, rollover, etc.) subdivided by investment fund, please provide the ending dollar account balance and share account balance per participant if applicable. Please provide these balances on a cash basis. Do not accrue any contributions or earnings into the balance. Please provide documentation listing the source name, the investment fund and the order in which they are presented on the electronic file.
- If the participants have life insurance, provide the cash value of the policy and the death benefit.
- If the plan has employer stock as an investment, provide the number of shares each participant owns, the cost basis and the dollar value of the stock liquidity fund per participant.

- Vested percentage per participant per source. Please provide hard copy documentation defining the sources and the order in which they are presented on the electronic file.
- Eligible vesting years. Enter the number of past years in which the employee completed the required number of hours of service to receive a year of vesting credit.
- For each participant loan please provide the

Loan ID number	Loan origination date
First payment date	Originating principal amount
Loan interest rate	Term of loan in months
Number of payments per year	Payment amount
Current loan balance	Balance due each source of money
Number of payments made to date	Total interest paid to date
Highest loan balance in past 12 months	Original source loan was withdrawn from and the amount from each source of money

Life-to-Date Contribution Information

- Frozen 12/31/88 elective deferral account balance minus hardship withdrawals made from the balance for each participant.
- Cumulative elective deferrals made since 12/31/88, without interest, less hardship withdrawals made from the amount for each participant.
- After-tax employee contributions made through 12/31/86, minus after-tax employee contribution withdrawals from this account for each participant.
- After-tax employee contributions made from 1/1/86 to current date, minus after-tax employee contribution withdrawals from the account without interest.

Mid-Year Takeover Information

Please provide the following information, cumulative from the beginning of this plan year to the end of the valuation period the new firm is responsible for during this plan year.

Elective deferral contributions for each employee
Matching contributions for each employee
After-tax employee contributions for each employee
Gross compensation earned before elective deferral and 125 contributions
Net compensation earned after elective deferral and 125 contributions
Earnings received by source and fund for each employee

Sample Hard Copy Information Request

A typical ***hard copy information*** request may look like:

Hard Copy Information Request

Listed below are the items that we need in order to take over the recordkeeping of your 401(k) plan. Please forward a hard copy of each of the following as soon as possible:

_____ 1. Most current adoption agreement and master plan.

_____ 2. Loan policy, procedures and/or guidelines that may be in effect for the plan.

_____ 3. Each participant's loan documentation. This includes executed promissory note and amortization schedule.

_____ 4. Form 5500 series reports filed for the past three years.

_____ 5. Current Summary Plan Description.

_____ 6. Most recent Letter of Determination from IRS.

_____ 7. Plan's 9-digit Identification Number.

_____ 8. Plan Trustee Surety Bond.

_____ 9. Any qualified domestic relations order (QDRO) that the plan may be subject to because of an employee divorce.

_____ 10. Life Insurance Policies that the plan owns. Please provide a copy of the policy showing the face page, premiums and cash value for each employee.

_____ 11. Most recent top-heavy test.

_____ 12. Most recent ADP and ACP Tests.

_____ 13. Most recent asset statements that are provided for the plan. Please notify your current investment providers to provide us a copy of all future investment statements.

_____ 14. Valuation performed for the most recent plan year-end showing each participant's account balance by source of money and by type of investment. The report should reflect earnings, contributions, beginning balances and ending balances for the period. It should also reflect each participant's vested balance. These balances should tie to the financial statements and Form 5500 filings. If they do not, please provide a reconciliation of the balances.

_____ 15. If there are participants who are age 70 1/2 or older and have an account balance, please provide a copy of their election to defer payment until they terminate employment. If the participant has terminated employment, provide a copy of any elections they may have made to recalculate their minimum required distributions each year or their election to calculate over the joint lives of the participant and spouse.

If the administration firms are being changed during the plan year, please provide:

_____ 16. A copy of all valuations that have been performed during the year showing each participant's account balance by source of money and by type of investment. The report should show the earnings, contributions, beginning balances and ending balances for each participant. The report also should reflect the vested percentage.

Sample Daily Conversion Timeline

401(k) Daily Conversion Timeline
Cash Conversion

X	Client engages retirement plan administration firm to provide daily services.
X + 1	New retirement plan administration firm sends information request to client.
X + 1	New retirement plan administration firm sends electronic data file layout to client's payroll processor.
X + 1	Client provides blackout notice to employees.
X + 5	Client communicates with current retirement plan administration firm that client is leaving its services.
X + 5	Client provides current retirement plan administration firm with electronic file layout to send balance and historical data electronically to new retirement plan administration firm.
X + 6	Client completes information request and returns to new retirement plan administration firm.
X + 10	Client communicates to employees that a blackout period is being implemented during which no loans, hardships or distributions are made. Blackout period runs from first day of next valuation period till 30 days after new retirement plan administration firm receives electronic transmission of participant balances from current retirement plan administration firm. Client and investment advisor introduce new investment funds.
X + 15	Client provides a test electronic contribution file for new retirement plan administration firm to validate.
X + 17	New retirement plan administration firm provides client feedback on electronic contribution file. If file contains all employees, the firm loads employee data onto administration software.
X + 20	Client's participants return new investment election forms to client. Client creates a spreadsheet to provide data electronically to new retirement plan administration firm.
X + 25	Current retirement plan administration firm provides new retirement plan administration firm a test balance file and employee data.

X + 27 New retirement plan administration firm provides current retirement plan administration firm with feedback on file layout. New retirement plan administration firm loads employee data.

X + 30 Client provides new retirement plan administration firm investment elections on electronic file at least five days before receipt of first contribution file.

Qtr End Client communicates with payroll to send period end contribution file to new retirement plan administration firm in new retirement plan administration firm format. (This is necessary if the contributions are not invested by current retirement plan administration firm on or before the last day of the quarter. Current retirement plan administration firm should not accrue the contributions on the quarter valuation if invested after quarter end.)

Qtr End Current trustee liquidates all investments and transfers cash to new trustee.

First Day New trustee receives cash and invests in cash equivalent or mapped funds.

New Qtr Blackout Period Starts.

Qtr + 1 Retirement plan administration firm receives electronic contribution file.

Qtr + 2 Retirement plan administration firm calculates investment of contribution and places trades. This process continues with each contribution file.

Qtr + 3 Trades Settle.

Qtr + 4 IVR brochure drafted by retirement plan administration firm and sent to client for review.

Qtr + 30 Current retirement plan administration firm completes prior quarter’s cash valuation and sends electronic file, reconciliation and hard copy of valuation to new retirement plan administration firm.

Qtr + 35 Retirement plan administration firm loads history and balance information. Makes sure system is in balance and processing is up to date.

Qtr + 37 Retirement plan administration firm transfers beginning balance money market assets based on participant investment elections.

Qtr + 39 Retirement plan administration firm allocates cash equivalent income to beginning balance assets based on participant investment elections.

Qtr + 40 Retirement plan administration firm loads loan amortization schedules and processes loan repayments.

Qtr + 60 **End of blackout period (approximately 30 days from date participant balances are received electronically from current retirement plan administration firm).**

Qtr + 61 Retirement plan administration firm processes any participant requests for loans or distributions that have been on hold during the blackout.

Qtr + 62 IVR system set up tested by retirement plan administration firm.

Qtr + 64 Client tests IVR system and approves.

Qtr + 67 New retirement plan administration firm mails out IVR brochure and PIN letters to participants.

Qtr + 70 Client and new retirement plan administration firm conduct employee meetings to address IVR, new employee statement and daily features.

Qtr + 71 New retirement plan administration firm activates IVR system. Participants can call in to request transfers, changes to investment elections and obtain other information.

Qtr + 72 New retirement plan administration firm processes IVR requests.

Qtr End New retirement plan administration firm prepares to send out valuation and employee statements.

Qtr End+10 Participant statements are in the mail.

Sample Blackout Notice

A **Sample Blackout Notice** might look like this:

Sample Blackout Notice

(Based on Final DOL Regulations 1-24-03)

Sample Blackout Notice
Important Notice Concerning Your Rights Under the
[Enter Name of Individual Account Plan]

[Enter date of notice]
This notice is to inform you that the [enter name of plan] will be [enter reasons for blackout period, as appropriate: changing investment options, changing recordkeepers, etc.].

As a result of these changes, you temporarily will be unable to [enter as appropriate: direct or diversify investments in your individual accounts (if only specific investments are subject to the blackout, those investments should be specifically identified), obtain a loan from the plan or obtain a distribution from the plan]. This period during which you will be unable to exercise these rights otherwise available under the plan is called a "blackout period." Whether or not you are planning retirement in the near future, we encourage you to carefully consider how this blackout period may affect your retirement planning, as well as your overall financial plan.

The blackout period for the plan [enter the following as appropriate: is expected to begin on (enter date) and end [enter date]/ is expected to begin during the week of [enter date] and end during the week of [enter date]. During these weeks, you can determine whether the blackout period has started or ended by [enter instructions for use toll-free number or accessing web site].
[In the case of investments affected by the blackout period, add the following: During the blackout period you will be unable to direct or diversify the assets held in your plan account. For this reason, it is very important that you review and consider the appropriateness of your current investments in light of your inability to direct or diversify those investments during the blackout period.

For your long-term retirement security, you should give careful consideration to the importance of a well-balanced and diversified investment portfolio, taking into account all your assets, income and investments. [If the plan permits investments in individual securities, add the following: You should be aware that there is a risk to holding substantial portions of your assets in the securities of any one company, as individual securities tend to have wider price swings, up and down, in short periods of time, than investments in diversified funds. Stocks that have wide price swings might have a large loss during the blackout period, and you would not be able to direct the sale of such stocks from your account during the blackout period.]

[If timely notice cannot be provided enter: Federal law generally requires that you be furnished notice of a blackout period at least 30 days in advance of the last date on which you could exercise your affected rights immediately before the commencement of any blackout period in order to provide you with sufficient time to consider the effect of the blackout period on your retirement and financial plans. [Enter explanation of reasons for inability to furnish 30 days advance notice.]

Sample Electronic Payroll Data Request

A sample electronic payroll data request might look like this:

Electronic Payroll Data Request

Column Title	Column Width	Justification	Column Required	Characteristics
Social Security Number	11	Left	Yes	Dashes optional, must have nine digits
Participant Name	30	Left	Yes	No commas or periods
Date of Birth	10	Right	Yes	
Date of Hire	10	Right	Yes	
Date of Termination	10	Right	Yes	
Date or Rehire	10	Right	Yes	
Cumulative Hours Worked	5	Right	Yes	Must be whole number
Mailing Address				
Address Line 1	30	Left	No	No commas
Address Line 2	30	Left	No	No commas
City	30	Left	No	No commas
State	2	Left	No	Postal Abbreviation
Zip	10	Left	No	
Location/Division	5	Right	No	Numeric
Cumulative Comp. Field 1	12	Right	Yes	No commas or $ signs. Two decimals.
Cumulative Comp. Field 2	12	Right	Yes	No commas or $ signs. Two decimals.
125 Salary Deferral	12	Right	Yes, if applicable	No commas or $ signs. Two decimals.
Elective Deferral	12	Right	Yes, if applicable	No commas or $ signs. Two decimals.
Matching Contribution	12	Right	Yes, if applicable	No commas or $ signs. Two decimals.

Column Title	Column Width	Justification	Column Required	Characteristics
After-tax Salary Deferral	12	Right	Yes, if applicable	No commas or $ signs. Two decimals.
1st Loan Identification #	8	Right	Yes, if applicable	Numeric
1st Loan Repayment Amount	12	Right	Yes, if applicable	No commas or $ signs. Two decimals.
2nd Loan Identification #	8	Right	Yes, if applicable	Numeric
2nd Loan Repayment Amount	12	Right	Yes, if applicable	No commas or $ signs. Two decimals.
Elective Deferral Percentage	3	Right	No	Whole number. No decimal or % sign.
Name of Primary Ben.	30	Left	No	No commas or periods
Name of Secondary Ben.	30	Left	No	No commas or periods

If there is a negative number, put a negative sign "-" at the beginning of the number. Be sure the negative sign does not change the spacing of the record.