AMERICAN SOCIETY OF PENSION PROFESSIONALS & ACTUARIES

7th Edition

# RPF-2 COURSE

## Retirement Plan Fundamentals
## Part 2

ASPPA®

WORKING FOR AMERICA'S RETIREMENT

RPF-2 Course:

# Retirement Plan Fundamentals Part 2

7th Edition

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### About ASPPA

ASPPA—the American Society of Pension Professionals & Actuaries—is the premier national organization for career retirement plan professionals. The membership is comprised of the many disciplines supporting retirement income management and benefits policy. Members are part of the diversified, technical and highly regulated benefits industry. ASPPA represents the most committed individuals of the profession—those who have made a career of retirement plan and pension policy work.

The purpose of ASPPA is twofold:

- To educate retirement plan and benefits professionals
- To preserve and enhance the private pension system

Based in the nation's capital, ASPPA is a non-profit professional organization acting on behalf of its 7,500+ members to improve retirement income policy. In pursuit of these goals, ASPPA offers extensive educational opportunities for its members—from professional credentialing to continuing education. ASPPA Government Affairs department keeps a close watch on all legislative and regulatory activities affecting retirement benefits and pension policy.

ASPPA was founded in 1966 originally as an actuarial organization. Since then, ASPPA has carefully tracked the changing needs of the retirement plan industry. As a result, ASPPA has expanded and diversified its membership to include all types of pension professionals—from actuaries, consultants and administrators to insurance professionals, financial planners, accountants, attorneys and human resource managers. Embracing diversity, the 7,500+ members of ASPPA are united by their commitment to the private pension system.

Comprehensive education and examination programs are offered by ASPPA for its members and other retirement plan professionals because career and industry advancement are distinguishing characteristics of all ASPPA activities. Dedicated to providing practical and scholastic education programs, the curriculum is carefully expanded and improved each year to address legal and legislative changes affecting the pension system and the work of retirement plan professionals.

Visit **www.asppa.org** for more information about ASPPA's Education and Examination programs, including course syllabi, reading lists, exam procedures, and requirements for ASPPA credentials.

# Table of Contents

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



**Chapter 3: Annual Testing**

**Chapter 5: Differences between Balance Forward and Daily Valuation**

**Chapter 6: Fiduciary Considerations**



**Chapter 7: Daily Valuation Investment Basics**

**Chapter 8: Employer Stock Issues**

**Chapter 10: Daily Activities**

**Chapter 11: Mutual Fund Trading Practices**



**Chapter 12: Processing Transactions**

**Chapter 13: Trading Errors and Corrections**

**Chapter 15: Conversion Types and Methods**



**Chapter 16: Mergers and Terminations**

**Appendices**

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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.

### 7th Edition RPF-1 Course: Retirement Plan Fundamentals, Part 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
- Reporting and Disclosure
- Withdrawals While Actively Employed
- Participant Loans
- Distributions and Tax Rules
- Updating Plans and Error Corrections
- Record Retention

### 7th Edition RPF-2 Course: Retirement Plan Fundamentals, Part 2

- Retirement Plan Administration
- Allocations and Maximum Limitations on Benefits for Defined Contribution Plans
- Annual Testing
- Living in an Electronic World: Daily Valuation
- Differences Between Balance Forward and Daily Valuation
- Fiduciary Considerations
- Daily Valuation Investment Basics
- Employer Stock Issues
- Analyzing Investment Fees
- Daily Activities
- Mutual Fund Trading Practices
- Processing Transactions
- Trading Errors and Corrections
- Conversion Decisions and Issues
- Conversion Types and Methods
- 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 Internal Revenue Code (IRC) § number may be provided within the textual discussions.

***Should it be necessary to make any corrections or clarifications to the course or exams, this information will be posted on the ASPPA Web site at www.asppa.org/errata. It is the candidate's responsibility to regularly check the ASPPA Web site in order to obtain this information.***

Each part (RPF-1 and RPF-2) of the Retirement Plan Fundamentals Course has a separate syllabus and exam covering the material in that part. The syllabus reflects the learning objectives that will be coverd on the exam. 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 Web site at **www.asppa.org/rpf**. Once you register, you will receive access to the online exam via the ASPPA Web site. 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 85% (64 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, 2011.

**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.

**Webcourses:** ASPPA offers webcourses on the RPF-1 and RPF-2 materials. These webcourses provide introductory training for new employees and help prepare RPF-1 and RPF-2 exam candidates for the most challenging topics covered on the respective examinations. Webcourses offer many benefits to individual and companies alike:

- Self-paced: Review information at your own pace.
- Flexibility: View the courses from any location with an Internet connection.
- Continuing education: Earn continuing education credit for ASPPA credentials.

There are seven webcourses for RPF-1 and seven webcourses for RPF-2. Each set can be purchased on the ASPPA website. Each webcourse is divided into two modules. To register for the webcourses visit www.asppa.org/rpf-webcourses.

The RPF-1 set consists of the following seven webcourses:

- Plan Basics
- Defined Contribution Plans
- Defined Benefit Plans
- Plan Qualification and Document Language
- Distributions from A to Z (three modules)
- Participant Loans
- Plan Changes and Error Correction

The RPF-2 set consists of the following seven webcourses:

- Top-Heavy Plans and Coverage Testing
- HCEs and 401(k) Nondiscrimination Rules
- Defined Contribution Allocations and Annual Additions
- Investments in Daily Valued Plans
- Fiduciary Considerations
- Conversions: Decisions and Issues; Types and Methods (four modules)
- Differences Between Balance-Forward and Daily Valuations

### Other Education Supplements

ASPPA offers practice exams for the RPF-1 and RPF-2 courses that may be purchased through the ASPPA office or the ASPPA online book store. In addition, ASPPA may offer review courses periodically. Contact the ASPPA office for additional information.

ASPPA encourages candidates to form local study groups to enhance their understanding and education.

For additional questions, please write to the ASPPA Customer Support 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 education@asppa.org.

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

## Important! Before You Begin

The exam for this course is based on the following required reading:

- *RPF-2 Course: Retirement Plan Fundamentals Part 2, 7th Edition. Arlington, VA: ASPPA, 2012.*

The syllabus for this course lists the learning objectives covered on the exam and can be found at www.asppa.org/Document-Vault/PDFs/EE/Syllabi/RPF2-Syllabus.aspx. **It is each candidate's responsibility to obtain the syllabus**.

Periodically throughout the year, this text book and the exam are updated. These updates are called *errata*. **It is each candidate's responsibility to regularly obtain the errata by visiting www.asppa.org/errata**.

At the end of some chapters in the text book there are listings of other Supplemental Reading Materials and their locations on the Web. These materials apply specifically to topics discussed in the chapter however; they are NOT required nor are they tested over.

# Chapter 1
## Retirement Plan Administration



### §1.01 Learning Objectives

- List the documents to be collected to serve as the basis for plan administration.
- List the types of census data collected and the steps involved in evaluating its validity.
- Identify key employees from a list of employees and census data.
- Identify the effect of attribution rules on ownership.
- Identify HCEs from a list of employees and census data.

## §1.02 Course Overview

Retirement Plan Fundamentals II (RPF-2) is a continuation of Retirement Plan Fundamentals I (RPF-1). The course is designed to take the reader through the life cycle of a qualified plan from its implementation and administration to its termination.

In RPF-1 we addressed issues to consider in setting up a retirement plan, such as who can sponsor one, what type of retirement plan should be implemented, steps to set up a plan and what is in the plan document. The course then went on to discuss the administration of a plan and those activities that occur throughout the year. It covered enrollment of participants, reports provided to the governmental agencies and to the participants, events that allow a participant to withdraw funds while still employed and after terminating employment, events that may cause a plan document to be amended, what records are important to be kept, and the error correcting programs available through the Internal Revenue Service (IRS) and the Department of Labor (DOL).

The second part of the RPF series, RPF-2, will cover a few remaining administration issues, such as census verification, contribution limits, and annual testing in Chapters 1 – 3. The focus then changes to cover special administration issues for plans that allow participants to control the investment decisions of their account balances, primarily 401(k) plans. These plans, as was discussed in RPF-1, make up the majority of plans and have the most plan assets.

Chapters 4 and 5 address how the industry has transitioned from balance-forward administration to daily valuation administration and the differences between them. Daily valuation has unique trading and transaction processing issues that are presented in Chapters 10 – 13.

Fiduciary liability and how fiduciaries can minimize their investment liability by allowing participants to direct the investments of their account balances is addressed in Chapter 6. One of a fiduciary's duties is to make sure that fees paid by the plan are reasonable. A discussion of the various types of investments offered in retirement plans and the fees associated with them are covered in Chapter 7, 8 and 9.

Chapters 14 and 15 look at the many issues that should be considered by a plan sponsor when changing administration firms and/or moving from a balance-forward recordkeeping approach to daily valuation.

The course then completes the life cycle of a plan with a discussion in the last chapter of what happens to a plan that is merged with another plan, has a partial termination or is terminated completely by distributing all assets to the participants.

## §1.03 Chapter Introduction

Retirement plan administration covers a wide range of administrative and clerical functions associated with the operation of an employee benefit plan. One of those is the gathering of census data periodically during the year. Employee census information is the foundation for retirement plan administration work. Firms use the data to perform optional interim quarterly or semiannual nondiscrimination testing, as well as required 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, the financial activity and the census information.

### §1.04 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 the Employee Retirement Income Security Act of 1974 (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 (for an individually designed plan) or opinion letter (for a pre-approved prototype document) or advisory opinion (for a volume submitter document) for the plan; and
- A copy of the Summary Plan Description and any Summaries of Material Modification.

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

If the plan document is a 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. For a volume submitter plan, the IRS issues an advisory opinion, and it should also be on file with the administration firm. Any opinion letter or advisory opinion on file should be 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 should be kept on file for reference purposes. It is important to keep copies of the submission forms and determination letter because sometimes a determination letter may be limited in scope based on the information presented in the submission forms and may affect the plan administration.

### §1.05 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;
- Financial information (account activity);
- A copy of the prior year's Form 5500 (Annual Return/Report of Employee Benefit Plan), if not prepared by the firm doing the valuation; 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 and current years;
- Source documents, including fidelity bond, census and financial information for prior and current years;
- Government filings for prior year(s);
- Nondiscrimination testing results for prior year(s); and
- Determinations of key employees and highly compensated employees (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.

### §1.06 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 (IRC) 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.

## §1.07 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.

It is important to discuss with the plan sponsor the definition of compensation so the plan sponsor understands all the items that are included or excluded and the importance of each in doing allocations and the various compliance tests.

Where applicable, the data should provide additional information regarding elective deferrals, after-tax employee contributions, employer contributions (matching, profit sharing, etc.), employee numbers and division or union codes, as well as any available status indicators such as on military leave of absence or terminated due to death, disability or retirement. It should also include loan repayment information, if applicable.

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 IRC and ERISA.

### [A] Full and Complete Data

Upon receipt of the data, the retirement plan administrator should ascertain whether the employer has furnished the complete census, not just information regarding only those employees it has determined to be eligible or only those making elective deferrals (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 that 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 is important to census data review; because it is relevant in determining what data is required. For example, if the plan document specifies use of the elapsed time method for measuring service for all purposes (i.e. eligibility, vesting, etc.), then the census data need not contain hours worked but should contain all dates of hire, rehire and termination. (Missing information is discussed further 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 or the employer's payroll provider 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.

## §1.08 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 fewer 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?
- Do the employees' hours of service make sense when compared to compensation? For example, an employee reported with $4,000 of compensation and 1,000+ hours of service would not be reasonable, as $4 per hour is less than minimum wage.
- 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 (or that the plan was not amended to reflect a plan sponsor's decision to change the provisions).
- 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 valuation software systems will automatically compare census data and generate an exception report that reflects these kinds of inconsistencies. For example, a date of birth such as "2/15/2055" that should be "2/15/1955" will be highlighted by the report 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 subjective process. Generally speaking, any plan level change in the overall data from that of the prior period should have an accompanying explanation. However, the reason for certain changes can be determined if the reviewer has a good knowledge of the plan, the plan sponsor and the existing economic climate. Nonetheless, there should not be any mystery or blind acceptance of data discrepancies.

1. <u>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. Similarly, reductions in employees would be expected for technology-related employer in the wake of the dot.com implosion or for travel-related employers during a recession. Businesses emerging from newly established status into stable profitability might double their hiring practices or raise salaries significantly as their businesses become successful. 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.

The type of entity is also critical in knowing the form of compensation to request for the owners of the company. Compensation for an owner of a C corporation or S corporation is reported on a W-2 form. Compensation for self-employed individuals is reported on a Schedule C; while compensation for partners in a partnership and owners of Limited Liability Companies (LLC) or Limited Liability Partnerships (LLP) are reported on a K-1 (unless the LLC or LLP is owned by one individual, in which case the Schedule C is used).

2. Changes in Size of Employee Population

One reasonable comparison that can easily be made 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 to 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. (A significant number of terminations during a year might also give rise to concerns that a partial plan termination has occurred, which could cause full vesting for the terminated employees.)

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 to 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.

4. Discuss Significant Changes

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.

## §1.09 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 the participant's normal retirement date as defined in the plan document? Generally, benefit accruals and contribution allocations continue if the participant remains employed beyond retirement age (and the participant is fully vested at normal 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 who have otherwise dropped off the census and dates of termination are missing?
- If the plan sponsor has a cafeteria or commuter benefit plan, have the salary reduction contributions to that plan been provided to the retirement plan administrator, either separately or included in gross compensation?
- Does the definition of compensation in the plan document exclude bonuses, commissions or other types of compensation?
- For participants who became eligible to participate in the plan or a specific component of the plan, does the definition of compensation exclude pre-participation 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, has the prior employment history been requested?

## §1.10 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 IRC 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.

The determination of who is a key employee is based on 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 top-heavy for the 2012 plan year, the determination date is December 31, 2011. In this manner, the key employee determination and top-heavy status calculations, along with the current year's census and accounting data determine whether the next plan year is top-heavy and must satisfy top-heavy requirements.

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, regardless of whether or not that owner is an employee of the sponsor.

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

i. Includible officer;
ii. 1% owner; and
iii. 5% owner.

If an employee falls into any one of the three classifications of key employees, the employee 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 more than $160,000 (as indexed) for 2011 and ranking them in order of descending compensation. Please refer to Appendix A 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 multiplying the employee population by 10 percent and, if applicable, rounding 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 company has 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 3. Therefore, the resulting maximum officer count is 40.

**Example 1-2. Maximum number of officers.** A company has 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 3. Therefore, the resulting maximum officer count is 3.

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 more than $160,000 (as indexed) for 2011 ranked from highest to lowest compensation, only the 50 most highly paid officers are key employees.

In determining officer status keep in mind that it is based on what the person does, not necessarily the title they have. For instance, bank personnel may have officer titles; however they may not have the full responsibilities that the title may imply.

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. Determining 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 either actual or 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 IRC §318.

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.** Employee J has a daughter M. M is married to R and they have a son K. ABC Company is owned as follows:

| | Ownership % |
|---|---|
| J | 50% |
| M | 25% |
| K | 25% |

When considering attribution the ownership results are as follows:

| | Original Ownership % | Additional Ownership % Due to Attribution From | | | | Total Ownership % |
|---|---|---|---|---|---|---|
| | | J | M | R | K | |
| J | 50% | | 25% | | 25% | 100% |
| M | 25% | 50% | | | 25% | 100% |
| R | 0% | | 25% | | 25% | 50% |
| K | 25% | | 25% | | | 50% |

J is considered to be a 100% owner (his own 50%, plus his daughter, M's, 25%, plus his grandson, K's, 25%). M is also considered a 100% owner (her 25%, plus her father's (J) 50%, plus her son's (K) 25%). R is considered a 50% owner (his wife's (M) 25% plus his son's (K) 25%). K is considered a 50% owner (his own 25% plus his mother's (M) 25%). Note that his grandfather J's 50% interest is not attributed to K.

In familial relationships, double attribution of ownership is not permitted. After 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, T is an employee of Company B. The following ownership exists:

| | Company A | Company B |
|---|---|---|
| T | 100% | |
| Company A | | 25% |

After organizational constructive ownership is applied, the following ownership exits:

| | Company A | Company B |
|---|---|---|
| T | 100% | 25% |

T is considered to own 25% of Company B through attribution from Company A. T 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, including 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:

i. 5% owner; and
ii. Compensation.

If an employee falls into either of the two classifications of HCEs, the employee is considered to be 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 (i.e., owns or is deemed to own through attribution more than 5% of the company) in either the current year or the lookback year is considered to be 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 whether or not the plan uses the top-paid group election.

The **compensation test** includes as an HCE any employee who earns more than $110,000 (as indexed) for 2011 during the lookback period. The indexed dollar limit applies to the lookback year that begins in the calendar year. Thus, when making the HCE determination, the compensation limit applicable during the lookback year is used (since it is being applied to compensation in the lookback year). Hence, current year compensation is not required for HCE determination. For example, if the current plan year begins May 1, 2012 then the look back year begins May 1, 2011 and the dollar limit of $110,000, for 2011, applies when determining the compensation test since the beginning of the lookback year falls in the 2011 calendar year. Please refer to Appendix A 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** if provided for 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 and the current year.

This determination of HCEs and nonhighly compensated employees (NHCEs) 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 (HCEs)

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.

**Example 1-5. Comparison of Key Employee vs. HCE.** Consider the following census data and compare the key employees and the HCEs for the 2011 calendar year. Assume ownership and compensation have not changed in 2010 or 2011 and the top-paid group election is not made.

| Employee | Ownership | Officer | Compensation |
|---|---|---|---|
| A | 0% | Yes | $ 35,000 |
| B (1) | 50% | Yes | $187,500 |
| C (2) | 0% | No | $ 82,000 |
| D (3) | 50% | Yes | $240,000 |
| E | 0% | No | $ 16,423 |
| F | 0% | No | $120,000 |
| G | 0% | No | $ 5,480 |
| H | 0% | No | $ 68,000 |
| I | 0% | No | $ 48,450 |
| J | 0% | No | $ 46,200 |

(1) B is married to C and B is brother to D.
(2) C is married to B.
(3) D is brother to B.

In 2011, key employees are includible officers (earning $160,000 or more), 1% owners or 5% owners.

Key Employees:
B – 1% owner, 5% owner, includible officer
C – 5% owner (by attribution)
D – 1% owner, 5% owner, includible officer

In 2011, HCEs are 5% owners in 2010 or 2011 or satisfy the compensation test (earn more than $110,000 in 2010).

HCEs
B – 5% owner (2010 and 2011), compensation test
C – 5% owner (2010 and 2011 by attribution)
D – 5% owner (2010 and 2011), compensation test
F – Compensation test

In this example, the key employees determined for the 2011 calendar year will be used to establish whether the plan is top-heavy for the 2012 calendar year. Yet the HCEs determined for the 2011 calendar year will be used in the calculation for the coverage test, ADP/ACP test and general nondiscrimination tests for the 2011 calendar year.

## §1.11 Trust Accounting

The production and/or review of detailed and accurate statements of the funded status of the qualified plan are 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 (see below).

### [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 during the period. 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 (*e.g.*, cash, investments (identified by type) and expenses due to be paid).

The Income Statement provides a summary of the financial activity of the plan during the period. 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 for the prior year, plus the net income from the Income Statement for the current year, match the net assets on the Balance Sheet for the current year; and
- The cash balance on the Summary of Cash Receipts and Disbursements and the Balance Sheet for the year 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 in government reporting. 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.

## §1.12 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.

**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.

**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 more than $160,000 (as indexed) for 2011. 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, (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.

## §1.13 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, and 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.

- Trust accounting serves to identify trust fund activity, prohibited transactions and to prepare year-end financial statements for government reporting.

## §1.14 Review Questions

### [A] True or False

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

______ 2. Every officer earning more than $160,000 (as indexed) for 2011 is included as a key employee.

______ 3. Key employees are used to determine minimum coverage.

______ 4. Most retirement plan administration firms maintain a file containing the executed plan/trust document and executed amendments, if any.

______ 5. The census information serves as the basis for calculation of vesting, eligibility, participation and contributions.

### [B] Multiple Choice

6. 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 deferrals
   D. Number of children
   E. Compensation

7. 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

8. Based on the following information, determine 2011 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 | $155,000 |
| C | No | No | Married to B | $70,000 |
| D | No | Yes | None | $175,000 |
| 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 B, D and E only
E. Participants D and E only

9. Based on the following information, determine the 2011 HCEs:

- Ownership is the same for 2010 and 2011.
- The top-paid group election has not been made.

| Name | Direct Ownership | Officer | Relationship | 2010 & 2011 Compensation |
|---|---|---|---|---|
| A | 4% owner | No | None | $125,000 |
| 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 A, B, D and E only
C. Participants B and C only
D. Participants B, C and D only
E. Participants A, B, C, D and E

10. All of the following are HCE's, **EXCEPT**:

    - The top-paid group election has not been made.

    A. An employee who made over $250,000 last year
    B. An employee who owns 20% of the employer
    C. A brother of the 50% owner
    D. The spouse of the 25% owner
    E. The grandparent of the 15% owner grandchild

11. All of the following documents are collected to serve the basis for plan administration, EXCEPT:

    A. Plan and trust
    B. Amendments
    C. Summary Plan Description
    D. IRS Determination Letter
    E. Bylaws

12. All of the following attribute their ownership under IRC §318, **EXCEPT**:

    A. Spouse to spouse
    B. Grandchild to grandparent
    C. Child to parent
    D. Grandparent to grandchild
    E. Parent to child

### §1.15 Answers

1. **True.** Hours worked are necessary to complete retirement plan administration for the year. §1.07

2. **False.** The number of officers included as key employees are limited to 10 percent of the employee population subject to a minimum of three and a maximum of 50. §1.10 [A]

3. **False**. Key employees are used for determining top-heavy testing. HCEs are used for minimum coverage testing. §1.10 [B]

4. **True**. Most retirement plan administration firms maintain a file containing the executed plan/trust document and executed amendments, if any. These items are the basis for the plan administration work. The file may also contain an IRS determination letter, summary plan description and summary of material modifications, if any. §1.04

5. **True**. The census information serves as the basis for calculation of vesting, eligibility, participation and contributions. It is also necessary for 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 IRC and ERISA. §1.07

6. The correct answer is **D.** §1.07

   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.

7. The correct answer is **A.** §1.04, 1.07[A] & 1.08

   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.

8. The correct answer is **C.** To determine key employees for the 2011 year, the determination date will be in the 2010 year. An employee who is an includible officer, a 1% owner or a 5% owner in 2010 is considered a key employee in 2011. Employees A and D are includible officers (earning $160,000 or more in 2010). 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 2011. §1.10 [A]

9. The correct answer is **E.** An employee is an HCE in 2011 if the employee is a 5% owner in 2010 or 2011, or satisfies the compensation test. Employees B and C are 5% owners (own more than 5 percent directly or via attribution in 2009 or 2010). Employees A, B, D and E satisfy the compensation test (earned more than $110,000 in 2010). Therefore, employees A, B, C, D and E are HCEs in 2011. §1.10 [B]

10. The correct answer is **C**. §1.10

    A. Incorrect. This statement is true because a person who makes over $110,000, in 2010, for the look-back year is an HCE.
    B. Incorrect. This statement is true because a person who owns more than 5% of the stock is an HCE.
    C. Correct. This statement is false because the attribution rules of §318 state that a there is no attribution among siblings.
    D. Incorrect. This statement is true because the attribution rules of §318 state that a spouse is considered to own the stock of the other spouse.
    E. Incorrect. This statement is true because the attribution rules of §318 state that a grandparent is considered to own the stock of the grandchild.

11. The correct answer is **E**. §1.04

    A. Incorrect. This is true because the plan and trust is needed to do plan administration.
    B. Incorrect. This is true because amendments to the plan and trust are needed to do plan administration.
    C. Incorrect. This is true because the summary plan description is needed to do plan administration.
    D. Incorrect. This is true because the IRS determination letter is needed to do plan administration.
    E. Correct. This is false because the bylaws are not needed to do plan administration.

12. The correct answer is **D**. §1.10[A]

    A. Incorrect. This is true because the attribution rules of §318 state that a spouse is considered to own the stock of the other spouse.
    B. Incorrect. This is true because the attribution rules of §318 state that a grandparent is considered to own the stock of the grandchild.
    C. Incorrect. This is true because the attribution rules of §318 state that a child is considered to own the stock of the parents.
    D. Correct. This is false because attribution rules of §318 do not state that a grandchild is considered to own the stock of the grandparent.
    E. Incorrect. This statement is true because the attribution rules of §318 state that a parent is considered to own the stock of the child.

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



### §2.01 Learning Objectives

- Explain the concept of forfeitures.
- Describe how forfeitures may be used each year in a defined contribution plan.
- Calculate a basic contribution allocation 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 contributions/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 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 3 percent of eligible compensation, but each participant does not always receive an allocation of 3 percent of the participant's individual compensation. Instead, perhaps the plan document sets forth an allocation on the basis of service rendered to the employer or some other criteria.

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

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

First let's consider various forfeiture and contribution allocations to a participant account.

## §2.03 Forfeitures

### [A] Forfeiture Allocation

While a participant gradually accumulates ownership of employer contributed retirement benefits, or vesting, the termination of the participant's employment may give rise to the inverse, or forfeiture, of the portion of the employer contributed benefit that is not vested. That is, since vested percentages increase through performance of additional years of service, after 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 the date of termination, the participant owns only part of the benefit funded by the employer. The portion that is not owned by the participant, the nonvested portion, cannot be distributed to the participant and is forfeited to the plan.

**Example 2-1. Forfeiture.** T is a participant in the employer's profit sharing plan. T currently has an account balance of $10,000. The plan uses a six-year graded vesting schedule (0% after 1 year of service, 20% after 2 years, and then 20% per year thereafter), and T terminates employment with four years of service. Since T is 60% vested in the profit sharing account based on years of service, T receives a distribution of $6,000 ($10,000 x .60). The $4,000 remaining in T's account ($10,000 less $6,000 vested) eventually is forfeited: that is; removed from T's account in order to close it with a zero balance.

Under defined contribution plans, since these forfeited amounts represent monies held under the plans that 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:

- Use the forfeiture to reduce the employer's future contribution;
- Use the forfeiture to pay plan expenses; or
- Reallocate the forfeiture to the accounts of 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 a 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:

- The time at which a terminated participant receives a total distribution of the participant's vested account balance; or
- 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).

When 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.** J, age 45, ends employment in 2011 after completing 1,200 hours of service and receives a distribution of the entire vested balance in 2012. The plan document states that the non-vested 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 2012, the year that J receives the distribution.

Alternately, if J decides to leave the assets in the plan until J reaches the plan's normal retirement age of 65, the forfeiture would occur in 2016, the year in which J incurs a 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 employer contributions or be to the accounts of the same participants who receive contribution allocations, so any differences in methodology should be duly noted.

Forfeitures are often held in a suspense account and released at the end of the plan year in which they occur. The plan document will dictate when forfeitures will be released from suspense. At times, a plan document may specify a waiting period before forfeitures will be released. For example, a forfeiture may occur at the time in which a terminated participant receives a total distribution of the participant's vested account balance but may not be released from suspense until after that terminated participant has incurred two consecutive breaks in service.

## §2.04 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 that 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 type of termination event.

Compensation used to allocate employer contributions and forfeitures can also vary. However, compensation for allocation purposes cannot exceed the IRC §401(a)(17) limit of $245,000 for 2011. This amount is indexed each year. In addition, if parts of compensation are excluded discrimination testing may be required.

The formula for a ***pro rata* allocation** of contributions is:

Individual Compensation / Total Eligible 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 is its ease of use and effect on nondiscrimination testing. This allocation formula is automatically deemed to be nondiscriminatory. Simply stated, a *pro rata* allocation results in each eligible participant receiving the same percentage of eligible compensation as a contribution, regardless of highly compensated employee or nonhighly compensated employee status.

### §2.05 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 **permitted disparity**.

Under the concept of permitted disparity, 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 pay Federal Insurance Contributions Act (FICA) taxes on wages up to the stated, yearly **Social Security taxable wage base (TWB)**. The TWB is $106,800 for 2011. Please refer to Appendix A for a listing of current limits.

Because part of the Social Security tax is 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 allocation formula offsets the plan sponsors contributions made outside of the retirement plan.

For example, employees and employers each pay 6.2 percent of wages up to the TWB 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 was historically 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 TWB. However, no contribution has been made to Social Security (and no retirement benefit will be paid from Social Security) in relation to compensation above the TWB. 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 on some compensation.

Three key elements of the allocation under this method are the integration level, the base contribution percentage and the excess contribution percentage. The plan's allocation 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 TWB (the integration level) plus an excess contribution of 11.7 percent of compensation in excess of the TWB. In this manner, a participant whose compensation falls below the TWB 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 TWB receives that same 11.7 percent combination from the plan and Social Security on compensation up to the TWB, as well as the full 11.7 percent of compensation above the TWB from the plan (since Social Security does not receive contributions or pay benefits on compensation exceeding the TWB). 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 TWB, and they may set the base contribution percentage as something less than 5.7 percent. However, for the benefits provided under the plan to be automatically considered to be nondiscriminatory, the following requirements of the IRC 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 TWB as set forth below:

| Integration Level | Maximum Disparity Allowance |
|---|---|
| 100% of the TWB | 5.7% |
| Less than 100% but greater than 80% of the TWB | 5.4% |
| Less than or equal to 80% but greater than 20% of the TWB | 4.3% |
| Less than or equal to 20% of the TWB | 5.7% |

The TWB used in the allocation is the TWB in effect as of the beginning of the plan year. For example, for an October 1, 2011, to September 30, 2012, plan year, the 2011 TWB of $106,800 is used.

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 TWB (*e.g.*, 100 percent). If stated as a dollar amount, the integration level remains the same each year, pending a plan amendment, and the maximum disparity allowance may change as the ratio of the integration level to the current TWB is determined. If stated as a percentage, the integration level changes each year as the TWB 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 TWB in effect for the plan year. Participant J earns $120,000, Participant R earns $50,000 and Participant P earns $25,000. Determine the allocation for the plan year ending June 30, 2011.

First, determine the integration level. The plan year is July 1, 2010 to June 30, 2011. The TWB in effect as of the beginning of the plan year (2010) is $106,800. Since the integration level is 100% of the TWB, 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 |
|---|---|---|---|---|---|---|
| J | $120,000 | $106,800 | $4,272 | $13,200 | $1,056 | $5,328 |
| R | $ 50,000 | $ 50,000 | $2,000 | $ 0 | $ 0 | $2,000 |
| P | $ 25,000 | $ 25,000 | $1,000 | $ 0 | $ 0 | $1,000 |

Base compensation is the lesser of Compensation, or the TWB.
Excess compensation is the difference between Compensation and Base Compensation

Note that the total allocation for Participant R is 4% ($2,000 / $50,000) while the total allocation for Participant J is 4.44% ($5,328 / $120,000).

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 J earns $100,000, Participant R earns $50,000 and Participant P earns $25,000. Determine the allocation for the plan year ending December 31, 2011.

The TWB in effect as of the beginning of the plan year (2011) is $106,800. The integration level is 28.09% of the TWB ($30,000 / $106,800) 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 |
|---|---|---|---|---|---|---|
| J | $100,000 | $30,000 | $1,500 | $70,000 | $6,510 | $8,010 |
| R | $50,000 | $30,000 | $1,500 | $20,000 | $1,860 | $3,360 |
| P | $25,000 | $25,000 | $1,250 | $ 0 | $ 0 | $1,250 |

Base compensation is the lesser of Compensation, or the integration level ($30,000).
Excess compensation is the difference between Compensation and Base Compensation

Note that the total allocation for Participant P is 5% ($1,250 / $25,000), the total allocation for Participant R is 6.72% ($3,360 / $50,000) and the total allocation for Participant J is 8.01% ($8,010 / $100,000).

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, a base contribution of 6 percent of compensation up to the TWB plus an excess contribution of 11.7 percent of compensation in excess of the TWB can be alternately expressed as 6 percent of total compensation and 5.7 percent of excess compensation (compensation in excess of the TWB).

### §2.06 Maximum Limitations on Benefits

The limitation on benefits is governed by IRC §415. The maximum amount that can be allocated to a participant's account each plan year is called the **annual additions limit**. Over the years, the statutes surrounding the annual additions limit have created changes in how this maximum limit is calculated under the IRC. Therefore, the plan document must contain provisions that address the limitation.

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 annual additions 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, the amendment will result in a short plan year and a short limitation year.

**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, 2011, the plan is amended to equate the limitation year with the plan year. This creates a short limitation year of January 1, 2011 through September 30, 2011.

As a consequence of a short limitation period or year, the maximum annual additions limitation is applied separately to the short period and adjusted accordingly, as explained in [B] 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 – The limit is 100 percent of the participant's IRC §415 compensation.
2. Dollar Limit – For 2011, the dollar limit is $49,000 (as indexed).

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 A 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 can be allocated to a participant. 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. <u>What Allocations are Included as Annual Additions?</u>

Amounts that are considered annual additions include:

- Employer contributions;
- Elective deferrals;
- Designated Roth contributions;
- Matching contributions;
- Forfeiture allocations; and
- After-tax employee contributions.

Investment earnings, loan repayments, deferrals that exceed the maximum elective deferral limit, catch-up contributions and rollover contributions are not considered to be 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 IRC treats SEP, 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 individual retirement accounts (IRAs), SIMPLE-IRAs, nonqualified plans and cafeteria plans.

There are special rules for determining the annual additions limitation for employee stock ownership plans (ESOPs), which are beyond the scope of this course. An ESOP with an exempt loan, that is, where the ESOP has borrowed money to purchase shares, which invokes the special rules, 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.

2. <u>What Compensation is Used for Annual Additions Calculations?</u>

Compensation for maximum annual additions 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 IRC 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 and SIMPLE plans. The amount of compensation is generally subject to the maximum compensation limit, as indexed ($245,000 in 2011). 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 or the plan will be subject to disqualification. IRS procedures for correction of qualification problems provide that amounts allocated that are in excess of the annual additions limit should be removed from a participant's account and held in a suspense account for reallocation in future years. Furthermore, after-tax employee contributions and elective deferrals may be returned to the participant before any employer-provided contributions are removed from the affected participant's account to comply with the maximum annual additions limit. 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. Plan documents address this ordering method of returns and should be reviewed prior to making a correction for the particular plan.

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.

### [D] Sample Annual Additions Limit Calculation

S is a participant in the employer's calendar year 401(k) plan, the only plan sponsored by the employer. The limitation year is defined as the plan year. During 2011, S receives IRC §415 compensation totaling $67,000.

For 2011, S makes elective deferrals of $11,000 and after-tax employee contributions of $500. The employer allocates $4,680 in matching contribution and $2,000 in employer discretionary contribution in addition to a forfeiture allocation of $570. S's account had $520 of investment earnings during the year. Has S exceeded the annual addition for 2011?

<u>Step 1: Determine annual additions</u>
Annual additions include the sum of the following items:

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

Therefore, S's 2011 annual addition is $18,750 ($11,000 + $500 + $4,680 + $2,000 + $570). Note that the investment earnings of $520 are not included as an annual addition. Also, if S were catch-up eligible, any elective deferrals that are categorized as catch-up contributions would not be included in the limit.

Step 2: Calculate compensation used to determine the limit
The IRC §415 compensation for 2011 is applied using gross compensation, unreduced by elective deferrals under a 401(k) plan or a cafeteria plan. Therefore, S's IRC §415 compensation is $67,000. Remember, this compensation would be limited to the 2011 maximum of $245,000 had S's compensation been above that amount

Step 3: Determine the annual additions limit
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 ($49,000 for 2011).

Step 4: Determine whether the maximum limitation on benefits has been exceeded
The maximum annual additions limit is $49,000. S's annual additions are $18,750. Therefore, S's maximum limitation on benefits has not been exceeded.

### §2.07 Key Terms

**Annual Additions Limit:** The maximum amount that may be allocated to a participant's account balance as defined under IRC §415. The limit is equal to the lesser of 100% of compensation or the dollar limit. For 2011 the dollar limit is $49,000. The annual additions include contributions and forfeitures, including elective deferrals, designated Roth contributions and after-tax employee contributions

**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 between the base and excess allocation percentages allowed based on the plan's integration level and the TWB.

**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 eligible compensation as a contribution.

**Social Security Taxable Wage Base (TWB):** The amount of compensation above which a person does not pay Social Security contributions for retirement benefits and on which the person does not receive Social Security benefits.

### §2.08 Review of Key Concepts

- Generally, a forfeiture of a terminated participant's nonvested individual account occurs on the earlier of the end of the plan year in which a terminated participant receives a total distribution of the participant's 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 using the forfeiture is stated in the plan document and may be different than the method for allocating them.

- The plan document must state the method for determining employer 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 the participant's IRC §415 compensation or $49,000 (as indexed) for 2011.

- The maximum annual allocation 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.

## §2.09 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 additions limit under IRC §415 for limitation years ending in 2011 is the lesser of 100% of IRC §415 compensation or $49,000.

______ 4. The three key elements of a defined contribution permitted disparity allocation formula are the integration level, base contribution percentage and excess contribution percentage.

______ 5. Catch-up contributions are considered to be annual additions.

### [B] Multiple Choice

6. Based on the following information, determine Participant A's allocation of the employer's discretionary contribution for the 2011 calendar year:

    - The allocation is made pro rata based on compensation.
    - The employer contribution is $7,000.
    - The IRC §401(a)(17) compensation limit is $245,000 in 2011.
    - Total compensation for all eligible participants is $500,000.
    - No eligible participant's compensation is above the compensation limit of $245,000.
    - Participant A's compensation is $80,000.

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

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

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

8. All of the following are types of allocations included when calculating the maximum annual addition 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

9. Based on the following information, determine the participant's annual addition for 2011:

   - Gross compensation - $50,000
   - Elective deferrals, not including catch-up contribution - $16,500
   - 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. $33,000
   C. $36,500
   D. $44,000
   E. $49,000

10. Which of the following statements regarding the forfeiture amount from a terminated participant's account is/are **TRUE**?

    I. The nonvested portion of the account balance may be forfeited at the time in which the participant received a total distribution of the participant's vested account.
    II. The nonvested portion of the account balance is usually considered forfeited on the last day of the plan year in which the participant terminated for participants who have no vested benefit.
    III. The nonvested portion of the account balance may be forfeited at the end of the plan year after the participant incurred five consecutive one-year breaks in service.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II, and III

11. Based on the following information, determine Participant N's allocation of the employer's discretionary contribution for the 2011 calendar year:

- The allocation is made pro rata based on compensation.
- The employer contribution is $35,000.
- The IRC §401(a)(17) compensation limit is $245,000 in 2011.

| Participant | Compensation |
|---|---|
| M | $ 45,000 |
| N | $300,000 |
| O | $ 55,000 |
| P | $105,000 |
| Q | $ 75,000 |

A. $14,784.48
B. $16,333.33
C. $18,103.46
D. $20,000.00
E. $35,000.00

12. Based on the following information, determine the 2011 annual addition limit for Participant B:

- The limitation year is a calendar year plan.
- Participant B's compensation is $275,000.
- Participant B received a profit sharing allocation of $40,000.
- Participant B received a forfeiture allocation of $10,000.
- Participant B received earnings allocation of $2,300.
- Participant B paid back $4,000 on a loan from the plan.

A. $40,000
B. $49,000
C. $50,000
D. $52,300
E. $56,300

### §2.10 Answers

1. **True.** Forfeitures may be used to pay plan expenses. §2.03[A]

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 the participant's account balance or at the end of the plan year in which the participant incurs five consecutive one-year breaks in service. §2.03 [B]

3. **True.** The annual addition limit under IRC §415 for limitation years ending in 2011 is the lesser of 100% of IRC §415 compensation or $49,000. §2.06 [B]

4. **True**. Three key elements of the allocation are the integration level, the base contribution percentage and the excess contribution percentage. The plan's allocation 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. §2.05

5. **False**. Catch-up contributions are not considered part of the annual additions limit. Neither are investment earnings, loan repayments, deferrals that exceed the maximum elective deferral limit or rollover contributions. §2.06 [B] 1

6. 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. §2.04

7. The correct answer is **E.** §2.05

   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 TWB.
   D. Incorrect. This statement is true because the integration level can be a fixed dollar amount up to the Social Security TWB.
   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 TWB.

8. The correct answer is **B.** §2.06 [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.

9. 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 $16,500, matching contributions of $5,000, profit sharing contributions of $10,000 and forfeiture allocations of $1,500 for a total of $33,000. §2.06 [D]

10. The correct answer is **E**. §2.03[B]

    A. Incorrect because statements II and III are also true.
    B. Incorrect because statements I and III are also true.
    C. Incorrect because statement II is also true.
    D. Incorrect because statement I is also true.
    E. Correct because statements I, II and III are true.

11. The correct answer is **B**. The *pro rata* allocation formula is the individual's compensation divided by the total compensation times the contribution. Compensation is limited to the IRC §401(a)(17) amount of $245,000 for 2011. Thus, Participant N's $300,000 compensation must be cut back to $245,000. Total compensation for all participants is $525,000 with the reduction in Participant N's compensation. Participant N's allocation is $16,333.33 ($245,000 / $525,000 x $35,000). §2.04

12. The correct answer is **B**. The annual addition limit under IRC §415 for limitation years ending in 2011 is the lesser of 100% of IRC §415 compensation or $49,000. §2.06 [B].

## §2.11 Supplemental Education

**Webcourses:** ASPPA offers webcourses on the RPF-1 and RPF-2 materials. These webcourses provide introductory training for new employees and help prepare RPF-1 and RPF-2 exam candidates for the most challenging topics covered on the respective examinations. Webcourses offer many benefits to individual and companies alike:

- Self-paced: Review information at your own pace.
- Flexibility: View the courses from any location with an Internet connection.
- Continuing education: Earn continuing education credit for ASPPA credentials.

There are seven webcourses for RPF-1 and seven webcourses for RPF-2. Each set can be purchased on the ASPPA Web site. Each webcourse is divided into two modules. To register for the webcourses visit www.asppa.org/webcourse.

Webcourses relevant to this chapter:

- Defined Contribution Allocations and Annual Addition

# Chapter 3
## Annual Testing

### §3.01 Learning Objectives

- Define when a plan is top-heavy.
- Describe the contribution requirements that apply to top-heavy plans.
- 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.
- Explain the nondiscrimination tests applicable to deferrals and matching contributions.
- Identify whether a plan has passed the ADP and/or ACP test.
- List methods of correcting a failed ADP and/or ACP test.
- List the 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.
- List the benefits and requirements of automatic enrollment under EACA and QACA.

### §3.02 Introduction

An integral part of the administration of a qualified plan is the determination of key employee and highly compensated employee (HCE) status from the census data. 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 determining a plan's top-heavy status and continues with an explanation of the top-heavy minimum benefit or contribution requirements. Both defined benefit and defined contribution plans must 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.

Plans must also pass minimum coverage testing. 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 nonhighly compensated employees (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 is not satisfied, it does not matter how large a benefit is provided to those covered; the plan faces disqualification under the Internal Revenue Code (IRC).

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 IRC, qualified plans may not discriminate in favor of the HCE in the level or amount of benefits provided to NHCE. Each year, to demonstrate compliance with these statutes, a qualified 401(k) plan must show that HCEs are not contributing on either a pre-tax or an after-tax basis 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 IRC'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 through the use of a safe harbor 401(k) plan.

## §3.03 Top-Heavy Status

### [A] Top-Heavy Definition

After the key employees have been identified, the next task is the determination of the plan's top-heavy status. The plan document outlines 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.

While there are exceptions, in most cases 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. Although certain safe harbor plans are deemed to be non-top-heavy regardless of their amount of benefits for key employees, these plans are still included in the determination of top-heavy status.

Every plan that is tested with an aggregated group of plans, for top-heavy status, becomes top-heavy if the group is top-heavy, except a safe harbor 401(k) plan that has been granted non-top-heavy status is not top-heavy regardless of the outcome of the testing. Instead, its required nonelective or matching contribution may count toward fulfillment of top-heavy minimum contribution requirements for the group.

### [B] Determination Date

The calculations to determine 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 top-heavy for the 2011 plan year, the determination date is December 31, 2010.

In this manner, the key employee determination and top-heavy status calculations, along with the current year's census and accounting data determine 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. For example, to determine if a new calendar year plan is top-heavy in 2011, the determination is made as of December 31, 2011 for both the 2011 and 2012 plan years (i.e., it is the last day of the current year for the first plan year (2011) and the last day of the prior year for the second plan year (2012)).

**Example 3-1. Determination Date.** The LMN Company sponsors an existing profit sharing plan that has a January 31, 2012 year-end. The determination of who are the key employees using the January 31, 2012 data and the account balance information as of January 31, 2012 are used to establish whether the plan is top-heavy for the next plan year beginning February 1, 2012.

### [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 accrued 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 or the account balances of former key employees, which 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 as well as the next plan year. The first year calculation includes any receivable contributions but the second year calculation will not.
- 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 when the cash accounting method is used. If using an accrual accounting method, the IRS has indicated that the profit sharing contribution may be included.
- Contributions to money purchase plans are always included, whether or not they are received 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 added back into the top-heavy determination calculation, including distributions from a terminated plan of the same employer.
- Account balances for participants who terminated employment in prior years are excluded in the calculation, as are any distributions that occurred during the plan year ending on the determination date for such participants.
- 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 if the recipient is still employed or completed at least one hour of service during the plan year ending on the determination date. 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 retirement account (IRA) is also considered an unrelated rollover.
- Elective deferral accounts and designated Roth accounts must be included when calculating the top-heavy ratio each year.
- Catch-up contributions are disregarded for top-heavy purposes only for the plan year in which they are made. After that year, they are included in the calculation as part of the participant's account balance. Thus, when computing the top-heavy ratio for a plan year, since the account balances are determined as of the end of the prior year, the catch-up contributions that were made in the prior plan year are included in those account balances.

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. **Non-key employees** are employees who are not key employees. 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:

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

If no contributions were allocated to the key employees, no minimum top-heavy contributions are necessary for the non-key employees.

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, or excludes forms of compensation such as bonus, commissions, overtime pay, etc..

In determining whether a key employee has received a contribution, elective deferrals made by the key employee and forfeitures allocated to the key employee's account count as a contribution. However, catch-up contributions do not count. In the case of a profit sharing plan for which the plan sponsor declares no contribution for the year, then no contribution is required to be made for the non-key employee unless forfeitures are allocated.

2. <u>Defined Benefit Plans</u>
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:

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

Given the consequences of top-heavy status, documented, accurate performance of top-heavy testing remains critical to qualification and proper administration of the plan. This is especially true for smaller employers, whose plans are more likely to be top heavy if the key employees benefit under 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 IRC 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 in a 401(k) plan because the participant has reached the annual additions limit, the participant 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 but 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, employee stock ownership plans (ESOPs) must be separated from non-ESOPs and union components from nonunion components. Rollover contributions are not subject to the coverage rules.

The coverage rules also provide for permissive disaggregation, under which a plan sponsor may choose to segregate part of a plan for coverage testing on its own. This may occur when a company has two divisions and each division has its own plan.

Two or more plans have to be considered together for coverage testing, if one plan must rely on another plan in order to satisfy minimum coverage. This is called required aggregation.

Regardless of the manner in which the coverage groups are established after application of aggregation and disaggregation rules, a few precepts govern:

- When a plan or plan component contains no HCEs, coverage testing is automatically deemed to pass, as there is no one to discriminate in favor of within the testing group.
- When a plan or plan component contains only HCEs, (no NHCEs are employed or have met the plan's eligibility requirements) coverage testing again is deemed to pass, as there is no one to discriminate against.
- How the plan passes coverage is the basis for how the nondiscrimination testing is performed. For example, plans that are aggregated for coverage testing must be aggregated for nondiscrimination 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 (**statutory excludable employees**) from coverage testing. They are:

- Employees who do not satisfy 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;
  - 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).

After 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 is 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 3-2. Ratio Percentage Test.** The ABC Company sponsors a profit sharing plan and has 250 employees during 2011. 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 HCEs and NHCEs, the test looks like this:

| | | HCE | NHCE | TOTAL |
|---|---|---|---|---|
| (1) | Total employees during 2011 | 80 | 170 | 250 |
| (2) | Terminated employees who worked 500 or fewer hours and did not benefit | -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 $\geq$ .7 (83.33% > 70%), ABC Company's plan has passed the ratio percentage test for 2011.

### [E] Average Benefit Test—In General

If the ratio percentage test is failed, 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: a) reasonable, that is the classification is based on objective business criteria such as location, and b) nondiscriminatory.

The nondiscriminatory classification test is satisfied 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 who are NHCEs (the NHCE concentration percentage). Essentially, the higher the concentration of NHCEs in the employee population, the lower the 70 percent threshold may be. 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. In addition, some plan documents contain language stating the correction method that will be used if the ratio test fails. If such language exists, often called fail-safe language, the method as stated in the document must be used and the average benefit test may not even be an option.

### §3.05 Nondiscrimination Testing

Under the IRC, qualified plans may not discriminate in favor of the HCEs 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. Passing the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test demonstrates compliance for deferrals, matching contributions and after-tax employee contributions. Alternatively, 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. <u>Deferred Compensation</u>

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 the participant's compensation is deferred into the plan, these elective deferrals are considered to be employer contributions. If the plan document allows, elective deferrals may be pre-tax, after-tax (designated Roth contributions) or a combination of the two.

3. Matching Contribution

The employer's contributions made to the plan based on a participant's contribution are matching contributions. The employer may match all or part of the employee's pre-tax elective deferral, designated Roth contribution and/or after-tax employee contributions. The matching formulas may be different for each type of contributions.

4. 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.

5. 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 participant's elective deferrals. A separate accounting is maintained with respect to each type of contribution allocated to the participant's account including rollover contributions, pre-tax elective deferrals, designated Roth contributions, after-tax employee contributions, employer matching contributions, qualified matching contributions (QMACs), nonelective contributions, etc.

6. Excess Deferrals

Elective deferrals that exceed the annual individual deferral limit ($16,500 for 2011) are **excess deferrals** under the IRC.

7. Excess Contributions

Failure of an ADP test results in **excess contributions** for certain HCEs under the IRC, requiring the plan to take corrective measures.

8. Excess Aggregate Contributions

Failure of an ACP test results in **excess aggregate contributions** for certain HCEs under the IRC, requiring the plan to take corrective measures.

### [B] Actual Deferral Percentage (ADP) Test

The **actual deferral percentage (ADP) test** determines whether HCEs are (as a group) contributing proportionately more than a nondiscriminatory percentage of their compensation into the plan. Typically these elective deferrals are made on a pre-tax basis, but participants may make designated Roth contributions, which are elective deferrals made on an after-tax basis. Both pre-tax elective deferrals and designated Roth contributions are included in the ADP test. Catch-up contributions made that would otherwise cause the participant to exceed the annual additions limit or elective deferral limit are excluded from the ADP Test.

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, although it must be nondiscriminatory. Ratios are calculated to two decimal places (the nearest 1/100th of a percent), and then the ratios are used to produce average deferral percentages (ADPs) for the HCEs and the NHCEs. Those eligible participants who chose not to defer have ADRs of zero when deriving the overall averages.

To pass ADP testing, the ADP of the HCEs must not exceed the ADP of the NHCEs by more than a specified amount. The IRC states that the HCEs' ADP must not exceed the greater of:

- 1.25 times the ADP for NHCEs; or
- the lesser of:
    - Two times the ADP for NHCEs; or
    - The ADP for NHCEs plus two percentage points.

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 IRC 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 2012 has been determined by the NHCEs' ADP from 2011. This is called the **prior year testing method**, and it allows the plan sponsor and HCEs to know early in the new plan year what the HCEs' ADP limit is for that year, enabling them to make their financial decisions accordingly.

Alternatively, the plan sponsor can elect within the plan document to use a **current year testing method**. 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. This enables the HCEs to adjust their deferral rates for the balance of the year in an attempt to pass the ADP testing at year-end. HCEs that want to defer the maximum allowed under the IRC may not accomplish that goal if they attempt to adjust their deferral rates to avoid a failure. A refund of salary deferrals assures that the HCE deferred the maximum allowed amount based on the IRC and the terms of the plan.

Both prior year and the current year methods have their merits, and, under certain circumstances, plans may change methods. The testing method must be specified in the plan document. Consequently, the plan documents should be carefully consulted to determine whether ADP testing is calculated on a current or prior year basis.

**Example 3-3. Prior Year ADP Test.**

| Name | Current Year Compensation (2011) | Current Year Elective Deferrals (2011) | Current Year ADR (2011) |
|---|---|---|---|
| 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% |

**2011 ADP for HCEs** = 13.93% / 3 = **4.64%**

| Name | Prior Year Compensation (2010) | Prior Year Elective Deferrals (2010) | Prior Year ADR (2010) |
|---|---|---|---|
| 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% |

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 ADP for the HCEs is less than 5.38% (3.38% + 2), the test is satisfied.

It is important to note that, for purposes of prior year testing, the NHCEs included in the testing group are those that were NHCEs in the prior year. Usually, no adjustment is needed to the ADP from the prior year for the NHCEs, even though some may have terminated employment or become HCEs in the current year, or that new participants in the current year are not included in the prior year ADP.

### §3.06 Actual Contribution Percentage (ACP) Test

The **actual contribution percentage (ACP) test** measures the extent to which the average rate of HCE after-tax employee contributions and employer matching contributions provided to the HCEs exceeds the average rate of 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, which are different from after-tax employee contributions, are elective deferrals made on an after-tax basis but are tested in the ADP test.

#### [A] Qualified Matching Contributions (QMACs)

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

Alternatively, 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. Alternatively, 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, but using **actual contribution ratios (ACR)** instead of actual deferral ratios. First, each individual’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. Ratios are calculated to two decimal places (the nearest 1/100th of a percent) and then the ratios are used to produce average contribution percentages (ACPs) for the HCEs and the NHCEs.

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 more than 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 3-4. 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 (2011) | Current Year Employer Match (2011) | Current Year ACR (2011) |
|---|---|---|---|
| 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% |

**2011 ACP for HCEs** = 6.96% / 3 = **2.32%**

| Name | Prior Year Compensation (2010) | Prior Year Employer Match (2010) | Prior Year ACR (2010) |
|---|---|---|---|
| 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% |

**2010 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 that 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:

1. Raising the NHCE averages to achieve passing results; or
2. 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 example 3-2 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 total dollar amount of the correction determined in the first step is apportioned among the HCEs, 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, in the chart below that HCE A has the highest ADR at 8%, and HCE B has deferred the maximum amount in 2011 of $16,500 for an ADR of 6.73%. HCE C has the next highest dollar amount of deferral.

| HCE | 2011 Compensation | Elective deferral | ADR |
|---|---|---|---|
| A | $100,000 | $8,000 | 8% |
| B | $245,000 | $16,500 | 6.73% |
| C | $171,428 | $12,000 | 7% |

In order to lower the HCE average, if the highest individual ADR must be limited to 7% for the HCEs' ADP to pass testing, then:

- Step 1: HCE A, with an 8% ADR, would have deferrals limited to $7,000 ($100,000 x 7%). This would add $1,000 to the dollar amount of the correction ($8,000 less $7,000 maximum). Note that HCE A does not actually receive a distribution of $1,000.
- Step 2: HCE B, deferring $16,500, would receive a corrective distribution of $1,000 (plus associated earnings) since HCE B 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 who are at least age 50 by the end of the calendar year. As a result, to the extent possible, a corrective distribution must be reclassified as a catch-up contribution and thereby retained in the plan. Catch-up contributions are not included in the ADP or ACP tests, so this reclassification is considered to be a correction of the failure.

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 3-5. ADP Test Correction.**

| **Name** | **Current Year Compensation (2011)** | **Current Year Elective Deferrals (2011)** | **Current Year ADR (2011)** |
|---|---|---|---|
| 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% |

**2011 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:** Determine the amount to be refunded by reducing the highest ADR to the next highest ADR or by the full .26%:

| | | **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:** Allocate the amount determined in Step One among the HCEs by reducing the highest amount of deferrals to the next highest amount of deferrals or by the full required correction:

| | 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 |

### [C] When Must Corrective Distribution be Made?

Corrective distributions of excess contributions and excess aggregate contributions must be provided to affected participants within 2½ months after the close of the plan year-end for which the ADP test or ACP test is failed. If the corrective distributions are made later than 2½ months after the close of the plan year-end, then the employer must pay a 10% excise tax on the total amount of excess contributions and excess aggregate contributions. Under no circumstances should the corrective distribution be made more than 12 months after the end of the plan year being tested. At that point, the plan is considered to be discriminatory and may be disqualified.

However, if the plan is an **eligible automatic contribution arrangement** (EACA) then the 2½-month date is extended to the date that is 6 months after the close of the plan year. Automatic contribution arrangements, sometimes called negative elections, allow a 401(k) plan to automatically withhold a specified percentage of compensation as an elective deferral in the absence of an affirmative election by an eligible employee under the plan.

For the plan to be an EACA it must meet the following requirements:

- The default automatic elective contribution must be a uniform percentage of compensation; and
- A notice of the employee rights and obligations under the arrangement must be provided to each affected employee within a reasonable time before each plan year. The notice must:
    - Explain the rate of elective deferral that will be withheld and that the employee has the right to elect not to make an elective deferral or to defer at a different rate;
    - Explain how the elective deferral will be invested if the employee does not make an investment election; and
    - If the plan so elects, explain the employee's right to make a permissible

withdrawal and the procedures to elect such a withdrawal (plus earnings) without penalty within 90 days after the automatic enrollment began. The distribution would be included in the employee's gross income for the employee's tax year in which the distribution is made. Any matching contribution would be forfeited. If the participant makes this election, then the total of the refunded deferrals are not included in the ADP test for the plan year in which they were deferred. Likewise, forfeited match is not included in the ACP test.

If an EACA allows permissible withdrawals, it is important that ADP and ACP testing are not performed until after the end of the period in which participants are allowed to request a permissible withdrawal. Testing prior to the end of that period could result in the inclusion of deferrals and match that were later refunded as a result of a requested permissible withdrawal, causing the testing to be incorrect.

## §3.08 Safe Harbor 401(k) Plans

Employers may avoid the annual nondiscrimination ADP (and, if desired, ACP testing) by using a safe harbor 401(k) plan design.

### [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 an 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. This provides a maximum match of 4% of compensation. The plan may, but is not required to, provide the safe harbor contribution to the HCEs.

      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. The plan may, but is not required to, provide the safe harbor contribution to the HCEs.

For example, an enhanced matching formula of 100% of the first 4% of compensation satisfies the safe harbor requirements. It is also easier to explain then the basic match and may not be that much more expensive.

Another example would be an 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, to avoid having to test the matching contributions under 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 nonsafe harbor matching contributions is determined at the discretion of the plan sponsor, these matching contributions are limited to 4 percent of compensation; 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 to the above contribution requirements, a safe harbor 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. However, the use of the safe harbor must be specified in the plan document, so decisions to change the plan's approach must be documented through an amendment.

A plan that satisfies the safe harbor matching contribution may reduce or suspend the contribution during a year if the following are met:

- Notice must be given to the employees 30 days prior to the suspension or reduction;
- Eligible employees must be given a reasonable opportunity to change their elective deferral elections after receipt of the notice;
- The plan must satisfy all applicable nondiscrimination tests for the entire plan year;
- The plan must make all safe harbor matching contributions up to the amendment's effective date; and
- The compensation limits under IRC §401(a)(17) must be prorated.

A plan that satisfies the safe harbor using a QNEC may reduce or suspend the contribution during a year if the following are met:

- The employer suffers a substantial business hardship;
- The plan is amended prior to the end of the plan year;
- Notice must be given to the employees 30 days prior to the suspension or reduction;
- Eligible employees must be given a reasonable opportunity to change their elective deferral elections after receipt of the notice;
- The plan must satisfy all applicable nondiscrimination tests for the entire plan year;
- The compensation limits under IRC §401(a)(17) must be prorated.
- The plan must comply with the top-heavy rules.

4. Withdrawal Restrictions

The safe harbor contributions are subject to the same withdrawal restrictions as those that apply to elective deferrals under the IRC. In addition, unlike elective deferrals, safe harbor contributions may not be withdrawn for reasons of financial hardship. If the plan provides for employer contributions other than the ADP safe harbor contribution, the plan may permit distribution of the contribution on hardship or any other permitted distribution event.

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

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 meet the ACP safe harbor.

In the event that a safe harbor 401(k) plan includes other nonelective contributions or additional discretionary employer matches 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 nonsafe harbor related nonelective and matching contributions, and as long as these provisions are not utilized during a plan year and no nonsafe harbor related allocations are actually made, the plan will be deemed to be a non-top-heavy plan for that year.

### §3.09 Qualified Automatic Contribution Arrangement (QACA)

401(k) plans can provide that elective deferrals will be made for a participant unless the participant affirmatively elects otherwise. This feature has been called automatic enrollment or negative elections. Prior to 2008, there were no safe harbor rules that allowed plans that offered these features to automatically comply with the ADP and ACP tests. The Pension Protection Act of 2006 (PPA 2006) made a number of changes favoring automatic enrollment plans, reflecting Congressional desire to encourage increased participation in 401(k) plans in this manner.

A plan will automatically comply with the ADP and possibly the ACP tests if it offers a qualified automatic contribution arrangement (QACA). There are specific requirements a QACA must meet related to:

- The elective deferral percentage;
- The matching formula;

- The vesting schedule; and
- A notice to participants.

A plan that offers a QACA and under which no other types of contributions are made will be considered not top-heavy. In addition, the plan may allow participants who are automatically enrolled to withdraw their contributions (plus earnings) without penalty within 90 days after the automatic enrollment began. The distribution would be included in the employee's gross income for the employee's tax year in which the distribution is made. Any matching contribution associated with the withdrawn contributions would be forfeited.

### [A] The QACA Elective Deferral Percentage

The initial automatic elective deferral rate under a QACA must be between 3% and 10%. If the rate during the first year is less than 6%, then the participant's QACA rate must be at least:

- 3% in the first plan year;
- 4% in the second plan year;
- 5% in the third plan year; and
- 6% during the later years of participation.

Should the participant make an affirmative election to no longer make a contribution or to make an elective deferral at a different level, then these increasing rates no longer apply to that participant. For ease of administration, many employer elect to simply set the automatic elective deferral rate to a flat 6% so that they do not have to track the annual escalation required by the QACA rules.

### [B] The QACA Contribution Formula

The plan sponsor must make one of the following contributions under the QACA:

- A match of 100% of all NHCEs elective deferrals up to 1% of compensation, plus 50% of the next elective deferral up to 6% of compensation. This results in a maximum match of 3.5% of compensation.

  For example, a participant earns $30,000 in compensation and defers $1,800 or 6% of compensation. The employer match would be $1,050 ((30,000 x 1%=$300) plus ((30,000 x 5%) x 50%=$750).

  OR

- A nonelective contribution of at least 3% of compensation for all NHCEs eligible to participate regardless of whether they make an elective deferral.

The plan may, but is not required to, provide the QACA contribution to the HCEs.

### [C] The QACA Vesting Schedule

Under a QACA, any employee who has two years of service must be 100 percent vested in the QACA matching or nonelective contribution.

### [D] The QACA Notice to Participants

A notice must be given annually to the participants explaining their rights and obligations under the plan. The notice must be provided within a reasonable period before the beginning of each plan year. The notice must explain:

- The level of elective contributions that will be made on the participant's behalf in the absence of an affirmative election;
- The right to elect not to have elective deferrals contributed to the 401(k) plan;
- The right to elect a different deferral percentage;
- How the elective deferrals will be invested should the participant choose not to make an investment election;
- If the plan so elects, explain the right to make a permissible withdrawal and the procedures to elect such a withdrawal to refund elective deferrals that were withheld through the auto-enrollment without penalty, within 90 days after the automatic enrollment began; and
- The period of time in which the participant may make the deferral election after the participant receives the notice.

## §3.10 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 401(k) plan satisfies this requirement is determined with respect to the amount of deferral, matching, and after-tax employee contributions through use of the ADP and ACP tests discussed above. Similarly, nonelective contributions in a defined contribution plan (401(k) plans or otherwise) must be nondiscriminatory.

These contributions may be tested by comparing the level of contributions made for HCEs with those for NHCEs, or, alternatively, with respect to the equivalent amount of benefits provided to the participants in each group. 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. When a defined contribution plan is tested for nondiscrimination with regard to the provided benefits or a defined benefit plan is tested with respect to the equivalent contributions, this is called "cross-testing."

Because a contribution on behalf of a younger participant has more time to grow with interest than does a contribution on behalf of an older participant, it represents a more valuable retirement benefit. Therefore, a larger contribution may be provided to an older employee and it will not be discriminatory when examined on a benefits basis. A cross-tested defined contribution plan allows for discretionary contributions that are greater on behalf of the older (and often 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 or for more details on nondiscrimination testing for cross-tested plans.

## §3.11 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. Alternatively referred to as elective contributions, salary deferrals or salary reduction contributions.

**Eligible Automatic Contribution Arrangement (EACA):** A type of automatic contribution arrangement in a 401(k) plan that is given 6 months after the plan year-end to complete the ADP and/or ACP testing.

**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 to be benefiting.

**Non-key Employees:** Employees who are not key employees.

**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 Automatic Contribution Arrangement (QACA):** A type of automatic contribution arrangement in a safe harbor 401(k) plan that will automatically comply with the ADP and possibly the ACP test. There are specific requirements a QACA must meet.

**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:** 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.

## §3.12 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 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, including 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% 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.

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

______ 4. A matching contribution of 100% on the first 5% of compensation deferred will satisfy the enhanced formula for safe harbor 401(k) plans.

______ 5. A defined contribution plan is top-heavy if the account balances for key employees exceed 60 percent of the total account balances of all participants.

### [B] Multiple Choice

6. Based on the following information, determine the top-heavy ratio for the 2011 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, 2010.
   - The non-key employee balances total $410,856 as of December 31, 2010.
   - A non-key employee had in-service withdrawal in 2009 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. 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 or allocation 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 allocations

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%

14. Which of the following statements regarding failed ADP/ACP tests is/are **TRUE**?

    I. One correction option is distributing excess contributions and excess aggregate contributions to the HCEs.
    II. A QNEC can be made to increase the ADP averages of the NHCEs.
    III. A corrective distribution for a failed ADP test could be reclassified as a catch-up contribution if the HCE is at least 50 by the end of the calendar year.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II, and III

15. All of the following statements regarding automatic contribution arrangements are **TRUE, EXCEPT**:

    A. Under an EACA, the plan automatically satisfies the top-heavy test.
    B. Under a QACA, the 401(k) plan automatically complies with the ADP test.
    C. Under a QACA, the 401(k) plan is considered not top-heavy if no other types of contribution are made.
    D. Under an EACA, the 401(k) plan has 6 months after year-end to make corrections for a failed ADP test.
    E. Under both a QACA and EACA a notice must be given to participants prior to the beginning of the plan year that explains the rate of elective deferral.

16. All of the following statements regarding discrimination testing are **TRUE, EXCEPT**:

    A. Matching contributions are tested under the ACP test.
    B. Elective deferrals are tested under the ADP test.
    C. Designated Roth contributions are tested under the ADP test.
    D. After-tax employee contributions are tested under the ACP test.
    E. Rollover contributions are tested under the ACP test.

## §3.14 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.** 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]

4. **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]

5. **True**. 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. §3.03 [A]

6. The correct answer is **B.** The top-heavy ratio for the 2011 calendar year is based on account balances as of December 31, 2010. 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 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[D]

   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[B]

   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 allocations 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

14. The correct answer is **E**. §3.07[A] and [B]

    A. Incorrect because statements II and III are also true.
    B. Incorrect because statements I and III are also true.
    C. Incorrect because statement II is also true.
    D. Incorrect because statement I is also true.
    E. Correct because all statements are true.

15. The correct answer is **A**. §§3.07[C] and 3.09

    A. Correct. This statement is false because under an EACA the plan does not automatically satisfy the top-heavy test.
    B. Incorrect. This statement is true because under a QACA the 401(k) plan automatically complies with the ADP test.
    C. Incorrect. This statement is true because under a QACA the 401(k) plan is considered not top-heavy if no other types of contribution are made.
    D. Incorrect. This statement is true because under an EACA the 401(k) plan has 6 months after year-end to make corrections for a failed ADP test.
    E. Incorrect. This statement is true because under both a QACA and EACA a notice must be given to participants prior to the beginning of the plan year that explains the rate of elective deferral.

16. The correct answer is **E**. §§3.05 and 3.06

    A. Incorrect. This statement is true because matching contributions are tested under the ACP test.
    B. Incorrect. This statement is true because elective deferrals are tested under the ADP test.
    C. Incorrect. This statement is true because designated Roth contributions are tested under the ADP test.
    D. Incorrect. This statement is true because after-tax employee contributions are tested under the ACP test.
    E. Correct. This statement is false because rollover contributions are tested under the ACP test.

## §3.15 Supplemental Education

**Webcourses:** ASPPA offers webcourses on the RPF-1 and RPF-2 materials. These webcourses provide introductory training for new employees and help prepare RPF-1 and RPF-2 exam candidates for the most challenging topics covered on the respective examinations. Webcourses offer many benefits to individual and companies alike:

- Self-paced: Review information at your own pace.
- Flexibility: View the courses from any location with an Internet connection.
- Continuing education: Earn continuing education credit for ASPPA credentials.

There are seven webcourses for RPF-1 and seven webcourses for RPF-2. Each set can be purchased on the ASPPA Web site. Each webcourse is divided into two modules. To register for the webcourses visit www.asppa.org/webcourse.

Webcourses relevant to this chapter:
- Top-Heavy Plans and Coverage Testing
- HCEs and 401(k) Nondiscrimination Rules

**Publications:** Below is a listing of additional publications specific to topics found in this chapter. These resources are not required reading nor do they provide additional information to be tested. They are listed for those who may want more detail on a topic. The listing includes only those publications that are free and may be found on the Web.

1. Articles relevant to this chapter can be found at the ASPPA Web site:

   "Back-to-Basics: Average Deferral percentage Test" by William C. Grossman, QPA in *The ASPPA Journal*, Spring 2010, Vol. 40. No 2.

   "Compliance-A Year in Review-January to December" by Lisa Scalia, CPC, QPA, QKA in *The ASPPA Journal*, Fall 2010, Vol. 40. No 4. www.asppa.org/errata

2. An article relevant to this chapter can be found at the IRS Web site:

   "Automatic Enrollment 401(k) Plans" www.irs.gov/pub/irs-pdf/p4674.pdf

# Chapter 4
## Living in an Electronic World—Daily Valuation



### §4.01 Learning Objectives

- Define the term daily valuation.
- Differentiate between the role of the recordkeeper and the administrator.
- Identify the differences between 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.

The rest of this course considers retirement plan administration from the perspective of processing daily valued, participant-directed defined contribution plans. Participants commonly demand access to and information about their retirement plan accounts on a 24-

hour basis. Many 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 that shaped the industry. This chapter presents the many factors affecting daily valuation services 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

Daily valuation, otherwise known as daily val or daily, does not really mean that valuation of assets is performed every day, but the name 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 participant-directed defined contribution plans.

Before we expand your knowledge on daily valuation, let's discuss the history of valuation processes 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 (IRC). 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 Treasury issued proposed 401(k) regulations that were finalized in 1991, causing 401(k) plans to gain more popularity. In July 2003, the Treasury issued a new set of proposed 401(k) regulations that were finalized in December 2004. In these finalized regulations, the Treasury compiled rules related to 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 and technology developed, 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 participant-directed investments evolved and participants began actively making investment choices, plan sponsors adopted semiannual or quarterly valuation cycles 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 (*e.g.*, 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 made during the period.

In essence, this method treats all withdrawals to have been made on the first day and 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 or payments 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 business day. Daily valuation responds to participant demands for immediate access to information through automated response units such as 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. Certain of these investments may not be suitable for daily valuation plans. 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 contribution plans are administered:

1. It redefined the role of recordkeeper and differentiated it from administrator of the plan;
2. It changed the structure of the administration department due to the functionalizing of many tasks; and
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, which are 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, 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 the 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 §404 deduction limit, IRC §415 annual additions testing and catch-up contributions;
- Calculating employer contributions;
- Reviewing operational practices for compliance with the plan document and all regulations;
- 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 transactional 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-oriented 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.

The above 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.

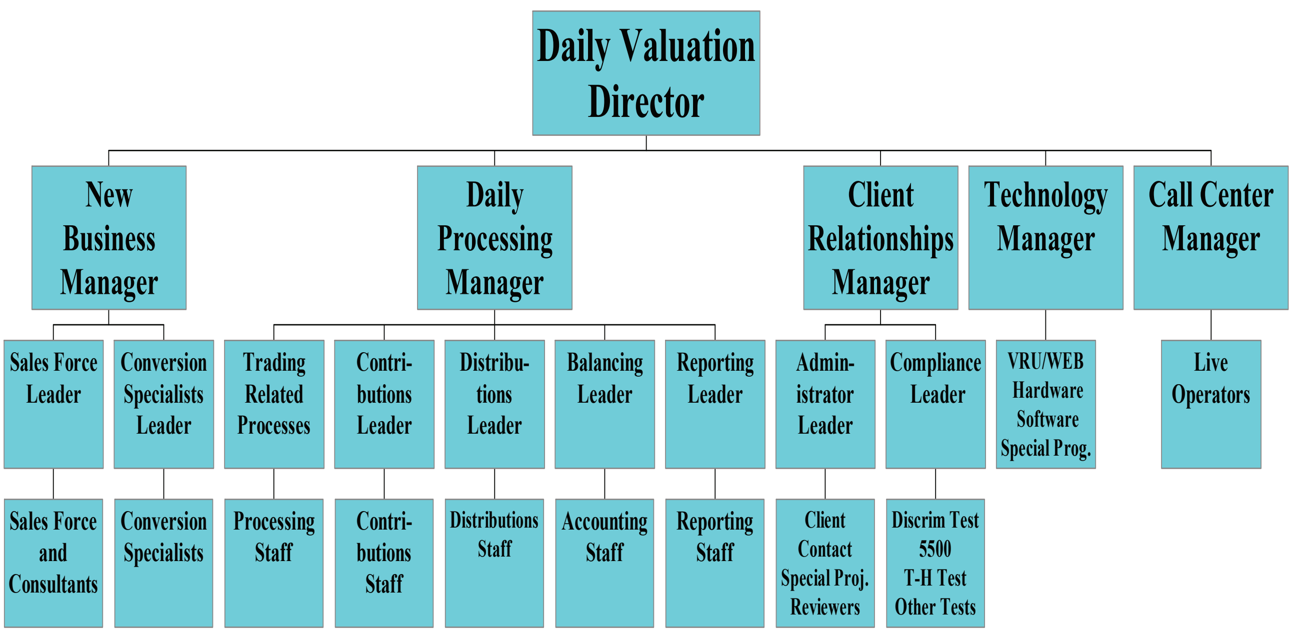
As retirement plan administration firms wrestled with decisions about how to provide daily valuation services to their clients, it quickly became obvious that the staffing model and department structures of the balance-forward environment no longer worked. This is because:

- 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 than balance-forward;
- Assets are valued on a daily basis; and
- There are many different time sensitive deadlines when processing daily valuation plans than balance-forward.

Thus, staff expected to work on balance-forward plans generally are not also assigned daily valuation recordkeeping.

Retirement plan administration firms have re-created themselves in various ways to provide daily valuation services. As the number of daily valuation plans increases, the plan administration firms have restructured their departments to functionalize the recordkeeper's role. A recordkeeper may be responsible for processing only distributions or only contributions, for example. The exhibit below shows a mature daily valuation department that has fully functionalized all tasks:

**Daily Valuation Department - Functionalized**




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, as is typical in balance-forward administration;
- The cost to employ a recordkeeper is minimized due to functionalizing of the recordkeeper's role;

- The many deadlines in daily valuation processing are easier for a recordkeeper to manage; and
- It allows the process to become efficient by permitting each team member to focus 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 given 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 Daily Valuation Market—Bundled Versus Unbundled

Daily valuation redefined the role of the recordkeeper and changed the structure of the daily unit, causing most to become functionalized. It also caused new ways to market the daily valuation product to the plan sponsor. **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 easier. The recordkeeping system maintains the number of mutual fund shares held by each shareholder (participant) and every evening, an operator updates the current price of each mutual fund within the plan. Mutual fund companies created plan administration departments to complement the investment services they already offered.

While some of these institutions, including insurance companies, were building special retirement plan departments and services, others decided to combine resources, realizing they did not have either the time or the money to effectively enter the daily valuation business. Retirement plan administration firms found that the easiest and quickest way to enter the daily valuation market was to combine resources in some way with another vendor or 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 in which 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. These service providers have built and maintained all of the systems (including proprietary daily valuation recordkeeping software) and services in-house. Developing these in-house, proprietary systems allow 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. 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. Under this structure, the main plan sponsor contact has retained the assistance of other entities to perform some of the services on a "back-shop" basis – that is, without identifying themselves separately to the plan sponsors. The plan sponsor is not aware of the other entities involved in providing the services. For example, such a structure could be a mutual fund company that 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 administrative work. For example, the plan sponsor could be happy with the investment choices but change the recordkeeper. The unbundled providers are sometimes more able than bundled providers to provide customized services to plan sponsors.

The unbundled **wrap plan** model has been popular 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, contribution calculating, maintenance of census data and overall general plan consulting. The insurance company or mutual fund company provides the recordkeeping, automated response units, 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 more 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 services 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. For example, a small bank or mutual fund company with proprietary systems may not be able to keep up with the technology advancements or staffing needs and realize 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. However, the bank or mutual fund will use 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 and Employee education |
| Bank | Paying agent services (loans, distributions, payroll processing, lockbox) and/or trustee services |
| Retirement Plan Administration Firm | Recordkeeping, compliance and nondiscrimination testing |

**Example 4-2. Strategic Alliance**

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

**Example 4-3. Strategic Alliance**

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

**Example 4-4. Strategic Alliance**

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

### Example 4-5. Strategic Alliance

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

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

### [D] Marketing Models

There are certain advantages and disadvantages inherent in each of the marketing models depending on the perspective from which they are being viewed.

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, are 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.

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 ensure the alliance works because their systems and products (and relationships with the plan sponsors) 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 both the plan sponsor's and the provider's perspectives.

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 Department of Labor (DOL), Internal Revenue Service (IRS), Securities and Exchange Commission (SEC) or Financial Industry Regulatory Authority (FINRA) 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. 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.

Each plan sponsor must decide which type of provider(s) (bundled or unbundled) works best for their plan's needs. Many things must be taken into account when deciding which option works best for them. Below is a summary of some of the key advantages and disadvantages of each option.

| **Bundled Provider** | |
|---|---|
| Advantages | Disadvantages |
| • Single provider of plan services<br>• Potentially lower overall costs | • Limited customization of services<br>• Entire plan must be moved if certain services fail to meet plan sponsor's objectives |

| Unbundled Provider | |
|---|---|
| Advantages | Disadvantages |
| • Ability to engage individual service providers who will customize plan services according to the plan sponsor's needs<br>• Ability to replace specific service providers while leaving others intact | • Coordination of multiple service providers<br>• Potentially higher overall costs |

### §4.07 Daily Valuation Recordkeeping Software

In all marketing models, software must be developed to track the participant accounts. This recordkeeping software has been developed internally by the bundled providers, as well as by independent firms that specialize in providing only the recordkeeping software. The software can be licensed by the recordkeepers from the independent firms with maintenance agreements attached so that the independent firms continue to update the software for law changes and specialized needs. The independent software developer then becomes a member of the team (most often unknown to the plan sponsor) providing services to the plan sponsor. The recordkeepers then must maintain computer hardware systems to process the software.

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**. 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 Application Service Provider hosts and manages Web-based software applications. The recordkeeper performs various functions on this software through the Internet.

The Application Service Provider is responsible for:

- Development and upkeep 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, anywhere, and at any time of day;

- The recordkeeper no longer needs servers to run the daily valuation software, freeing up memory, routers, server hardware and IT staff; and
- The recordkeeper no longer needs to maintain automated response units, freeing up phone lines and servers.

The disadvantages would include:

- There is another layer of technical processes added to the recordkeeping work in order to access the software;
- There may be more limited access to and control of data; and
- Data transmission/communication lines issues become increasing more critical.

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, it can become costly with increased volume of plans, participants and transactional activity.

### §4.08 Key Terms

**Administrator:** An administrator typically handles eligibility, nondiscrimination testing, and preparation of government filings, and monitors overall plan compliance.

**Application Service Provider:** The Application Service Provider hosts and manages Web-based software applications, allowing the recordkeeper to perform various functions through the Internet.

**Balance-Forward Valuation:** A recordkeeping method where the participant's account balance as of the last valuation date is updated for the intervening activity (*e.g.*, withdrawals, contributions and investment earnings) as of each subsequent valuation date.

**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 transactional 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, nondiscrimination testing, maintains census data and monitors overall compliance but an insurance company or mutual fund provides recordkeeping and investment services.

### §4.09 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 business day.

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

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

- The administrator's job function is to perform compliance tasks, including nondiscrimination testing, preparation of governmental forms, response to client inquiries and management of the process associated with participant activity.

- Daily products are marketed 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.

## §4.10 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.

______ 3. Daily valuation caused organizations to partner in providing a complete daily package due to the cost of such services.

______ 4. Daily valuation is a valuation process used in the administration of defined benefit plans.

______ 5. Daily valuation responds to participant demands for immediate access to information through automated response units.

### [B] Multiple Choice

6. 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

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

   A. Least expensive method to use when an administrative firm is entering the daily valuation market.
   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.

8. All of the following statements regarding marketing models that are entered into to provide daily valuation services are **TRUE, EXCEPT**:

   A. In a strategic alliance, all parties work together for the mutual benefit of each other.
   B. The plan sponsor that chooses an unbundled model is aware of two or more of the entities providing services.
   C. The wrap model requires small retirement plan administration firms to invest significant resources in providing service.
   D. The unbundled providers are sometimes more able to provide customized services.
   E. The bundled strategic alliance model allows plan sponsors to obtain all services under one vendor.

9. All of the following are reasons a retirement plan administration firm decides to choose one marketing model over another, EXCEPT:

   A. Increased revenue and profitability
   B. Availability of employee education material
   C. Potential liability from IRS, DOL and SEC
   D. Preferences of the plan sponsor's employees
   E. Advancing technology

10. All of the following are functions of the daily valuation administrator, **EXCEPT**:

   A. Determines eligibility
   B. Responds to client calls
   C. Performs nondiscrimination testing
   D. Updates the daily pricing of investments
   E. Prepares Form 5500 series reporting

11. Which of the following statements regarding daily valuation is/are **TRUE**?

   I. Daily valuation allows for the valuation of investments every business day.
   II. Daily valuation is a valuation process substituted for balance-forward methodologies.
   III. Daily valuation is used in participant-directed defined contribution plans.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

12. Which of the following statements regarding daily valuation is/are **TRUE**?

    I. The daily recordkeeper prepares governmental forms.
    II. The daily recordkeeper deals with compliance processes.
    III. The daily recordkeeper deals with transactional processes.

    A. II only
    B. III only
    C. I and II only
    D. I and III only
    E. I, II and III

### §4.11 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. **True.** Daily valuation has caused many firms to partner due to the cost of providing such services. §4.06

4. **False**. Daily valuation is a valuation process used in the administration of participant-directed defined contribution plans not defined benefit plans. §4.03

5. **True**. Daily valuation responds to participant demands for immediate access to information through automated response units. §4.03[B]

6. 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.

7. The correct answer is **A.** §4.06

   A. Correct. This statement is false because an un-bundled wrap model is the least expensive approach for an administration firm to use when first entering the daily valuation market.
   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.

8. The correct answer is **C**. §4.06

   A. Incorrect. This statement is true because in a strategic alliance all parties do work together for the mutual benefit of each other.
   B. Incorrect. This statement is true because the plan sponsor who chooses an unbundled model is aware of two or more of the entities providing services.
   C. Correct. This statement is false because the wrap model does not require small retirement plan administration firms to invest significant resources in providing service.
   D. Incorrect. This statement is true because the unbundled providers are sometimes more able to provide customized services.
   E. Incorrect. This statement is true because the bundled strategic alliance model does allow plan sponsors to obtain all services under one vendor.

9. The correct answer is **D**. §4.06[D]

   A. Incorrect. True because increased revenue and profitability is a reason retirement plan administration firms use to determine the marketing model they will use.
   B. Incorrect. True because availability of employee education material is a reason retirement plan administration firms use to determine the marketing model they will use.
   C. Incorrect. True because potential liability form IRS, DOL and SEC is a reason retirement plan administration firms use to determine the marketing model they will use.
   D. Correct. False because preferences of the plan sponsor's employees are not a reason retirement plan administration firms use to determine the marketing model they will use.
   E. Incorrect. True because advancing technology is a reason retirement plan administration firms use to determine the marketing model they will use.

10. The correct answer is **D**. §4.04[A]

   A. Incorrect. True because a daily valuation administrator does determine eligibility.
   B. Incorrect. True because a daily valuation administrator does respond to client calls.
   C. Incorrect. True because a daily valuation administrator does perform nondiscrimination testing.
   D. Correct. False because a daily valuation administrator does not update investment prices daily. The recordkeeper does this.
   E. Incorrect. True because a daily valuation administrator does prepare Form 5500 series reporting.

11. The correct answer is **E**. §4.03

    A. Incorrect because statements II and III are also true.
    B. Incorrect because statements I and III are also true.
    C. Incorrect because statement II is also true.
    D. Incorrect because statement I is also true.
    E. Correct because all statements are true.

12. The correct answer is **B**. §4.04

    A. Incorrect because statement II is false.
    B. Correct because statement III is the only true statement.
    C. Incorrect because statements I and II are false.
    D. Incorrect because statement I is false.
    E. Incorrect because statements I and II are false.

# Chapter 5
## Differences between Balance-Forward and Daily Valuation



### §5.01 Learning Objectives

- Identify differences and similarities in balance-forward and daily valuation accounting, reconciliation and earnings allocation methods.
- Describe how earnings and dividends are credited to participant accounts in daily

recordkeeping.

- Differentiate between balance-forward and daily valuation methods when processing distributions and transfers.
- 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. This chapter addresses the differences in the administration between balance-forward plans and daily valuation plans. 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 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.

In daily valuation, processing becomes more efficient, thus reducing the time plan sponsors spend on administration of the plan. 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.

### §5.03 Accounting Methods

#### [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. 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. NAV is the price at which mutual funds shares are redeemed by investors. 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) |

The next day, the unrealized gain or (loss) is recomputed using the new NAV compared again to the cost of the shares at that the time they were purchased. This continues each day.

### [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 120 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 in which 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, suppose 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.

## §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. These include:

- 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 (*i.e.* 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 in proportion to 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 other 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.

1. Fluctuating Value Assets. Assets that fluctuate in value, such as mutual funds, generate both unrealized and realized income. The unrealized income (or loss) is that which is earned due to an increase (or decrease) in the value of the asset and is reflected in the change in share or unit price of the investment. This value is not actually received (or lost) until the investment is sold or realized. The asset also may pay dividends, interest and other income (*e.g.*, capital gain distributions) 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 identifies the number of shares on 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 dividend dollars. The allocation, however, is not posted to the daily system until the date the dividend is actually paid.

The details may be received in the form of a written communication, by mail, fax or an electronic file. Upon payment of the dividend, the recordkeeper posts the distribution on the daily system and allocates it *pro rata* based on shares held by the participants' accounts 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 the participant's 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 the original transfer was made.

2. Dollar Par Value Assets. 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.

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. The participant receives no interest allocation for the portion of the month during which the participant's 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 the participant's account remains invested in the fund. 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.

### [C] Differences between Methods

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, which consequently gives it a more accurate allocation of the earnings.

### [D] 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 unit (ARU). At the end of the accrual period, the income is released, or posted, permanently to the participant's account and is disclosed on the ARUs.

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.

### §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 the valuation date for the participant to receive the distribution if quarterly valuations are performed.

**Example 5-2. Balance-Forward Distribution.** Participant X terminates employment on December 15, 2011. The next quarterly accounting is performed as of December 31, 2011. The allocations are completed and reported to the plan sponsor on or about February 15, 2012. The Participant is paid out after February 15, 2012 based on the value of the Participant's vested account balance as of December 31, 2011.

Daily valuation plans perform valuations every business day; therefore, distributions can be processed at any time and often only take five to 10 days after the distribution request is received to complete. 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.** Participant Y terminates employment on December 15, 2011, and the recordkeeper receives instructions on January 5, 2012 to make the benefit payment. On January 6, 2012, shares are sold to cover the distribution to the participant.

The value of the participant's vested benefit is the value on January 6, 2012. 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 contribution has been received and processed for the participant's final payroll period 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 contribution data is submitted to the recordkeeper to be processed. For example, a plan that submits contribution data on a monthly basis may have a longer delay in processing distributions due to a termination of employment than a plan that submits contribution data each week. It is more efficient to include the amount of any deferral and loan repayment the participant made from the 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, 2012. The transfer is effective July 1, 2012; however, the administrator does not complete the June 30, 2012, valuation until July 28, 2012. 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

In a daily valuation environment, participants may request an initial transfer as often as each business day. To initiate the transfer, a participant may complete a transfer request form, but it is more typically requested through an ARU. The transactions to initiate the transfer are launched no later than the next business day. Transfers are typically executed on a same-day basis, where both the sell and buy side of the transfer are executed the same night and confirmed the next day.

The retirement plan administration firm 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, such as 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. Generally, these types of trading restrictions are imposed by SEC rules or by the fund itself. In any event, the transfers can occur more frequently and quickly than in a balance-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, commonly 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 10 and 30 business days later. If a balance-forward plan allows for participant directed investments, the participants must be provided with statements no later than 45 days after the close of each calendar quarter.

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 10 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. If participants are permitted to direct the investment of their account, the report shows the value of each investment in which the participant elected to invest. 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 ARU.

### §5.09 Paying More Attention

Participants are 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 the participant's accounts each day by multiplying the price of the fund by the number of shares held. Some retirement plan administration firms are offering participants downloads of their account balance information into personal financial software applications such as Quicken, MS Money, etc.

Make no mistake: participants are paying more attention to their retirement plan accounts, particularly given the changes in the economic climate in the past few years. 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.

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 participant can look up a mutual fund's price (NAV) in the newspaper if the participant 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. There is a column labeled offer price, which is what it costs to buy new shares of the fund. There also 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 among, including:

- Mutual funds;
- GICs;
- Money market accounts;
- Real estate;
- Variable annuities;
- Exchange-traded funds;
- Stocks;
- Bonds;
- Certificates of Deposits;
- 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 at the latest.

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, also known as interactive voice response;
- Transferring to a live operator through the interactive voice response;
- Connecting to a Web site or Web response unit 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** (ARUs). They are designed to provide information to participants 24 hours a day seven days a week and to 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 ARUs that participants initiate transactions. To ensure privacy, participants use a personal identification number 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 to enable them to:

- Check the current value and make-up of their current account balance;
- Check loan availability;
- Determine the status of an outstanding loan;
- Check amounts available for hardship withdrawal;
- Check their vested percentages;

- Project account balance amounts to retirement age;
- Check the number of shares held in each investment fund;
- Verify the value of each investment;
- Initiate transfers of existing assets;
- Make changes to deferral elections;
- Make changes in investment elections for future contributions;
- Modify their PIN;
- Initiate loans or do loan modeling;
- Request distributions; or
- Enroll themselves in the plan.

Some retirement plan administration firms have eliminated manual entry entirely by requiring that all participant transfers and exchanges be made via the ARUs; 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 and plan sponsors to relinquish control of certain administrative procedures of the plan.

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

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

### §5.13 Key Terms

**Accruing:** Describes 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. With regard to contributions, it describes posting employee contributions withheld and employer contributions allocated during the accrual period, but not yet deposited.

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

**Automated Response Units (ARUs):** They are designed to provide information to participants 24 hours a day seven days a week and to allow them to initiate certain transactions. This can be done through dialing a voice response unit, connecting to a Web site or Web response unit via the Internet or interacting with a kiosk.

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

**Net Asset Value (NAV):** The price at which mutual funds shares are redeemed by investors.

**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 the balance-forward method.

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

- 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 in a daily plan can occur more frequently and quickly than in a balance-forward plan.

______ 3. The method for allocating investment gains or losses to a participant-directed individual account is stated in the plan document.

______ 4. In a daily valuation plan 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, subject to the vesting schedule.

______ 5. Balance-forward plans track investment information on a share basis where daily valuation plans track investments on a dollar basis.

### [B] Multiple Choice

6. 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

7. 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.

8. 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.

9. 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.

10. Which of the following statements regarding how dividends are credited to participants in daily recordkeeping is/are **TRUE**?

    I. Mutual fund dividends are allocated to participants who own a share on the record date.
    II. Dividends are automatically reinvested in the investment that generated the income.
    III. Participants who have transferred out of a fund never receive an allocation of the dividend if they were a shareholder on the record date.

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

11. Which of the following statements regarding differences between balance forward and daily administration is/are **TRUE**?

    I. Daily valuation reconciles uninvested cash daily.
    II. Daily valuation reconciles the asset shares reflected on the daily software to the shares held by the trustee daily.
    III. Balance-forward reconciles assets on their periodic valuation dates.

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

12. All of the following are difference between balance forward and daily administration, EXCEPT:

    A. Daily valuation computes the unrealized gain or loss by multiplying the number of shares held by the price per share at the valuation date compared to the cost of shares at the time they were purchased.
    B. Daily valuation computes the unrealized gain or loss separately for each block of shares purchased.
    C. Balance-forward computes the unrealized gain or loss after the investment statements are received showing the transaction activity for the accounting period.
    D. Balance-forward processing is more efficient and time sensitive than daily.
    E. Balance-forward computes the unrealized gain or loss based on dollar accounting.

## §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 in a daily plan can occur more frequently and quickly than in a balance-forward plan. §5.07[B]

3. **True.** The method for allocating investment gains or losses to a participant-directed individual account is stated in the plan document. §5.05[A]

4. **True**. In a balance-forward plan when a distribution is made the participant receives the value of the account as of the last valuation date. In a daily valuation plan shares can be sold daily to make a distribution and 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. §5.06

5. **False**. 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. 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. §5.03 [A] & [B]

6. The correct answer is **D.** §5.10 [B]

   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.

7. 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.

8. 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.

9. 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.

10. The correct answer is **C.** §5.05

    Statements I and II are true.

    Statement III is false, because a participant who has transferred out of a mutual fund is entitled to receive the participant's 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 the original transfer was made.

    A. Incorrect because statement II is also true.
    B. Incorrect because statement III is false.
    C. Correct because statements I and II are the only true choices.
    D. Incorrect because statement III is false.
    E. Incorrect because statement III is false.

11. The correct answer is **E**. §5.04

    A. Incorrect because statements II and III are also true.
    B. Incorrect because statements I and II are also true.
    C. Incorrect because statement III is also true.
    D. Incorrect because statement I is also true.
    E. Correct because statements I, II and III are true.

12. The correct answer is **D.** §5.03

    A. Incorrect. This statement is true because daily valuation does compute the unrealized gain or loss by multiplying the number of shares held by the price per share at the valuation date compared to the cost of shares at the time they were purchased.
    B. Incorrect. This statement is true because daily valuation does compute the unrealized gain or loss separately for each block of shares purchased.
    C. Incorrect. This statement is true because balance-forward does compute the unrealized gain or loss after the investment statements are received showing the transaction activity for the accounting period.
    D. Correct. This statement is false because daily valuation processing is more efficient and time sensitive than balance-forward.
    E. Incorrect. This statement is true because balance-forward does compute the unrealized gain or loss based on dollar accounting.

### §5.17 Supplemental Education

**Webcourses:** ASPPA offers webcourses on the RPF-1 and RPF-2 materials. These webcourses provide introductory training for new employees and help prepare RPF-1 and RPF-2 exam candidates for the most challenging topics covered on the respective examinations. Webcourses offer many benefits to individual and companies alike:

- Self-paced: Review information at your own pace.
- Flexibility: View the courses from any location with an Internet connection.
- Continuing education: Earn continuing education credit for ASPPA credentials.

There are seven webcourses for RPF-1 and seven webcourses for RPF-2. Each set can be purchased on the ASPPA Web site. Each webcourse is divided into two modules. To register for the webcourses visit www.asppa.org/webcourse.

Webcourses relevant to this chapter:

- Differences Between Balance-Forward and Daily Valuations

# Chapter 6
## Fiduciary Considerations



### §6.01 Learning Objectives

- Determine which parties are fiduciaries.
- Identify which plans are subject to the new ERISA §404(a) participant disclosure regulations.
- Identify required disclosures under ERISA §404(a) that must be given to participants who direct their investments.
- Explain opportunity to exercise control and provide a broad range of investments under ERISA §404(c).
- Explain what an employer must do to maintain ERISA §404(c) protection if using a default investment.
- Explain what the fiduciary must do to maintain ERISA §404(c) protection if utilizing mapping.

- Identify ministerial duties that do not give rise to fiduciary status.
- Explain when elective deferrals, loan payments and matching contributions must be deposited into the trust.

### §6.02 Introduction

One of the liabilities a fiduciary has is 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 are to be invested, specific disclosure is required to the participant and beneficiaries under ERISA §404(a) and 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.

Here we look at the rules in effect under ERISA §§404(a) and (c) and how plan sponsors can comply with guidance published by the Department of Labor (DOL).

### §6.03 Who Is a Fiduciary

The identification of the fiduciary is very important.

Under ERISA §3(21), a person becomes a **fiduciary** with regard to a plan if the person:

- Gives investment advice with respect to any money or other property of a plan in exchange for a fee or other compensation; or
- Has or exercises any discretionary authority or responsibility to manage the plan or its assets; or
- Has any discretionary authority or responsibility with regard to the administration of the plan.

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

Generally, the following individuals or entities will be fiduciaries:

- 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 or other form of payment.

Our focus is on how the fiduciary rules affect the selection of plan investments, disclosure to the participant, as well as activities by retirement plan administration firms that might create fiduciary liability for such 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.

A fiduciary may minimize the 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. The 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 the participant exercises control over the assets in the participant's account. 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 the opportunity to exercise control over the investment of their assets 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 may permit participants to invest in almost anything of their choice. When participants are permitted to direct investments there are certain disclosures that the fiduciary must comply with. Transferring the investment responsibility to the employee 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 primarily responsible for choosing and monitoring the investment options made available to participants. 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 most outstanding fund in every investment category or constantly switch funds looking for the best performer. However, it does mean the fiduciary must periodically (at least annually, and possibly more often) 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 (IPS) and formal minutes of fiduciary meetings should be maintained, together with copies of all of the materials reviewed for the meeting. This process serves to document the fact that the fiduciaries acted prudently in decision-making, that is, that they upheld their fiduciary standards.

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 investment class; for example, offer 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.
- Monitor administrative costs that are absorbed by the accounts of participants to make sure they are reasonable.
- 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.

## §6.05 Fiduciary Disclosure to Participants

When a fiduciary decides to allow participants to direct all or a portion of the investments in their accounts, the participants are given certain rights and responsibilities. In addition, the fiduciary must provide to the participant sufficient information regarding the plan and designated investment alternatives in order to allow the participant to make informed decisions regarding the management of their individual accounts. This information includes fees and expenses that affect the plan and the investments. The DOL issued these regulations in 2010 to be effective for the first plan year beginning on or after November 1, 2011; or if later 60 days after the effective date of the fiduciary–level fee disclosure regulations discussed in Chapter 9, Section 9.14 .

### [A] Plan Related Disclosures

The following plan related disclosures must be provided to the participant on or before the date the participant can first direct the investments and at least annually thereafter:

- An explanation of the circumstances under which a participant may give investment instructions;

- An explanation of any specified limitations including any restriction on transfer to or from a designated investment alternative;
- A description or reference to plan provisions relating to the exercise of voting, tender and similar rights or restrictions on such rights related to the designated investment alternatives;
- Identification of the investment alternatives offered;
- Identification of any designated investment managers;
- A description of any self-directed brokerage accounts (described further in Chapter 7) or similar plan arrangements that allow the participant to select investments beyond those designated by the plan;
- An explanation of the fees and expenses for general plan administrative services (e.g., legal, accounting, recordkeeping) that may be charged against all participants' account balance and how they will be allocated to all the participants' account balance; and
- An explanation of the fees and expenses that may be charged to the individual account of a participant on an individual basis (e.g., fees for loans, investment advice, RMDs, QDROs, transfers, front or back-end loads).

Quarterly the participant must receive additional plan disclosures. These include:

- The dollar amount of the fees and expenses describe above that were actually charged during the preceding quarter to the participants account;
- A description of the services to which the charges relate (e.g., plan administration, including recordkeeping, legal accounting services or individual participant charges such as loan processing fee); and
- If applicable, an explanation of any fees paid from the total annual operating expense of the designated investment alternatives (e.g., revenue sharing arrangement, 12b-1 fees, sub-transfer agent fees, all described in Chapter 9).

### [B] Investment Related Disclosures

The participants must also be given information about the investments offered on or before the date the participant can first direct the investments and at least annually thereafter:

- Identifying information. The name of each designated investment alternative and the type or category of the investment (e.g., money market fund, balanced fund, large cap fund).
- Performance information. The average annual total return of the investment for 1-, 5- and 10-calendar year periods ending on the date of the most recently completed calendar year.
- Benchmarks. The name and returns of an appropriate broad-based securities market index over the 1-, 5- and 10-calendar year period comparable to the performance data of the designated investment alternatives.
- Fee and expense information. The amount and a description of each shareholder–type fee and operating expenses as a percentage and as a dollar amount for each designated investment alternative.

- Internet Website address. A Web address that provides specific information about the designated investment alternative.
- Glossary of Terms. A Web address that is sufficiently specific to provide access to a general glossary of terms to assist in understanding the designated investment alternatives.

Upon request of the participant, the following information must be provided to the participant:

- Copies of the prospectuses;
- Copies of any financial statements or reports on the plan's designated investment alternatives;
- A statement of the value of a share of each designated investment alternative and the date of the valuation; and
- A list of the assets comprising the portfolio of each designated investment alternative and the value of each such asset.

The above disclosures are required any time a plan offers the participants the opportunity to self-direct the investment of their account balance. An employer may take this one-step further by deciding to comply with ERISA §404(c), which forces certain additional steps to be taken.

### §6.06 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 the participant chooses. Mutual funds, common/collective trust funds and employer stock are popular choices.

To effectively shift investment responsibility under ERISA §404(c) to the participants, the fiduciary must meet two broad requirements. The participants must have:

1. The opportunity to exercise adequate control over the assets in the participants' accounts; and
2. A broad range of investment alternatives from which to choose.

### [A] Opportunity to Exercise Control

The plan must present the participant with the opportunity to exercise control over the assets in the participant's account.

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

1. <u>Plan Design</u>

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. If instructions are provided by electronic means, the participants must 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.*, interactive voice response) 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 Web site 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) relieves plan fiduciaries of liability. The summary plan description 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 IPS provided to the participants or a separate notice.
- The disclosure information described above in Section 6.05 (A) and (B).
- If the plan offers employer securities, a description of the procedures established to provide for the confidentiality of information relating to the purchase, holding and sale of employer securities and the exercise of voting, tender or similar rights incidental to ownership after the participant has invested in that security and the name address and phone number of the plan fiduciary responsible for administering compliance with the procedures.

### [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 the participant's account 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 percent in a year. Those who lose sleep after a 10 percent 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 fiduciary selecting 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 ensure that, if a participant is to be responsible for the investment of the participant's account, the participant is physically able to form an investment strategy and carry it out.

### [C] Investment Education and Investment Advice

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 as well as investment education provided on Web sites.

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. 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?

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.

There are several key elements related to the provision of investment education to participants. The first element is that the presenter must be objective, even if the presenter may prefer one investment over another. For example, if the presenter is from the insurance industry then the presenter may want to encourage the participants to invest into insurance products. However, these products may not be best for the participants, especially if they are younger in age.

A second key element is to provide participants examples of investment allocations. The examples should be geared toward participants of different age groups that are representative of the audience. Not only should the examples discuss the allocation of investments among the various options, but also how a younger participant may consider riskier options than a participant closer to retirement. Studies have shown that one of the key elements to successful investing in pension plans is not the individual investment selection but the allocation of the investments.

Lastly, it is helpful to discuss the future expectations of investments, such as the best and worst case analysis of how certain investments can react to different market cycles. This is particularly helpful to participants who are investing for the first time. A participant can probably obtain a better return in the long run if the participant understands the ups and downs of the short term.

The Pension Protection Act of 2006 (PPA 2006) provided that investment advisors who provide advice to participants for a fee will avoid having the transaction become a prohibited transaction if they use an eligible investment advice arrangement. Under these arrangements the advisor must either:

- Provide that fees received by the advisor do not vary based on investment options selected or transactions completed; or
- Generate investment allocations via computer model.

The eligible investment advice arrangement, whether it is advice from an investment advisor or through computer models, must:

- Base the advice on generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
- Take into account investment management and other fees and expenses that apply to the recommended investments; and
- Take into account the participant's age, time horizons (life expectancy, retirement age), risk tolerance, current investments, other assets or sources of income and investment perspective.

## §6.07 Default Funds and Mapping

The protection offered under ERISA §404(c) is available only for investments made as a result of a participant's affirmative election. However, relief is provided to fiduciaries that invest participant assets in certain types of default investment alternatives in the absence of participant investment direction and when mapping participant accounts from one investment fund to another.

### [A] Default Investment Alternatives

Sometimes when participant-directed investments are available, a participant fails to make an election with regard to the investment of the participant's account balance. This might occur because of an absence from work, the inability of the plan sponsor to locate a terminated participant, or simply inaction by the participant. Rather than leave the participant's account uninvested, which would be a breach of the trustee's fiduciary duties, the trustee or other fiduciary instructs the recordkeeper to deposit those monies into a default investment alternative.

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

In order for the normal fiduciary who chooses the default investment alternative to obtain fiduciary relief similar to that of ERISA §404(c), the assets must be invested in a **qualified default investment alternative** (QDIA). A QDIA is an investment that has a mix of equity and fixed income assets, is diversified to minimize the risk of large losses and is designed to provide varying degrees of long-term appreciation and capital preservation. DOL regulations outline that a QDIA must be one of the following:

- A lifecycle or targeted retirement date fund based on the participant's age, target retirement date or life expectancy whose risk level, over time, becomes more conservative as the age of the participant increases;
- A balanced fund with a target level of risk appropriate for participants of the plan as a whole; or
- An investment management service where an investment manager allocates the assets of a participant's individual account using investment alternatives available under the plan, based on the participant's age, target retirement date or life expectancy, and whose risk level, over time, becomes more conservative as the age of the participant increases.

These funds are described further in Chapter 7 of this course.

In addition, for the fiduciary to obtain relief, the plan must comply with the following conditions:

- The participant must have had the opportunity to direct the investment of the assets in the participant account but did not do so;
- The participant must be given a notice about the QDIA either:
    - at least 30 days in advance of the first investment opportunity; or
    - on or before the date of plan eligibility; and

  then annually thereafter, with at least 30 days advance notice prior to the beginning of the new plan year;
- Investment information, such as prospectuses, proxy voting material, etc. about the QDIA must be given to the participant;
- At least quarterly, the participant must be given the opportunity to transfer, in whole or in part, the assets to any other investment alternative available under the plan without

financial penalty; and

- The plan must offer a broad range of investment alternatives.

The notice given to the participants must describe:

- The circumstances under which the assets may be invested in QDIAs;
- The QDIA, and what are the risk, return and fees associated with the investment;
- The rights of the participant to direct the investment to other investment alternatives under the plan without financial penalty; and
- An explanation of where additional investment information concerning the other investment alternatives can be found.

### [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 Growth Fund, and that Fund was under performing in its asset class. As a result, the fiduciary decides to replace that option with the DEF Growth 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), because the treatment of the assets after the fund is eliminated is being affirmatively directed by each participant; or

2. Alternatively, the plan sponsor can liquidate the existing fund and transfer the proceeds to the new fund that is replacing the eliminated fund. This is called "mapping," and is used almost exclusively when the new fund is substantially similar to the old fund – for example, the new fund might be a new large capital equity fund that is replacing the old large capital equity fund. The presumption is that, if the participant elected to invest that part of their money in that type of fund, they would want it to stay similarly invested when the old fund is eliminated. However, because the participant has not affirmatively participated in the decision to move the fund to its replacement, certain conditions must be met to preserve the protection of the fiduciary that chose the mapped fund under ERISA §404(c).

In order to maintain fiduciary relief under the mapping alternative in 2 above, all of the following conditions must be met:

- The ERISA requirements of authorizing and implementing a blackout period must be met. These are described in Chapter 13;
- No more than 60 days (but at least 30 days) before the effective date of the qualified change in investment option, a notice is provided to the participants;
- The participant has not provided in advance of the effective date of the change an

election different than that proposed by the mapping; and
- The participant's investments prior to the effective date of the change were invested based on the participant's exercise of control over the assets.

The notice must compare the existing and new investment options. In addition, the notice must state that, unless the participant provides other investment instructions, the account will be mapped as described.

The change in investment options must provide that the participant account is mapped to one or more remaining or new investment options and that the stated characteristics of the remaining or new investment options after the change are reasonably similar to the characteristics (risk and rate of return) of the investment option existing immediately before the change.

## §6.08 Retirement Plan Administration Firms as Fiduciaries

A retirement plan administration firm performing daily valuation administration may find itself 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 and withdrawals or arranging other transactions involving the transfer of plan money. 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 the processing of wire-transfers between plan accounts could trigger fiduciary status for the retirement plan administration firm if the firm is considered to exercise control in 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 such handling relates to the collection and application of contributions. Status as a fiduciary hinges on whether the retirement plan administration firm is exercising discretion or simply 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 on its own authority.

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 to be considered as overseeing the retirement plan administration firm work.

It is important for the administration firm, in conjunction with the plan sponsor, 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.

## §6.09 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 from each paycheck. It is essential that these contributions be transferred to the employer's plan in a timely manner and not remain part of the employer's general assets. This includes pre-tax elective deferrals, designated Roth contributions, loan payments and after-tax employee contributions.

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 will generally determine that monthly transmittal of plan assets (when payroll periods are more frequent) 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 contributions 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. However, for plans with fewer than 100 participants at the beginning of the plan year there is a safe harbor. This safe harbor states that elective deferrals (pre-tax and designated Roth contributions), after-tax employee contributions and loan repayments must be deposited to the trust within seven (7) business days. The seven-day period would start on the day following the date on which the participant contributions would otherwise have been paid to the participants.

For employers that cannot meet these time frames, 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.

Failure to transmit participant contributions in a timely fashion is generally considered to be a prohibited transaction. This is because, by delaying the transmission of contributions to the trust, the participants' contributions are in the general assets of the employer. This could then be considered a loan from the plan to the employer, because the employer could be using the assets for business purposes. A loan from the plan to the employer is a prohibited transaction.

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 nondeferral dollars contributed by the employer are not considered to be plan assets until actually deposited to the plan. Therefore, the timing of deposits of such contributions is not subject to the same rule as described above for elective deferrals.

### §6.10 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 the participant's 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, which do not give rise to fiduciary status.

**Qualified Default Investment Alternative (QDIA):** A QDIA is an investment that has a mix of equity and fixed income assets, is diversified to minimize the risk of large losses, and is designed to provide varying degrees of long-term appreciation and capital preservation.

**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.

### §6.11 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 the desire to increase plan participation by offering participants a larger number of investment alternatives against concerns about overwhelming the participants with too many choices and the need to minimize investment fees and administrative costs absorbed by participant accounts.

- Under the ERISA §404(c) regulations, participants must have the opportunity to exercise control over the investment of their accounts, 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 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 use of interactive investment material. Investment advice is specific information about a fund and recommendations of a fund.

- 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. Small plans have a 7-day safe harbor.

## §6.12 Review Questions

### [A] True or False

_______1. Generally, retirement plan administration firms that calculate participant benefits are not acting as fiduciaries.

_______2. A plan that allows participant investment direction must provide the disclosures under ERISA §404(a).

_______3. A plan that permits participants to invest in any asset of their choice automatically satisfies the broad range of investment requirement under ERISA §404(c).

_______4. A money market fund, bond fund and equity fund are three funds that satisfy the diversification standards under ERISA §404(c).

_______5. Making the decision to remove a poorly performing fund is a ministerial function that does not give rise to fiduciary status.

### [B] Multiple Choice

6. All of the following are required disclosures automatically given to participants under ERISA §404(a), **EXCEPT**:

   A. Identification of the investment alternatives offered
   B. Investment prospectus
   C. Identification of investment fees and expenses
   D. Investment performance information
   E. Identification of any designated investment managers

7. 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 15th 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. To take advantage of an extension of time to deposit deferrals, the plan sponsor must notify participants of the delay in depositing elective deferrals.

8. All of the following statements regarding participants' opportunity to exercise control over their assets in order to maintain ERISA §404(c) protection 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. Participants must be advised as to who is the fiduciary to which their investment instructions must be given.
   D. Participants must be advised as to who is responsible for complying with participant investment instructions.
   E. The DOL is concerned that participants have the opportunity to receive written confirmation of the instructions they have given.

9. All of the following are considered fiduciaries, **EXCEPT**:

   A. The human resources director
   B. The plan administrator named in the plan document
   C. The person who provides investment advice for a fee
   D. The trustee
   E. The investment advisor appointed to manage plan assets

10. All of the following conditions must be met in order to maintain ERISA §404(c) protection when using mapping, **EXCEPT**:

    A. The participants must have directed the investment of their assets prior to the effective date of the investment change.
    B. The participants must not have provided an election different than that proposed by the mapping prior to the effective date of the investment change.
    C. All of the investment choices must be liquidated and replaced at the same time.
    D. A notice is provided to the participants at least 30 but no more than 60 days before the effective date of the investment change.
    E. The ERISA requirements of authorizing and implementing a blackout period must be met.

11. Which of the following statements regarding the QDIA is/are **TRUE**?

    I. The QDIA can be similar to a lifecycle fund or a balanced fund.
    II. Fiduciary liability can be minimized if a QDIA is used that complies with the DOL recommendations.
    III. A participant notice must be given at least 30 days in advance of the first investment opportunity and annually thereafter.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II, and III

12. All of the following must be deposited to the trust within 7 businesses days for an employer who sponsors a 401(k) plan that has 55 participants, **EXCEPT**:

    A. Designated Roth contributions
    B. Matching contributions
    C. After-tax employee contributions
    D. Participant loan repayments
    E. Elective deferrals

## §6.13 Answers

1. **True.** Generally, retirement plan administration firms who calculate participant benefits are not acting as fiduciaries. §6.08 [A]

2. **True.** A plan that allows participant investment direction must provide the disclosures under ERISA §404(a). The DOL issued these regulation in 2010 to be effective for the first plan year beginning on or after November 1, 2011. §6.05

3. **True.** In order to minimize liability, fiduciaries that permit participants to invest in any asset of their choice automatically satisfies the broad range of investment requirement under ERISA §404(c). §6.06[B]

4. **True.** A money market fund, bond fund and equity fund are three funds that satisfy the diversification standards under ERISA §404(c). §6.06 [B]

5. **False.** Making the decision to remove a poorly performing fund is a fiduciary function not one considered ministerial. §6.08[A]

6. The correct answer is **B.** §6.05

   A. Incorrect. This is true because the identification of the investment alternatives offered must be provided to participants in a participant-directed plan.
   B. Correct. This statement is false because the investment prospectus does not have to be given unless the participant requests it.
   C. Incorrect. This statement is true because information regarding investment fees and expenses must be provided to participants in a participant-directed plan.
   D. Incorrect. This statement is true because investment performance information must be provided to participants in a participant-directed plan.
   E. Incorrect. This statement is true because the identification of any designated investment managers must be provided to participants in a participant-directed plan.

7. The correct answer is **A**. §6.09

   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 if an extension is to be requested.

8. The correct answer is **B.** §6.06 [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.

9. The correct answer is **A.** §6.03

   A. Correct. This is false because a human resource director is not providing investment advice and has no discretionary authority over the plan or its assets.
   B. Incorrect. This is true because the plan administrator named in the plan document is a fiduciary.
   C. Incorrect. This is true because the person who provides investment advice for a fee is a fiduciary.
   D. Incorrect. This is true because the trustee is a fiduciary.
   E. Incorrect. This is true because the investment advisor appointed to manage plan assets is a fiduciary.

10. The correct answer is **C.** §6.07[B]

    A. Incorrect. This statement is true because participants must have directed the investment of their assets prior to the effective date of the investment change.
    B. Incorrect. This statement is true because participants must not have provided an election different than that proposed by the mapping prior to the effective date of the investment change.
    C. Correct. This statement is false because all of the investment choices do not have to be liquidated and replaced at the same time.
    D. Incorrect. This statement is true because a notice is provided to the participants at least 30 but no more than 60 days before the effective date of the investment change.
    E. Incorrect. This statement is true because the ERISA requirements of authorizing and implementing a blackout period must be met.

11. The correct answer is **E**. §6.07[A]

    A. Incorrect because statements II and III are also true.
    B. Incorrect because statements I and III are also true.
    C. Incorrect because statement II is also true.
    D. Incorrect because statement I is also true.
    E. Correct because all three statements are true.

12. The correct answer is **B**. §6.07[B]

    A. Incorrect. This is true because designated Roth contributions are employee contributions and must be deposited within 7 business days for small plans.
    B. Correct. This is false because matching contributions are employer contributions and do not need to be deposited at the same time employee contributions do.
    C. Incorrect. This is true because after-tax employee contributions must be deposited within 7 business days for small plans.
    D. Incorrect. This is true because participant loan repayments must be deposited within 7 business days for small plans.
    E. Incorrect. This is true because elective deferrals must be deposited within 7 business days for small plans.

## §6.14 Supplemental Education

**Webcourses:** ASPPA offers webcourses on the RPF-1 and RPF-2 materials. These webcourses provide introductory training for new employees and help prepare RPF-1 and RPF-2 exam candidates for the most challenging topics covered on the respective examinations. Webcourses offer many benefits to individual and companies alike:

- Self-paced: Review information at your own pace.
- Flexibility: View the courses from any location with an Internet connection.
- Continuing education: Earn continuing education credit for ASPPA credentials.

There are seven webcourses for RPF-1 and seven webcourses for RPF-2. Each set can be purchased on the ASPPA Web site. Each webcourse is divided into two modules. To register for the webcourses visit www.asppa.org/webcourse.

Webcourses relevant to this chapter:

- Fiduciary Considerations

**Publications:** Below is a listing of additional publications specific to topics found in this chapter. These resources are not required reading nor do they provide additional information to be tested. They are listed for those who may want more detail on a topic. The listing includes only those publications that are free and may be found on the Web.

1. Articles relevant to this chapter can be found at the ASPPA Web site:

    "Emerging Trends for PPA Fiduciary Advisors" by Jason C. Roberts in *The ASPPA Journal*, Winter 2008, Vol. 38. No 1.

    "Education with IMPACT - The Edu-tainment Experience™" by Charles D. Epstein and Sue Ellen Lovejoy in *The ASPPA Journal*, Winter 2008, Vol. 38. No 1.

    "Chart a Path to Target Date Fund Selection with a Fiduciary Process" by Glenn A. Dial in *The ASPPA Journal*, Winter 2010, Vol. 40. No 1.

    "DOL Finalizes Participant Disclosure Regulation for Participant-directed Individual Account Plans" by Stephen M. Saxon in The ASPPA Journal, Spring 2011, Vol. 41. No 2.
    www.asppa.org/errata

2. Articles relevant to this chapter can be found at the DOL Web site:

    "Meeting Your Fiduciary Responsibilities"
    http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html

# Chapter 7
## Daily Valuation Investment Basics

[A] True or False
[B] Multiple Choice
§7.12 Answers
§7.13 Supplemental Education

### §7.01 Learning Objectives

- Explain the three basic asset classes in which mutual funds invest.
- Differentiate among the different types of mutual funds.
- Explain the characteristics of GICs.
- Differentiate between a traditional mutual fund and an ETF.

### §7.02 Introduction

While there are many investment vehicles available to retirement plans, as mentioned in Chapter 5, Section 5.10, some are more appropriate to balance-forward plans than to daily valuation. Balance-forward plans offer a wide variety of assets among which participants may choose, including:

- Individual stocks and bonds;
- Mutual funds;
- Guaranteed investment contracts (GICs);
- Money market accounts;
- Real estate;
- Variable annuities;
- Exchange-traded funds (ETFs);
- Managed/pooled accounts;
- Limited partnerships; and
- Employer stock.

Sometimes the investment choices may be valued daily; 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.

It is important to mention again that, 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 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. These stipulations also 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. Some daily valuation plans even offer life insurance, hedge funds and unit investment trusts.

This chapter describes many investment vehicles that are most often seen in daily valuation plans.

### §7.03 Mutual Funds

A mutual fund company is an investment company that pools the funds of many investors to purchase a portfolio of individual securities. The individual **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.

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.

### §7.04 Asset Classes

Each mutual fund invests in one or more of the three primary asset classes as defined in its prospectus:

1. Stocks;
2. Bonds; and/or
3. Cash investments.

#### [A] Stocks

A **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 after 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 maturing in less than five years;
- Intermediate bonds with maturities ranging from five to ten years; or
- Long-term bonds generally maturing 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 investment, 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.” Following this rule, plan sponsors usually offer different types of investments to allow each participant to create a diversified portfolio. A participant who can choose among stock, bonds and/or cash investments can achieve diversification by spreading the assets among the different types of investments offered. However, this may be difficult, particularly for a small account, as the individual stocks or bonds may be costly. A mutual fund is a portfolio of investments purchased with funds provided by many people or plans, with the investment philosophy outlined and followed by the person or entity that manages the portfolio. For example, a large cap mutual fund would invest primarily in the stock of companies that are considered to be large-cap because of their size. Similarly, a balanced fund is one that invests in both stocks and bonds and is designed to offer a somewhat balanced risk portfolio. Because a mutual fund, by virtue of its structure, invests in many individual stocks or bonds, it offers investors internal diversification that they may not be able to achieve on their own.

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 company runs such a fund, it is called a mutual fund. Is the type of fund, bank managed, insurance company managed, or investment company managed important? Probably not; what is important is 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 (*e.g.*, a stock or bond index). The passively managed account then only invests in the stocks or bonds that are part of that index fund. For example, an S&P Index Fund is designed to mirror the investments of the Standard & Poor 500 Index. Therefore, the fund manager need only follow the lead of Standard & Poor.

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 or 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, the S&P 500 Index Fund buys the same 500 stocks that make up the index. Other index funds track with the Russell 2000 Fund, 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 type of industry, such as energy, technology or health care.

### [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 values 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 companies that they believe are undervalued and that they expect 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 (*i.e.*, they will tend to 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

Lifestyle funds (also known as asset allocation funds, strategic allocation funds or lifecycle funds) are normally 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, because 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, the participant's risk tolerance is probably lower inasmuch as the participant may want to be more secure in the absolute value of the 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. Because the lifestyle fund represents a fully diversified portfolio, they are designed so that participants invest 100 percent 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 is the age-based fund, also known as target date fund, targeted retirement date fund or target maturity fund. These funds also are designed so that participants invest 100 percent of their contribution into one fund. Each fund offered matches a projected retirement date. The funds are diversified and structured for the investments to rebalance into a more conservative portfolio 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. Some of these funds gear the invest mix to liquidate as the retirement year approaches. Others take the position that the investment mix liquidates as life expectancy is reached. The difference in the two positions could have a dramatic affect on the risk and return of the fund as a participant approaches retirement and desires to liquidate the asset.

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 well as less potential for significant losses) 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.

## §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 the 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 and Capital Gains

Mutual funds may have income in the form of dividends and capital gains. 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 into more mutual fund shares rather than being paid to the plan in cash.

### [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 also offer 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 or open architecture. Such delivery systems 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 company. These separate accounts are the vehicles holding the various mutual funds. Each mutual fund owned by the insurance company usually resides in its own separate account. Those separate accounts are offered to all of the customers of the insurance company. 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 company are regulated by individual state insurance boards and are exempt from regulations by the SEC 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.

Many plans 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 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 (Stable Value Funds)

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. One negative to the pooled GIC is that they are often subject to a 12-month put option, which may limit a plan sponsor's ability to liquidate the asset and move it to a different provider.

### [B] Equity Wash Restrictions

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 (*e.g.*, insurance) contracts. Money market funds, certain fixed-income funds and some balanced funds are examples of so-called competing funds. An equity wash restriction applies most often when a plan offers more than one stable value fund, including pooled contracts such as GICs, or a plan has a self-directed brokerage account option.

When an equity wash restriction is in place, participants must first transfer plan assets to a noncompeting 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 unit. 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 Other Investments

### [A] Brokerage Accounts

Another investment option in the participant-directed market is to allow participants to set up self-directed brokerage accounts (SDBAs). 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 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 unit is not up-to-date and thus inaccurate. As a result, recordkeepers may not use automated response units to handle transfers to or from the SDBA; rather, they may be required to use a customer service representative or complete a written request. However, some trading partners are able to provide daily SDBA updates electronically to facilitate electronic transfers via automated response units.

### [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] 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.

### [D] Individual Annuity Contracts

Individual annuity contracts are only normally set up when a plan is designed and administered by an insurance company. 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 company (the insurance company, recordkeeper or plan sponsor) is responsible for distributions and tax reporting.

### [E] Exchange-Traded Funds (ETFs)

**Exchange-traded funds (ETFs)** are similar to traditional 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 an ETF:

- 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.

ETFs, along with the other investment alternatives described in this chapter, are found in many daily valuation plans. They all have in common the fact that they can be traded daily, have a price per share that can be obtained daily, can be bought and sold in fractional shares, are available to purchase in shares for the full dollars and cents available to be spent, can be set up so that dividends and other income are immediately reinvested in the investment and have trade information available the day after any trade occurs. These are the essential requirements for any investment to be handled in an efficient manner in a daily valuation plan.

## §7.09 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 (ETFs):** Similar to traditional 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.

### §7.10 Review of Key Concepts

- A mutual fund is an investment that pools the funds of many investors to purchase a portfolio of stocks, bonds and cash investments. The SEC 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 either actively managed or passively managed.

- 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.

- ETFs are similar to traditional mutual funds but have the trading flexibility and continual pricing of individual stocks.

## §7.11 Review Questions

### [A] True or False

_______1. ETFs are more flexible than mutual funds because they can be bought, sold and priced throughout the day, where mutual funds are bought, sold and priced at the end of the day.

_______2. The three asset classes that mutual funds invest in include common stock, preferred stock and fixed income.

_______3. ETFs are made up of bond securities while mutual funds are made up of stock securities.

_______4. A stock is a security that represents proportionate ownership in a corporation.

_______5. 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.

### [B] Multiple Choice

6. All of the following statements regarding GICs are TRUE, EXCEPT:

   A. The insurance company guarantees both principal safety and a specific interest rate.
   B. The insurance company that offers the GIC 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 all 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 statements 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 normally 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. Which of the following statements regarding mutual funds is/are **TRUE**?

    I. A mutual fund is an investment company that pools the money of many investors to purchase securities.
    II. A mutual fund provides diversification because it holds investments of more than one company.
    III. An actively managed mutual fund attempts to outperform a selected market index by constantly analyzing individual fund holdings.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

11. All of the following are assets that a money market fund would invest in, **EXCEPT**:

    A. Treasury bills
    B. Certificates of deposit
    C. Stocks
    D. Commercial paper
    E. Cash

12. All of the following statements regarding bond are **TRUE, EXCEPT**:

    A. Short-term bonds are unsecured.
    B. Long-term bonds generally mature after ten or more years.
    C. Bonds are used to raise capital.
    D. Bondholders have no equity interest.
    E. Bondholders have no creditor status.

## §7.12 Answers

1. **True.** ETFs 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 [E]

2. **False.** The three asset classes that mutual funds invest in include cash, bonds and equities. §7.04

3. **False.** ETFs are made up of the same types of securities that make up mutual funds. §7.09 [E]

4. **True**. A stock is a security that represents proportionate ownership in a corporation. 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. §7.04 [A]

5. **True**. 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. §7.04 [B]

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[J]

   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 [B]

   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 normally 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 **E.** §7.03 & 7.05

    A. Incorrect because statements II and III are also true.
    B. Incorrect because statements I and III are also true.
    C. Incorrect because statement II is also true.
    D. Incorrect because statement I is also true.
    E. Correct because all three statements are true.

11. The correct answer is **C.** §7.05 [K]

    A. Incorrect. This is true because money market funds invest in treasury bills.
    B. Incorrect. This is true because money market funds invest in certificate of deposits.
    C. Correct. This is false because money market funds do not invest in stocks.
    D. Incorrect. This is true because money market funds invest in commercial paper.
    E. Incorrect. This is true because money market funds invest in cash.

12. The correct answer is **E.** §7.04 [B]

    A. Incorrect. This is true because short-term bonds are unsecured.
    B. Incorrect. This is true because long-term bonds generally mature after ten or more years.
    C. Incorrect. This is true because bonds are used to raise capital.
    D. Incorrect. This is true because bondholders have no equity interest.
    E. Correct. This is false because bondholders do have creditor status.

## §7.13 Supplemental Education

**Webcourses:** ASPPA offers webcourses on the RPF-1 and RPF-2 materials. These webcourses provide introductory training for new employees and help prepare RPF-1 and RPF-2 exam candidates for the most challenging topics covered on the respective examinations. Webcourses offer many benefits to individual and companies alike:

- Self-paced: Review information at your own pace.
- Flexibility: View the courses from any location with an Internet connection.
- Continuing education: Earn continuing education credit for ASPPA credentials.

There are seven webcourses for RPF-1 and seven webcourses for RPF-2. Each set can be purchased on the ASPPA Web site. Each webcourse is divided into two modules. To register for the webcourses visit www.asppa.org/webcourse.

Webcourses relevant to this chapter:

- Investments in Daily Valued Plans

**Publications:** Below is a listing of additional publications specific to topics found in this chapter. These resources are not required reading nor do they provide additional information to be tested. They are listed for those who may want more detail on a topic. The listing includes only those publications that are free and may be found on the Web.

Articles relevant to this chapter can be found at the SEC Web site:

"Beginners' Guide to Asset Allocation, Diversification and Rebalancing"
www.sec.gov/investor/pubs/assetallocation.htm

# Chapter 8
## Employer Stock Issues



### §8.01 Learning Objectives

- Identify the administrative issues when employer stock is offered as a participant investment.
- Explain the blackout period applicable for restricted employees.
- Identify the requirements of the diversification notice when employer securities are an investment option.
- Identify the two methods commonly used to account for employer stock as a plan investment in a daily valuation plan.

### §8.02 Introduction

Investments that are offered in daily valuation plans need to have certain characteristics to be efficiently administered. In this chapter, we will cover one investment category that is frequently offered in daily valuation plans but does not meet all the standards that allow it to be efficiently administered. This then causes special daily valuation processing issues that will be addressed.

The offering of stock in a daily valuation plan is one such investment. In particular, we will discuss the offering of stock of the plan sponsor. It not only requires additional daily valuation processing issues, because it does not meet the standards for an efficient investment, but it also has other special administration issues because of it being stock of the plan sponsor. This investment is generally called employer stock.

In this chapter, we will limit our discussion to publicly traded employer stock. Publicly traded stock is generally priced on a daily basis whereas privately held stock may be priced annually. Investments offered in daily valuation plans must be priced daily to allow for transaction processing on a daily basis.

## §8.03 Employer Stock

Plan sponsors have many different methods for offering employer stock as an investment option in qualified plans. Some plan sponsors establish an employee stock ownership plan (ESOP), which by definition is intended to invest primarily in employer stock. Other plan sponsors offer employer stock as a general investment of the plan.

Some plan sponsors decide to offer participants the right to direct the investment of their accounts into 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 all matching contributions in employer stock.

In December of 2010, the U.S. Department of Labor Employee Benefits Security Administration published its annual "Private Pension Plan Bulletin Historical Tables and Graphs." This data is from the 2008 Form 5500 filings. The report indicated that the dollars invested in employer securities were as follows:

| Type of Asset | 401(k) Plans | All Defined Contribution Plans |
|---|---|---|
| Mutual Funds | $2,036,476,000 | $2,342,476,000 |
| Employer Stock | $140,326,000 | $222,046,000 |
| Participant Loans | $49,053,000 | $50,696,000 |
| Other Assets | $4,333,000 | $17,321,000 |
| Total Assets | $2,230,188,000 | $2,662,537,000 |

There are more assets invested in employer stock then there are in participant loans. In 401(k) plans, over 6% of the total assets are invested in employer stock compared to 8% for all defined contribution plans.

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. In addition, the discussion of employer stock in an ESOP is beyond the scope of this course.

Recordkeeping for employer stock that is publicly traded is the same as that of any other publicly traded 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. The 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.

Publicly traded 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. The inability for publicly traded stocks to be bought in fractional shares is the major reason that special recordkeeping processes are needed in order to handle the stock in daily valuation plans.

When employer stock is privately 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.

Let's turn first to some of the unique issues that come up when working with publicly traded employer stock as opposed to other stock. These features also add a number of tasks to the recordkeeper’s to do list that do not exist with mutual fund investment options.

## §8.04 Issues Unique to Employer Stock

### [A] Voting Rights of Employer Stock

If the shares of employer stock owned by the plan have voting rights, some plan sponsors 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 company 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.

Occasionally a retirement plan administration firm has multiple plans for the same plan sponsor. In these situations, the plan sponsor 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 plan sponsor. Invariably, some of the participants do not return their proxy votes. Therefore, the trustee has written instructions regarding how the shares are to be voted, although the trustee always has a fiduciary responsibility to vote for the exclusive benefit of the participants and beneficiaries of the plan.

### [B] Blackout Periods for Restricted Employees

Plans holding publicly traded employer stock may be subject to blackout periods for restricted employees. Under the Securities and Exchange Commission (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 a plan sponsor’s fiscal quarter when the plan sponsor 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. Restricted employees generally are directors, officers and more than 10% owners of publicly traded employers. 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 transaction requests 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 transactions that do not involve employer stock to be processed, but holds back transactions with employer stock until after the blackout period ends. In our example, the restricted employee's transfer from Fund A to Fund B is fully executed at the time it is requested, as 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 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 or to take only the amount currently available.

### [C] Pass-through Dividends

A plan sponsor may decide to pay its dividend in cash rather than reinvesting it in employer stock. When this happens, the dividends may be paid in cash to the plan and allocated to participants' accounts that own employer stock or they may be paid directly to the participants. When paid directly to the participants the dividends are called pass-through dividends. This is most likely to occur when a C corporation has a plan with an ESOP feature, because pass-through dividends that can be paid to the participants can be deducted by an ESOP sponsor (normally dividends are not deductible). Note: the tax ramifications of pass-through dividends are beyond the scope of this course.

There are special processing considerations if:

- The plan sponsor pays the dividends to the participant; or
- The trustee and recordkeeper handle the payment of dividends to the participants.

If the plan sponsor pays the dividends directly, it needs an electronic file of all the participants invested in employer stock 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.

### [D] Contributions of Shares versus Cash

An ESOP (including an ESOP with a 401(k) feature) may receive contributions in the form of shares of stock rather than cash. The plan sponsor 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 plan sponsor 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 plan sponsor 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 plan sponsor would have to make a portion of the contribution in cash along with the shares of stock.

### [E] 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 withdrawal from the plan.

### [F] Benefit Payments

When a participant takes a distribution from a plan with investments in 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.

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 nonstock portion of the distribution, even though the stock value 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 (*e.g.*, 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, faster and much safer than having stock certificates issued to the participant.

When a participant takes an in-kind distribution of stock, the cost basis of the stock must be determined and reported as part of the taxable distribution on Form 1099-R. The cost basis is what the plan paid for the stock when it was acquired. The net unrealized appreciation, that is, the difference between the current value of the stock and its original purchase price, is not taxable to the participant until the stock is sold.

### [G] Diversification Rights

Participants in defined contribution plans (except ESOPs) must be given the right to direct the trustee to sell any publicly traded employer securities in their account and reinvest an equivalent amount in other investment options. If the employer securities are part of the participant's:

- Pre-tax elective deferrals, designated Roth contributions, employee after-tax contribution or rollover accounts, the participant must be given the right to sell at least quarterly; and
- Matching or nonelective contribution account, the participant must be given the right to sell at least quarterly, after the participant has completed three years of service.

The plan must offer not less than three investment options, other than employer securities, in which the participant may reinvest the proceeds from the sale of the employer stock. The investment options must be diversified and have different risk and return characteristics.

A diversification notice must be given to the participants 30 days before the participant is first eligible to exercise the right. The notice must describe the diversification rights and explain the importance of diversification.

There are transitional rules that apply to the diversification rights that are beyond the scope of this course.

## §8.05 Recordkeeping of Employer Stock Accounts

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 withdrawals and to participants who have terminated employment.

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. This method is referred to as the unitized stock method.

Let's review these methods in detail.

### [A] Stock Liquidity Fund Method

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 obtained on the automated response units.

Purchase and Sales under the Stock Liquidity Fund Method

Purchases and sales of employer stock may involve only 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 8-1. Stock Liquidity Fund Method.** Assume that the investment allocation of five participants' contributions results 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 Fund 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, in the above Example 8-1, terminates employment, is 100 percent vested in the account and requests a total distribution. 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 cash used is tracked by reflecting the withdrawal from the stock liquidity fund in a dummy participant account called the stock management account and the fractional share is moved from the terminated participant's account into the stock management account. This account holds all fractional shares and tracks all cash transactions 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 plan sponsor contributions made to the plan.

Processing Dividends under the Stock Liquidity Fund 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 Fund Method

Plans using daily valuation attempt to minimize the number of purchases 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, the unitized stock method, uses a single account, rather than two separate accounts as described above.

### [B] Unitized Stock Method

A unitized stock method 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.

Purchases and Sales under the Unitized Stock Method

The difference between the unitized method and the stock liquidity fund method can be illustrated by using the same facts as in Example 8-1 above.

**Example 8-2. Unitized Stock Method.** 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.

Withdrawals under the Unitized Stock Method

Unitized stock methods may 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 without having to wait three days for the stock sale to settle.

According to some practitioners, the unitized stock account should hold only employer stock, because the participants may lose the benefit of the gain in the value of the stock when the plan sponsor 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. Furthermore, if the stock is thinly traded, keeping cash in the unitized fund will permit participants to liquidate out of their stock holdings if they elect to do so (or if the diversification rules discussed above apply).

<u>Processing Dividends under the Unitized Stock Method</u>

When companies pay dividends, the shareholders as of a certain date, known as the record date, receive the dividends issued by the plan sponsor. 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.

### §8.06 Review of Key Concepts

- Employer stock investments create unique administration issues due to proxy voting, blackout periods for restricted employee and pass through of dividends.

- Defined contribution plans (except ESOPs) that invest in publicly traded employer securities must provide the participants a notice that explains their diversification rights and the importance of diversification.

- Employer stock offers 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 stock liquidity fund method the other is the unitized stock method.

## §8.07 Review Questions

### [A] True or False

_______1. In the stock liquidity fund method the real number of shares, price per share and cash are tracked.

_______2. A diversification notice must explain the diversification rights.

_______3. Employer stock can be bought and sold in whole and fractional shares.

_______4. The unitized recordkeeping method may make it difficult to determine which participants should receive an allocation of a dividend.

_______5. Shares accounted for at the participant level can reflect fractional shares.

### [B] Multiple Choice

6. All of the following statements regarding accounting for employer stock are **TRUE, EXCEPT**:

   A. In the stock liquidity fund method, employer stock is used exclusively to provide employee loans.
   B. In the unitized stock method, the price per share reported is fictitious.
   C. In the stock liquidity fund method, the participant has two accounts.
   D. In the stock liquidity fund method, the stock management account holds all of the fractional shares that need to be sold to reimburse cash.
   E. In the unitized stock method, employer stock and cash are in one account.

7. Which of the following statements regarding employer stock offered in daily valuation plans is/are **TRUE**?

   I. It should only be offered to participants if the stock pays dividends annually.
   II. Participants who own employer stock may have voting rights.
   III. The stock should be actively traded on one of the major stock exchanges so that the stock can be valued daily.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II, and III

8. All of the following statements regarding the blackout period for restricted employees are **TRUE, EXCEPT**:

   A. Restricted employees may be aware of confidential information about the plan sponsor that is unavailable to the public, during certain periods of time.
   B. Restricted employees are prohibited from buying or selling employer stock during the blackout period.
   C. Blackout periods apply to restricted employees who participate in defined contribution plans that invest in publicly traded employer stock.
   D. The officers of the plan sponsor may be considered insiders and restricted from buying or selling employer stock during the blackout period.
   E. Blackout periods may occur for extended periods of time while the plan sponsor goes through performance evaluations for each employee.

9. All of the following statements regarding administration issues special to processing employer stock in a daily valuation defined contribution plan are **TRUE**, **EXCEPT**:

   A. Stock distributed to terminated participants may require several different calculations from the recordkeeper.
   B. Stock with voting rights may require the recordkeeper to provide the employer each participant's, name, address and shares held.
   C. Publicly traded stock may require blackout periods during the year when certain employees cannot buy or sell the stock.
   D. Publicly traded stock can sell whole and fractional shares.
   E. Stock that pays cash dividends may require the recordkeeper to provide the employer each participant's name, address and shares held.

10. Which of the following statements regarding the diversification notice used when employer securities are an investment option is/are **TRUE**?

    I. Participants must be notified of their right to sell any publicly traded employer securities 30 days before first eligible to exercise the right.
    II. The notice must describe the importance of diversification.
    III. Participants that have employer stock in their matching account have the right to diversify as soon as the stock is allocated to the participants' account.

A. I only
B. III only
C. I and II only
D. II and III only
E. I, II and III

11. Which of the following statements regarding the blackout period for restricted employees is/are **TRUE**?

    I. The blackout period prohibits restricted employees from making elective deferrals to the plan during that time.
    II. Restricted employees generally are the directors, officers and more than 10% owners.
    III. Plans holding publicly traded employer stock may be subject to blackout periods for restricted employees.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II, and III

12. All of the following contribution accounts must be allowed to liquidate employer securities, held in the account, at least quarterly, EXCEPT:

A. Rollover accounts
B. Employee after-tax contribution accounts
C. Nonelective contribution accounts
D. Pre-tax elective deferral accounts
E. Designated Roth contribution accounts

## §8.08 Answers

1. **True.** In the stock liquidity fund method the real number of shares, price per share and cash are tracked. §8.05

2. **True.** A diversification notice must explain the diversification rights. It must also explain the importance of diversification. §8.04 [G]

3. **False.** Employer stock can only be bought and sold in whole shares. §8.03

4. **True.** The unitized recordkeeping method may make it difficult to determine which participants should receive an allocation of a dividend. §8.05[B]

5. **True**. Shares accounted for at the participant level can reflect fractional shares. §8.05 [A]

6. The correct answer is **A.** §8.05[A] & [B]

   A. Correct. This statement is false because employer stock is not used exclusively to provide employee loans in the stock liquidity fund 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 fund method.
   D. Incorrect. This statement is true because the stock management account holds all of the fractional shares in the stock liquidity fund method.
   E. Incorrect. This statement is true because employer stock and cash are in one account in the unitized stock method.

7. The correct answer is **D**. §8.04

   A. Incorrect because statement I is false.
   B. Incorrect because statement III is also true.
   C. Incorrect because statement I is false.
   D. Correct because statements II and III are true.
   E. Incorrect because statement I is false.

8. The correct answer is **E.** §8.04[B]

   A. Incorrect. This statement is true because restricted employees may be aware of confidential information about the plan sponsor that is unavailable to the public, during certain periods of time.
   B. Incorrect. This statement is true because restricted employees are prohibited from buying or selling employer stock during the blackout period.
   C. Incorrect. This statement is true because blackout periods apply to restricted employees who participate in defined contribution plans that invest in publicly traded employer stock.
   D. Incorrect. This statement is true because the officers of the plan sponsor may be considered insiders and restricted from buying or selling employer stock during the blackout period.
   E. Correct. This statement is false because blackout periods are tied to when the plan sponsor is calculating its earnings for the prior quarter.

9. The correct answer is **D**. §8.03 and 8.04

   A. Incorrect. This statement is true because there may be several different calculations required when stock is distributed to a participant for instance to determine bases, the amount of withholdings, etc.
   B. Incorrect. This statement is true because when stock with voting rights is allocated, the participants can vote on certain issues thus the employer may need to know the participants name, address and shares held by the participant.
   C. Incorrect. This statement is true because there are periods of time when certain employees may not be allowed to buy or sell stock because they may know information that is not yet public knowledge.
   D. Correct. This statement is false because publicly traded stock can only be bought and sold in whole shares not fractional shares.
   E. Incorrect. This statement is true because dividends maybe passed onto the participants that own employer stock in the plan and thus the employer would need to know who these participants are, their address and the amount of shares held.

10. The correct answer is **C**. §8.04[G]

    Statements I and II are true.
    Statement III is false because a participant has the right to diversify after he or she has completed three years of service.

    A. Incorrect because statement II is also true.
    B. Incorrect because statement III is false.
    C. Correct because statements I and II are the only true choices.
    D. Incorrect because statement III is false.
    E. Incorrect because statement III is false.

11. The correct answer is **D**. §8.04[B]

    Statement I is false because elective deferrals can be made by restricted employees to the plan. The investment of the contribution into employer stock is what the blackout restricts during that period.
    Statements II and III are true.

    A. Incorrect because statement I is false.
    B. Incorrect because statement II is false.
    C. Incorrect because statement I is false.
    D. Correct because statements II and III are the only true choices.
    E. Incorrect because statement I is false.

12. The correct answer is **C.** §8.04[G]

    A. Incorrect. This is false because rollover accounts must be allowed to liquidate employer securities at least quarterly.
    B. Incorrect. This is false because employee after-tax contribution accounts must be allowed to liquidate employer securities at least quarterly.
    C. Correct. This is false because nonelective contribution accounts must be given the right to sell employer stock quarterly only after the participant has completed three years of service.
    D. Incorrect. This is false because pre-tax elective deferral accounts must be allowed to liquidate employer securities at least quarterly.
    E. Incorrect. This is false because designated Roth contribution accounts must be allowed to liquidate employer securities at least quarterly.

# Chapter 9
## Analyzing Investment Fees

## §9.01 Learning Objectives

- Explain the plan fiduciary's responsibilities regarding assessing fees and disclosing fees and 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-TA fees and shareholder servicing fees.
- Explain revenue sharing and its affect on participant account balances.
- Identify which plans are subject to the new fiduciary fee disclosure regulations.
- Identify the disclosures that must be made under the new fiduciary fee disclosure regulations.

## §9.02 Introduction

Fees related to or paid automatically from 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.

## §9.03 Investment Fees and Expenses

### [A] Shifting the Burden

There was a silent revolution during the last two decades. 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 Department of Labor (DOL) has 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. 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 has released 401(k) fee disclosure materials 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 investments, sales, administrative and compliance services.

Copies of these materials are available directly from the DOL Employee Benefits Security Administration (EBSA) Web site at **www.dol.gov/ebsa**. Go to Pension Publications/Reports and then to Consumer Publications, Retirement and Compliance Assistance Publications, Retirement.

In May 2003, the DOL issued a field advisory bulletin addressing the allocation of plan expenses and 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 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 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 defined contribution plan activities may be charged to the accounts of the specific participant or beneficiary. These activities include 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.

In the continuing concern about fees and the disclosure of them, the Government Accounting Office released in November 2006 the details of a study they conducted about fees called "Changes Needed to Provide 401(k) Plan Participants and the DOL Better Information on Fees." Their recommendation was that:

> Congress should consider amending ERISA to require sponsors to disclose fee information on each 401(k) investment option in the plan to participants and to require that 401(k) service providers disclose to plan sponsors the compensation providers receive from other service providers. In addition, Government Accounting Office recommends that DOL require plan sponsors to report a summary of all fees paid out of plan assets or by participants. DOL generally agreed with the finding and conclusions of our report.

In 2010, the DOL issued regulations on two major fee disclosure initiatives. The first one issued July 16, 2010, discussed the disclosure to plan fiduciaries of direct and indirect compensation received by certain service providers and registered investment advisors. These regulations were enacted to assist the fiduciary in assessing the reasonableness of fees and potential conflicts of interest that may affect the service providers' performance. This interim final regulation became effective April 1, 2012.

The second initiative, issued October 20, 2010, related to the disclosure to participants of fees paid by participant-directed accounts. This final regulation was effective for plan years beginning on or after November 1, 2011; or if later, 60 days after the effective date of the fiduciary-level fee disclosure regulation, the first initiative discussed above.

### [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 allocated to accounts of 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, such as the administrative costs charged by the administrator and/or recordkeeper.

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 (or 25bps) 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, the participant count is usually not limited to those who are actually contributing; rather, it is based on the total number of eligible participants in the plan and may include terminated participants who maintain an account balance.

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 due to the investment products purchased with plan assets. 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 and some small plan sponsors may 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. These arrangements are not addressed specifically in this chapter.

## §9.04 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 and/or sales charges and back-end loads and/or sales charges; and
- Internal fees, such as 12b-1 fees and management fees.

### [A] Sales Charges

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. They 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.

Funds that apply back-end and/or front-end loads are called loaded funds. 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.

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.

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 sale on a daily basis.

Net asset value (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. The load reduces the NAV that is used to calculate the value of shares being redeemed. Not all mutual fund companies impose sales charges, in which case NAV and POP are the same.

Most mutual fund companies that impose sales charges allow shares to be purchased at NAV without the imposition of any sales charges, when certain conditions are met. 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.

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 back-end load to prevent market timing. This may be charged if a sale occurs within a given period from 60 days up to one year following the purchase of shares. These fees are referred to as short-term redemption fees and are discussed in greater detail in Section 9.05[E] of this Chapter.

### [B] Securities and Exchange Commission (SEC) Rule 12b-1 Fees

Funds often pay a portion of their assets to cover distribution expenses related to advertising and sales support. 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; thus, these charges are generally referred to as 12b-1 fees. 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 Financial Industry Regulatory Authority (FINRA) classifies 12b-1 fees into two categories:

1. <u>12b-1 distribution fee</u>: This fee cannot exceed 0.75% of the fund's average net assets per year. This fee represents a sales charge, which is paid out of the fund's assets over time; and

2. 12b-1 service fee: This fee is limited to 0.25% of the fund's average net assets per year. 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 FINRA sets a maximum overall sales charge (including 12b-1 fees) that is allowed under any circumstances of 8.5%. Under a complex set of FINRA rules that governs 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 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 units?
- 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 (often called churning).

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 | No | Yes | Often | No |
| 12b-1 distribution fee | No | Yes | Yes | No |
| 12b-1 service fee | Often | Yes | Yes | No |

## §9.05 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 NAV.

### [B] Custodial, Transfer Agent and Transaction Fees

Custodial and transfer agent fees are assessed 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 (Sub-TA) 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 mutual fund company to operate in this manner. In return, the mutual 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 (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, often 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 process of deciding between load and no-load funds is to identify any additional services that may be provided by the broker offering load funds. If there are education and enrollment meetings, counseling, ongoing 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 having access to good service is worth the cost, making the loaded fund more valuable to the plan than the less expensive fund.

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 points 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.

### [E] Short Term Redemption Fees

**Short-term redemption fees** may occur when mutual fund shares are bought and then sold within a prescribed period of time. In this situation, the mutual fund may impose a fee of up to 2 percent of the value of the redeemed shares. The purpose is to deter participants from frequent trading in an attempt to time the market. Some mutual funds apply redemption fees to all shares bought and sold, regardless of the reason, whereas some funds apply fees only to transfers (*i.e.*, shares bought as part of a normal periodic payroll may not be subject to fees).

The ability to impose redemption fees and trading restrictions falls under SEC Rule 22c-2. This rule also requires the tracking and reporting by recordkeepers (if requested) of investors whose trading violates fund restrictions on short-term trading.

The SEC recognizes that there are other ways to limit short-term trading. A mutual fund could limit the number of trades within a specified period, delay the payment of proceeds from redemptions for up to 7 days or indentify market timers and restrict their trading. Thus, the SEC does allow the mutual fund some flexibility on whether to charge the fee.

This redemption fee does not apply to money market funds or funds that specifically state in the prospectus that short-term trading of its securities are allowed.

## §9.06 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 US 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.

### §9.07 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.

### §9.08 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.

An 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 annuity distributes amounts to the participant over at least the life of the participant. There are two types of annuity contracts:

1. Immediate Annuities: These annuities typically begin payout immediately after the annuity is purchased. They generally are purchased with one payment.

2. Deferred Annuities: A deferred annuity can be purchased with a single or multiple payments. The funds are then invested with payments to the participant beginning sometime in the future. Thus, the annuity accumulates financial value over a period of time.

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.

This section focuses on the variable rate annuity contracts. These contracts provide investments from a combination of proprietary investment accounts, proprietary and nonproprietary mutual funds, and guaranteed investment contracts (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, are often concerns 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 nonproprietary (managed by an outside investment management company)?

   Proprietary mutual funds offered in the contract typically have lower expense ratios than those of a nonproprietary nature. Often times, the nonproprietary 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 ensure 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 varies 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.

### §9.09 Guaranteed Investment Contract (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 (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 of the contract 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. This contract adjustment does not apply to participants selling their shares of the contract but comes into play when the plan sponsor decides to liquidate the whole contract. Equity wash restrictions temper participants from selling their shares and reinvesting into other fixed rate investments.

Many GICs 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.

### §9.10 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.

These fees 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 the mortality and expense risk associated with the guaranteed death benefit of the contract. Guaranteed death benefits apply 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 in which the contract holder invested. 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 already 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 automated response unit 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.

### §9.11 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. When 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 with another investment approach in addition to an annuity arrangement.

### §9.12 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, which have in the past been paid by the plan sponsor. These fees were associated with plan administration and recordkeeping. These fees have been converted to soft dollars embedded 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 grows, 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. Thus, the participants continue to pay, from their account balances, more of the plan expenses and in larger amounts as the assets increase, even without additional services being provided. Over time, these fees can drastically reduce a participant's retirement benefit.

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-TA 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 and/or 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 and reduced fees or higher fees with the use of no-load funds rests squarely on the plan sponsor and/or 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 nonfiduciary, 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-TA 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.

### §9.13 Financial Advisor Fees

This chapter has addressed the fees associated with the investment products, and those charged by recordkeepers, insurance companies, and bank trustees. One other party that may be involved with the retirement plan is the financial advisor.

Financial advisors may play a role in managing plan assets. They may also provide investment advice or education to the plan sponsor and/or participants. How they are compensated varies greatly.

Some financial advisors receive commissions only off the investment products that are placed in the plan. Others charge a fee for their services that is not dependent on the investments placed in the plan.

As the DOL has focused on the reporting and disclosure of fees and how they define investment advice versus investment education, the method of paying financial advisors has become more important. In any event, their cost must be considered in the overall cost and benefit analysis evaluated by the plan fiduciaries particularly if the plan, thus the participants, are paying for the services of a financial advisor.

## §9.14 Fee Disclosures

In order to assist plan sponsors in determining the various fees being charged to the plan the DOL issued guidance in 2010 that require certain fee disclosures by covered service providers. These regulations were effective April 1, 2012. The regulations apply to any covered service provider who received $1,000 or more of direct or indirect fees from a plan.

These requirements apply to all qualified retirement plans including daily valuation plans, balance forward plans, defined benefit plans and ERISA-covered 403(b) plans. Non-ERISA 403(b) plans, 457 plans, IRAs, SEPs and SIMPLES are excluded.

A covered service provider includes a fiduciary or registered investment advisor. It includes a recordkeeper or brokerage service provider that provides services to a defined contribution plan that offers participant investment direction. It also includes a service provider that provides to the plan accounting, auditing, actuarial, appraisal, banking, consulting, custodial, insurance, investment advisory, legal, recordkeeping, securities or other investment brokerage, third party administration or valuation services.

The covered service provider must generally, disclose the following information in advance of entering into, extending or renewing a contract or arrangement with the plan:

- A description of the services to be provided;
- A statement that the covered service provider is providing the services as a fiduciary or as a registered investment advisor, if applicable;
- A description of all direct and indirect fee received;
- A description as to whether the fee is on a transaction basis or is charged directly against the investment and reflected in the NAV;
- Identification of the services for which the fee will be paid and who is receiving the fee;
- A description of any fees that will be charged if the contract or arrangement is terminated;
- A description of whether the fees will be billed or if the fee will be deducted directly from the participant's accounts or investments;
- For recordkeeping services, the direct or indirect fees charged for such services and if such services are not explicitly charged for or they are offset or rebated based on other fees received then a reasonable good faith estimate of the fees for the specific recordkeeping services provided; and
- For each investment in the plan, a description of the expense ratio if the return is not fixed, any ongoing expenses in addition to the expanse ration (e.g. wrap fees, mortality and expense fees) and any fee charged directly or indirectly against the amount invested (e.g. sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees and purchase fees);

The above fee disclosures should go a long way in leveling the playing field between bundled platforms that in the past may not have disclosed the recordkeeping fees and the unbundled platforms that have. Plan sponsors should be able to obtain the information necessary to determine all the services being provided by the various covered service providers and the fees for such services.

### §9.15 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 and to avoid a prohibited transaction resulting from the plan paying unreasonable fees for services. The DOL fee disclosure regulations should help the plan sponsor identify these fees.

### §9.16 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.

**Short Term Redemption Fees**: Fees imposed by a fund company when a shareholder redeems its shares within seven days of purchase. The redemption fee may be up to two percent of the value of the shares redeemed shortly after their purchase.

**Soft Dollars:** A term used to describe expenses covered by increased investment management fees that a bundled provider is able to keep.

### §9.17 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 exist.

- 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 (Sub-TA) fees 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.

**§9.18 Review Questions**

**[A] True or False**

______ 1. Class B shares of mutual funds are traded at NAV but include a level basis-point trailer for sales commissions.

______ 2. Fee disclosures must be made to plan sponsors by any covered service provider who received $1,000 or more of direct or indirect fees from a plan.

______ 3. A fiduciary is obligated to use plan assets to pay no more than reasonable fees for necessary plan services.

______ 4. Class A shares include front-end loads and 12b-1 service fees.

______ 5. Revenue sharing can be used 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 to determine true cost of the fund.
   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 must be given fee disclosures by service providers, **EXCEPT**:

   A. Defined benefit plans
   B. Nonqualified plans
   C. Daily valuation plans
   D. Balance-forward plans
   E. IRAs

8. All of the following statements regarding revenue sharing are **TRUE, EXCEPT**:

   A. It typically is an asset-based fee.
   B. It may raise ethical questions regarding fund recommendations.
   C. It reduces fees paid by the plan sponsor.
   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 fiduciary should always choose the lowest-priced provider to deliver services.
   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 the plan sponsor.

11. All of the following are fee disclosures that must be made by the service provider to plan sponsors, **EXCEPT**:

   A. A description of all direct and indirect fees received by the service provider.
   B. A description of the services to be provided by the service provider.
   C. A description of fees charge by the service provider if the contract is terminated.
   D. A description of the profitability of the service provider.
   E. A description of whether fees are billed or deducted directly from the participant's accounts or investments by the service provider.

12. All of the following are service providers under the fee disclosure requirements, **EXCEPT**:

   A. Registered investment advisor
   B. Brokerage service provider
   C. Recordkeeper
   D. Fiduciary
   E. Plan sponsor

### §9.19 Answers

1. **False.** Class R shares of mutual funds are traded at NAV but include a level basis-point trailer for sales commissions. §9.04 [C]

2. **True**. Fee disclosures must be made to plan sponsors by any covered service provider who received $1,000 or more of direct or indirect fees from a plan. §9.14

3. **True.** A fiduciary is obligated to use plan assets to pay no more than reasonable fees for necessary plan services. §9.03[A]

4. **True.** Class A shares include front-end loads and 12-b1 service fees. §9.04 [C]

5. **True.** Revenue sharing helps to offset administrative expenses. §9.05[D]

6. The correct answer is **B.** §9.05 [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 **B.** §9.14

    A. Incorrect. This is true because defined benefit plans must be given fee disclosures by service providers.
    B. Correct. This is false because nonqualified plans do not have to be given fee disclosures by service providers.
    C. Incorrect. This is true because daily valuation plans must be given fee disclosures by service providers.
    D. Incorrect. This is true because balance-forward plans must be given fee disclosures by service providers.
    E. Incorrect. This is true because IRAs must be given fee disclosures by service providers.

8. The correct answer is **D**. §9.12

   A. Incorrect. This statement is true because revenue sharing fees are typically asset-based 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 does reduce the fees paid by the plan sponsor.
   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.** §9.03

   A. Correct. This statement is false, as the fiduciary does not have to always choose the lowest-priced service provider.
   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.** §9.05 & 9.06

   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 the plan sponsor. They are paid directly from the mutual fund assets.

11. The correct answer is **D.** §9.14

    A. Incorrect. This statement is true because a description of all direct and indirect fees received by the service provider is a fee disclosure.
    B. Incorrect. This statement is true because a description of the services to be provided by the service provider is a fee disclosure.
    C. Incorrect. This statement is true because a description of fees charge by the service provider if the contract is terminated is a fee disclosure.
    D. Correct. This statement is false because a description of the profitability of the service provider is not a fee disclosure.
    E. Incorrect. This statement is true because a description of whether fees are billed or deducted directly from the participant's accounts or investments by the service provider is a fee disclosure.

12. The correct answer is **E.** §9.14

    A. Incorrect. This is true because registered investment advisors are service providers.
    B. Incorrect. This is true because brokerage service providers are service providers.
    C. Incorrect. This is true because recordkeepers are service providers.
    D. Incorrect. This is true because fiduciaries are service providers.
    E. Correct. This is false because plan sponsors are not service providers.

### §9.20 Supplemental Education

**Publications:** Below is a listing of additional publications specific to topics found in this chapter. These resources are neither required reading nor do they provide additional information to be tested. They are listed for those who may want more detail on a topic. The listing includes only those publications that are free and may be found on the Web.

1. Articles relevant to this chapter can be found at the ASPPA Web site:

   "Impact of the 408(b)(2) Regulations on TPAs" by Bruce L. Ashton, APM and Fred Reish, APM in *The ASPPA Journal*, Winter 2011, Vol. 41, No1.
   www.asppa.org/errata

2. Articles relevant to this chapter can be found at the DOL Web site:

   "A Look at 401(k) Plan Fees"
   www.dol.gov/ebsa/publications/401k_employee.html

   "Understanding Retirement Plan Fees And Expenses"
   www.dol.gov/ebsa/publications/undrstndgrtrmnt.html

   "401(K) Plan Fee Disclosure Form"
   www.dol.gov/ebsa/pdf/401kfefm.pdf

# Chapter 10
## Daily Activities



### §10.01 Learning Objectives

- Explain the recordkeeping process for a daily valuation plan including reconciliation of fund positions, placing trade orders, processing transactions and backing-up functions.
- Describe the process involved when participants initiate transactions.

### §10.02 Introduction

Recordkeepers perform many functions that are repeated each day. Many of those tasks are automated. In this chapter, a list is compiled 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.

The chapter also reviews processing of certain participant-initiated transactions and the effect of those transactions on investment funds, whether they are transfers, rebalancing, distributions or loans.

### §10.03 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:

- Updating prices;
- Settling trades;
- Releasing trades;
- Refreshing values for participant communication (*e.g.* live operator, automated response units (ARU));
- Reviewing outstanding trades;
- Reconciling fund positions;
- Monitoring cash, loans and balancing fund shares;
- Sending participant confirmations and personal identification numbers (PINs);
- Placing trade orders;
- Processing participant-driven ARU transactions;
- Processing employer-driven transactions (contributions);
- Processing distributions, withdrawals, loan requests, transfers, rebalancing; and
- Performing backups and other maintenance functions.

The first function given attention in most operations is the updating 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.

### §10.04 Updating Prices

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 ARUs. 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 updated 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 mutual funds 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 from 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 may be.

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. In some cases, for those insurance companies that have sophisticated software, contract level pricing may make each plan’s fund pricing unique.

## §10.05 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.

For example, when contributions are processed on the recordkeeper's system, the transaction is recorded to each participant's account in dollars as unconfirmed or pending trades, 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 obtained on the ARU.

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 net asset value 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 dollars involved in the 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 ARUs are refreshed to reflect the latest activity.

### [C] The Refresh Process

Refreshing is the process by which the ARU is updated with current account balance and pricing information. It may occur once per day or, most often, it occurs when a participant accesses the ARU. This function is affected by whether the ARU is a separate system from the recordkeeping system or it is the same.

If it is a separate system and refresh occurs once per day, it will occur after pricing has been updated, and trades have been settled and released for the day. Generally, a firm establishes a deadline for performing the refreshing activity so that a participant can expect to obtain current pricing and account balances by a specific time (*e.g.*, noon of each business day). 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. This 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. The more participants the longer it takes to run the refresh process.

However, most systems refresh on demand. In other words, they refresh a participant's information only when the participant accesses the ARU. Still other systems do not have to actually refresh the participant data because the ARUs are directly tied into the recordkeeping software and 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? Did the trading partner reject the trades? Were the trades simply missed being sent to the specific trading partner?

## §10.06 Reconciling Plan Assets

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 and cleared on the same day.

Practically speaking, however, it may take a couple of days for most transactions to clear, or settle. It may take even more time for checks to be written and for those checks to clear. As a result, a critical part of daily recordkeeping where there are separate trust and recordkeeping systems is the monitoring and reconciliation of incomplete transactions on a daily basis. These discrepancies may appear when attempting to monitor or balance the plan's cash, fund shares or loans.

### [A] Monitoring Cash

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 situations 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;
- Checks were written but not cashed;
- 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 Fund Shares

In addition to monitoring cash, share positions are monitored as well. Each plan has a fund share position (*i.e.* total of participants' 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 monitoring, 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.

### [C] Monitoring Loan Payments

As participants are issued new loans, several transactions are tracked. First, the sale of assets to provide the cash for the loan is monitored and then the cash distribution of the loan proceeds to the participant is also monitored, to complete the transaction.

The loan then becomes a new asset in the system with regular payments of cash back to the plan to pay down the participant loan principal and accrued interest. Each payment amount is verified, that it agrees with the amortization schedule, is made timely and applied to the appropriate loan. Typically, loan repayments are invested back into other plan assets based on the participant's current investment elections.

Participant loans generally are repaid through payroll withholdings. Frequently, the amount of the last payment on a loan may vary from the other payments because of rounding adjustments during the term of the loan. Loan tracking requires that the last payment amount be monitored and that no additional payments are received on a paid-off loan.

## §10.07 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. Along with PIN numbers, some systems require additional passwords and user names.

Participants often forget their PIN or use an incorrect PIN and lock themselves out of their accounts. In such cases, the PIN must be reset or unlocked by the recordkeeper. This can be accomplished by resetting the PIN to the original default PIN, sending the participant a new system-generated PIN or by giving the participant an opportunity to reset the PIN after he or she answers a security question originally provided by the participant.

## §10.08 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 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.

## §10.09 Processing Transactions

### [A] Processing Participant-Driven Transactions

If a participant initiates a transaction on an ARU, such as a transfer or portfolio rebalancing, it must be extracted and traded by an established trading deadline (*e.g.*, 2 p.m., 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 ARU in order to place corresponding trades. **Refresh** is the process by which the ARU is updated with current account balance and pricing information. Some refresh processes have been eliminated due to the increased technological functionality to reflect changes to a participant's account balance on a real-time basis.

When a participant initiates a sell transaction, all future requests are denied or blocked until the participant's initial request is traded, settled and released. Depending on timing, the automated response software may allow a participant to change a transaction and stop a trade before it is executed. It is important, therefore, that blocked trades on the ARU 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 ARU. 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 ARU package is not the same as the vendor for the recordkeeping software. The passing of information between the two component systems creates 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 percent bond funds and 70 percent 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.

Existing shares in undesired funds are sold and the resulting cash is used to purchase shares in the desired funds. Under many trading platforms, the buy and sell occurs on the same day among same fund families, as well as multiple fund families.

Many firms require that participants request these types of transactions via the ARU. 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 and loan repayments 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 and loan 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 also be checked. Often, an administrator handles some of this work before turning over the transaction to the recordkeeper.

1. <u>Processing Distribution Transactions</u>

Distributions usually involve the benefit payment made on behalf of a terminated participant, beneficiary or alternate payee, 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. Withdrawals may be requested for a variety of reasons:

- Hardship withdrawal;
- In-service withdrawal;
- Required minimum distribution at age 70½;
- Refund to highly compensated employees due to plan's failure of the actual deferral

percentage and/or actual contribution percentage 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 beneficiary, along with any related paperwork.

As with many of the daily functions, there are a variety of ways in which distributions and withdrawals 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 essential to providing timely, accurate distributions.

2. <u>Processing Loan Transactions</u>

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 should be applied consistently and may be identified through the plan's written loan procedures. The employer coordinates the start of loan repayments on its payroll.

Some automated response systems permit the participant to work through various what-if loan scenarios called loan modeling. 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 systems, participants can request loans on the ARU, and the required paperwork, such as the promissory note, 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 limit 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:

- A minimum loan amount;
- A set number of outstanding loans permitted at any one time; and
- A set method to determine the loan interest rate.

### §10.10 Backup and Other Maintenance Functions

During each trading day, many activities 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 ARUs. These functions are often handled outside the daily unit.

Whoever performs the backup functions is responsible for verifying that they work thoroughly each night; that is, that the system itself and all plans are backed up and that the backup data is usable. The backups should be stored off-site to be available in case a catastrophe occurs at the daily processing site.

Because of all the variables associated with ARUs, 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 during their first week or so of operation to avoid unanticipated problems in the setup.

To ensure continuous access to the ARUs, 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 ARU must be brought off-line for maintenance, most systems activate a message on the unit in advance 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.

### §10.11 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.

### §10.12 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 it is common for the plan information to change on a daily or even more common basis, backing up is a critical daily function.

## §10.13 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. After 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.

______ 3. Investment pricing occurs each business day.

______ 4. Trades that are released on the recordkeeping system means that 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.

______ 5. It is important to perform daily backups on the software and ARUs because many activities are occurring during the day and different people could affect information about a plan.

### [B] Multiple Choice

6. All of the following are examples of situations 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 charged to the plan but not allocated to participant accounts

7. All of the following are activities that occur on a daily basis, **EXCEPT**:

   A. Pricing updates
   B. Placing trades
   C. Reconciling shares
   D. Settling trades
   E. Posting profit sharing contributions

8. Which of the following statements regarding participant driven transactions is/are **TRUE**?

   I. Participant initiated transactions requested on the ARU must be received prior to the trading deadline to be traded the following business day.
   II. Refresh is the process by which the ARU is updated with current account balance and pricing information.
   III. Extract is the process of pulling participant-driven requests from the ARU in order to place corresponding trades.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

9. All of the following statements regarding daily recordkeeping activities are **TRUE, EXCEPT**:

   A. The daily monitoring of incomplete trades is a critical part of reconciliation when balancing cash, loans or fund shares.
   B. Omnibus level trading is when trade amounts are combined to create net transactions to minimize cash flow and trade costs.
   C. Participant-directed portfolio rebalancing is a realignment of an existing account balance among funds.
   D. Uninvested cash may be a result of improperly executed transactions.
   E. Balancing shares held by the plan to those reported to be held on the New York Stock Exchange is a daily process.

10. All of the following statements regarding processing transactions for a daily valuation plan are **TRUE, EXCEPT**:

    A. Cash and shares are reconciled weekly to insure that there are no outstanding trades and no uninvested cash.
    B. Mutual fund settlement typically occurs a day after a trade has been executed and confirmed.
    C. The refresh process updates the automated response system with current account balance and pricing information which may be done on demand.
    D. Trades are released on the daily system after they have been settled and the results are reconciled by plan and by fund.
    E. Trade settlement is when the proceeds of a trade are actually transmitted to the mutual fund company and normally performed by the trading partner.

11. All of the following are items to check when processing a loan transaction on the daily software, **EXCEPT**:

    A. Loan fund and source hierarchy
    B. The inflation rate
    C. The number of loans permitted at one time
    D. Maximum loan limit
    E. Minimum loan amount

12. Which of the following statements regarding participant driven transactions is/are **TRUE**?

    I. When a participant initiates a sell transaction all future requests are blocked until the initial request is completed.
    II. Participant initiated transactions must be extracted and traded by an established trading deadline.
    III. The plan sponsor will be responsible for any losses caused by faulty extracts of ARU transactions.

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

## §10.14 Answers

1. **False.** Portfolio rebalancing is when a participant rebalances the fund positions within the plan account. §10.09 [B]

2. **True.** After 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. §10.08

3. **True.** Pricing investments does occur each business day. §10.04

4. **True**. Trades that are released on the recordkeeping system means that 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. §10.05[B]

5. **True**. During each trading day, many activities 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 ARUs. §10.10

6. The correct answer is **C.** §10.06 [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 charged to the plan but not allocated to participant accounts may result in a cash discrepancy.

7. The correct answer is **E**. §10.03

   A. Incorrect. This is true because pricing updates do occur on a daily basis.
   B. Incorrect. This is true because placing trades does occur on a daily basis.
   C. Incorrect. This is true because reconciling shares does occur on a daily basis.
   D. Incorrect. This is true because settling trades does occur on a daily basis
   E. Correct. This is false because posting profit sharing contribution is not an activity that occurs every day. It could occur any day but does not occur every day.

8. The correct answer is **D**. §10.09[A]

   A. Incorrect because statements II and III are true.
   B. Incorrect because statement III is also true.
   C. Incorrect because statement I is false.
   D. Correct because statements II and III are true and I is False.
   E. Incorrect because statement I is False.

9. The correct answer is **E.** §10.06 10.08 & 10.09

   A. Incorrect. This statement is true because the daily monitoring of incomplete trades is a critical part of reconciliation when balancing cash, loans or fund shares
   B. Incorrect. This statement is true because omnibus level trading is when trade amounts are combined to create net transactions to minimize cash flow and trade costs
   C. Incorrect. This statement is true because Participant-directed portfolio rebalancing is a realignment of an existing account balance among funds.
   D. Incorrect. This statement is true because uninvested cash may be a result of improperly executed transactions.
   E. Correct. This statement is false because balancing shares held by the plan is to those held by the trading partner, custodian or fund company that maintains the records. The New York Stock Exchange does not report the shares held by the plan.

10. The correct answer is **A.** §10.05 & 10.06

   A. Correct. This statement is false because cash and shares are reconciled daily to insure that there are no outstanding trades and no uninvested cash.
   B. Incorrect. This statement is true because mutual fund settlement typically do occur a day after a trade has been executed and confirmed.
   C. Incorrect. This statement is true because the refresh process does update the automated response system with current account balance and pricing information which may be done on demand.
   D. Incorrect. This statement is true because trades are released on the daily system after they have been settled and the results are reconciled by plan and by fund.
   E. Incorrect. This statement is true because trade settlement is when the proceeds of a trade are actually transmitted to the mutual fund company and normally performed by the trading partner.

11. The correct answer is **B**. §10.09[D]

    A. Incorrect. This is true because when processing a loan transaction on the daily software the loan fund and source hierarchy should be checked.
    B. Correct. This is false because when processing a loan transaction on the daily software it is not necessary to check the inflation rate. It may be necessary to check the prime interest rate or some other loan rate to determine the interest rate for the loan but not the inflation rate.
    C. Incorrect. This is true because when processing a loan transaction on the daily software the number of loans permitted at one time should be checked.
    D. Incorrect. This is true because when processing a loan transaction on the daily software the maximum loan limit should be checked.
    E. Incorrect. This is true because when processing a loan transaction on the daily software the minimum loan amount should be checked.

12. The correct answer is **C**. §10.09[A]

    A. Incorrect because statement II is also true.
    B. Incorrect because statement III is false.
    C. Correct because statements I and II are the only true statements.
    D. Incorrect because statement III is false.
    E. Incorrect because statement III is false.

# Chapter 11
## Mutual Fund Trading Practices



### §11.01 Learning Objectives

- Define the role of the recordkeeper, trading partner, transfer agent and mutual fund company or investment manager in a participant trade request.
- Define the following terms: forward pricing, trade partner, transfer agent omnibus level trading, trading deadlines, settlement date and fund position.

### §11.02 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. A **trade** is a purchase or sale of a security, such as shares of a mutual fund.

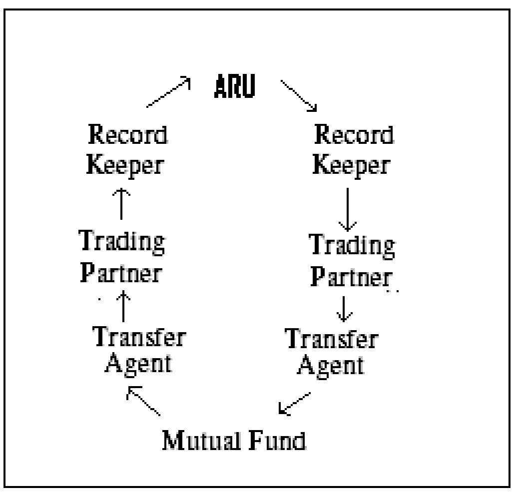
How does all of this happen? This chapter takes a look at the path a transaction follows from the moment a participant initiates it via the plan's automated response unit to the point in time at which the participant can get the results via the automated response unit. In this chapter, more terminology is introduced that relates strictly to the investment trading activity.

Part of understanding daily valuation requires appreciating all the trading activity that occurs each day and who is involved in processing a trade.

### §11.03 Daily Valuation Is a Circle

Those new to the daily valuation world may find it confusing because 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. 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 automated response units. 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 to place the trade with the mutual fund company. **Placing trades** (or an order) means, making a specific request to buy or sell a security or mutual fund.

The transfer agent settles the trade with the mutual fund company 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 its daily system accordingly. At that point, the data is updated on the automated response units, and the participant can see the result of the original trade and also 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.

### §11.04 Trading Partners

Trading activity is usually managed through a trading partner, also called a trading platform. A **trading partner** or platform provides daily fund pricing information to the recordkeeper, handles the placement of trades with the transfer agent and handles the physical movement of the money related to those trades. Other responsibilities include monitoring and providing information to the recordkeeper regarding the dividend and capital gain income distributions. Trade files are normally transmitted from the recordkeeper to the trading partner. **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.

A retirement plan administration firm may work with more than one trading partner. In deciding which trading partner is the best for it, the firm 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? **Links** are programs that are written to accommodate the type of software used by each party so their computers can talk to each other and efficiently transfer information without manual intervention. Specially built links facilitate the transfer of electronic files that allow for electronic trading. **Electronic trading** is a method of trading accomplished by use of files and some form of electronic connection.
- What safety valves are in place and how often does the trading partner experience problems with its trade files?
- How often should the recordkeeper expect to have trouble getting trades placed or confirmed?
- What mutual funds are available through the trading partner?
- 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 (Sub-TA) credits to the retirement plan administration firm?
- Does the trading partner 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 recordkeeper 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. **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, and someone on the other side must receive the fax or call and manually effect the trade.

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.

### §11.05 Transfer Agents

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. 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 that do not act as their own transfer agent often have a bank act in that role. A major stock transfer agent is Depository Trust Corporation.

It is important to investigate the level of automation that exists 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 sending email instructions or phone instructions, returning confirmations in the same format. The trading partner then 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 the recordkeeper, trading partner or transfer agent fail to operate properly on any given day. For example, if the transfer agent rejects a trade due to file errors or lack of cash, the trade confirmation file may not return to the recordkeeping system. The recordkeeper should expect such breakdowns to occur and have procedures, called "soft systems," in place that alert them to the system failures.

## §11.06 Areas of Importance for a Relationship with a Trading Partner

### [A] Automation

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.

### [B] Omnibus Level Trading

The recordkeeping system may create separate trade files each day at the plan level (*i.e.*, each plan would have—at the most—one buy and one sell trade for each mutual fund, which represents the accumulation of all trades for the plan with such fund) or single trade files with separate trade records for each plan. At trading time, a recordkeeper may have many such trade files or records ready to transmit to the trading partner for all the plans it services. These files or 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.

However, there are distinct disadvantages to using omnibus level trading. Confirmation back to the recordkeeper typically takes longer to allow the trading partner to break the trade results down into transactions at a plan level. In addition, omnibus level trading makes it difficult to work with brokers, because trades for many plans are combined. Brokers need to retain their identity in the trade files that are sent to the mutual fund companies in order to get paid their commissions.

### [C] Continuous Net Settlement

Continuous net settlement is a service offered by the 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.

### [D] 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.

### [E] Sub-Transfer Agent (Sub-TA) 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 (Sub-TA) credits. These credits are typically shared with the recordkeeping firm; however, the trading partner sometimes retains that income for its own purposes, perhaps offsetting its fees.

### [F] Balancing 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.

The single most important daily valuation 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 a 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 units could be wrong.

### §11.07 Mutual Fund Trading Through the National Securities Clearing Corporation (NSCC)

The purpose of the National Securities Clearing Corporation (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 Exhibit 11-A, Section 11.10, (Mutual Fund Trading Through the NSCC) for a summary of the two primary methods of trading through the NSCC.

The following are additional NSCC terminologies 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**: 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.

### §11.08 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, although typically they are all executed such that the buy and sell occur on the same day:

**Step 1** Participant initiates transaction by completing written form or through automated response unit.

**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 accumulates purchase and sale transactions from the recordkeeper, and 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 units.

### [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 contribution 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 net buy 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 units.

**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 linked electronically 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 selling the actual funds, the trading itself is most likely managed by the trading area of the operation rather than by the recordkeeping division. An investment company that permits participants to select funds other than those specifically managed by the investment company generally uses an outside trading partner.

### § 11.09 Trading Deadlines, Pricing and Settlement Dates

The **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 or by trading partner. 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.

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.

A mutual fund trade placed by the trading deadline will receive 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.

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 after 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.

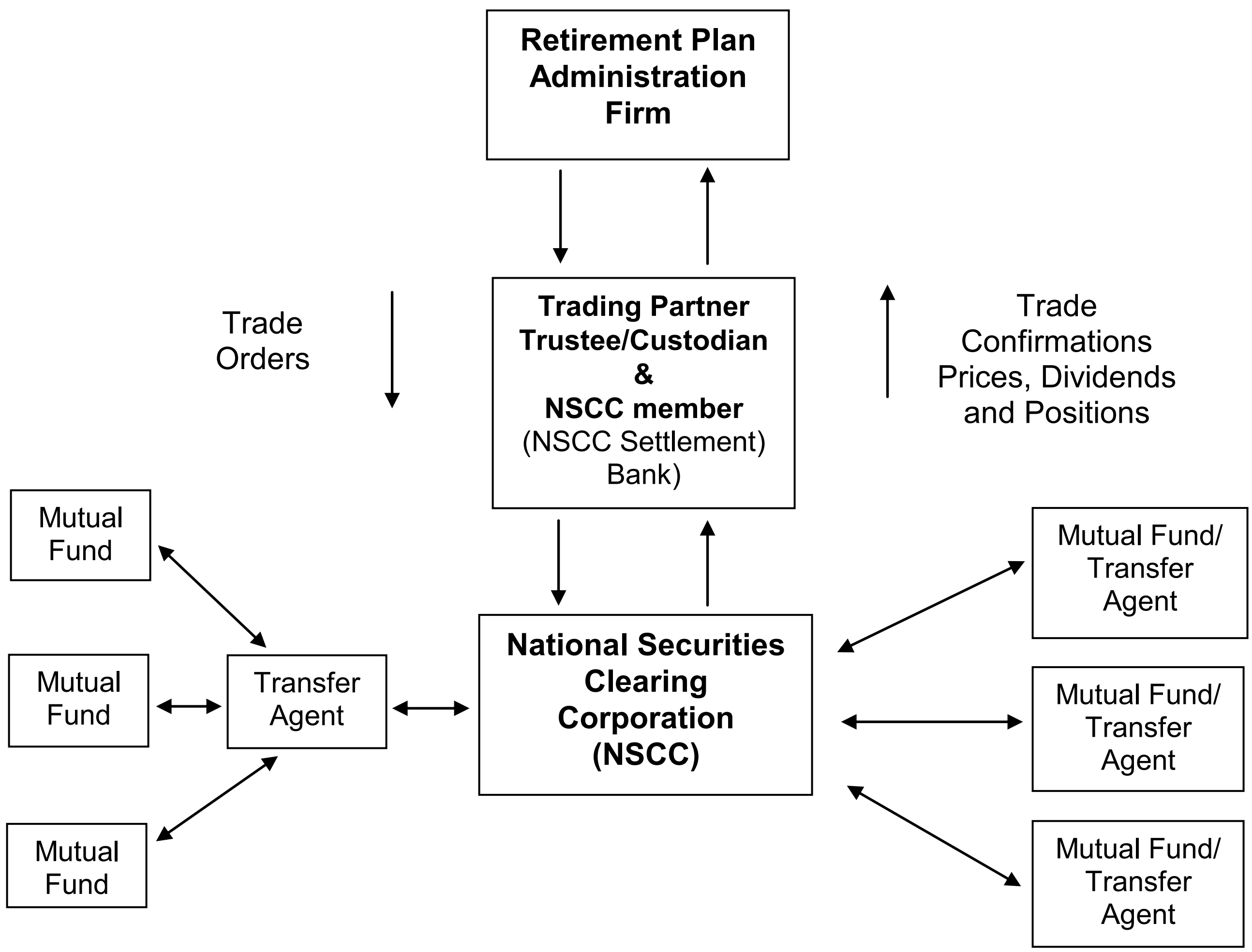
The length of time it takes to settle a trade is a function of the number of processing layers. Investment regulations require that mutual funds be settled within three days of the trade date, or T+3. Mutual funds that act as their own transfer agent usually can complete the process by T+2; however, 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.

## §11.10 Exhibits

**Exhibit 11-A: Mutual Fund Trading Through the National Securities Clearing Corporation (NSCC)**

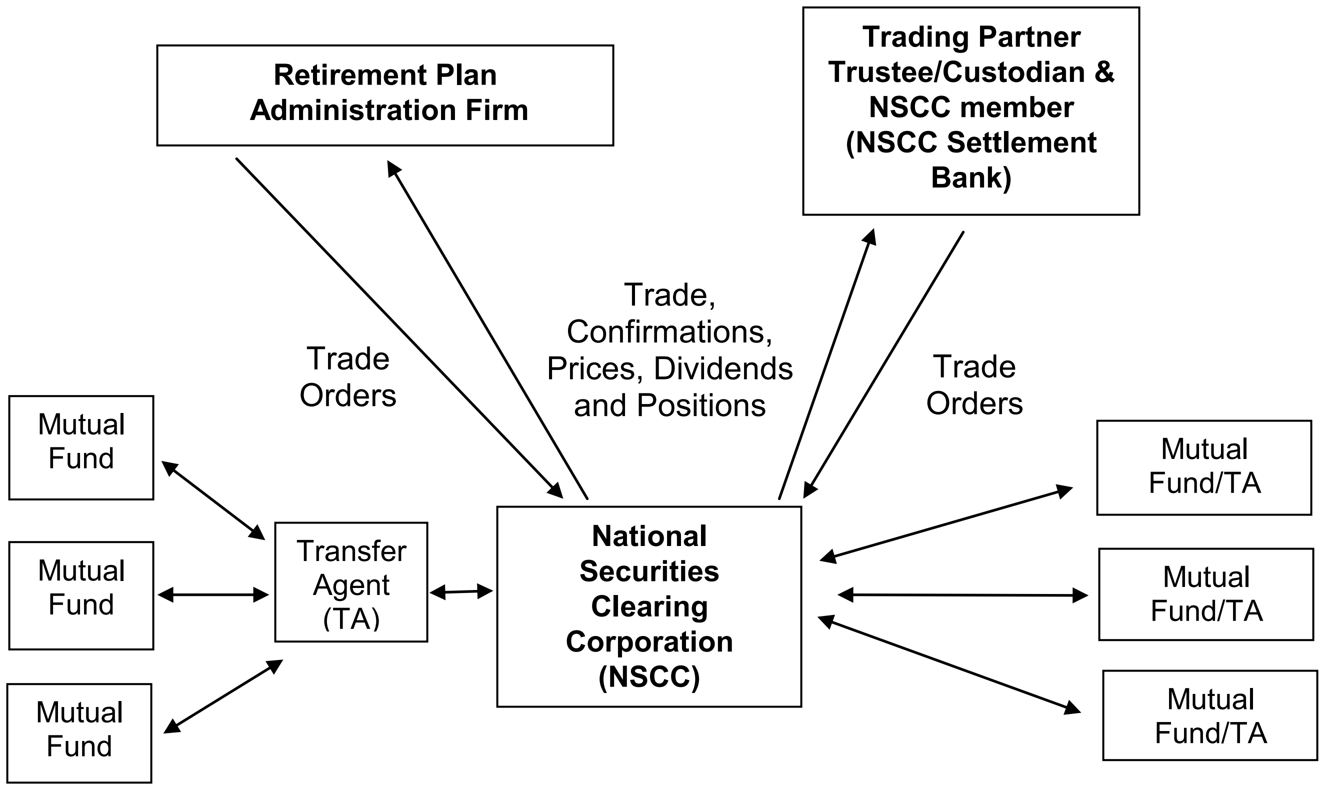
# Diagram 1

# Mutual Fund Trading Through the National Securities Clearing Corporation (NSCC)



# Diagram 2

## Mutual Fund Trading Through the National Securities Clearing Corporation (NSCC)



## §11.11 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.

**Electronic Trading:** A method of trading accomplished by use of files and some form of electronic connection.

**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 held by the plan, for each mutual fund.

**Inside Funds:** Funds managed by the same entity that provides recordkeeping services.

**Links:** Programs 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.

**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.

**Omnibus Level Trading:** Combining trade amounts for multiple plans to create net transactions.

**Outside Funds:** Funds managed by someone other than the entity that provides recordkeeping services.

**Placing Trades** (or an order): Making a specific request to buy or sell a security or mutual fund.

**Settlement Date:** The day that money from a sale is available for other purposes.

**Trade:** A purchase or sale of a security.

**Trade Files:** Represent a summary of the buys and sells needed to carry out the investment, transfer, distribution or other activity requested.

**Trading Partner:** Entity that provides daily fund pricing information, handles the placement of trades, completes the physical movement of money related to those trades, monitors dividend and capital gain distributions and provides settlement information. This is often referred to as a trading platform.

**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.

## §11.12 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 fundinvolved. The transaction is executed, flows back through the transfer agent and trading partner, back to the recordkeeping system and is then refreshed on the automated response units—where the participant initially requested it.

- Trading partners or platforms 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.

**§11.13 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.

______ 4. 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.

______ 5. Forward pricing is used to purchase stock.

**[B] Multiple Choice**

6. All of the following statements 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.

7. All of the following are functions of the trading partner**, EXCEPT**:

   A. Provides daily fund pricing information to the recordkeeper
   B. Monitors the dividend and capital gain income distributions
   C. Provides an electronic file to the recordkeeper with trade results
   D. Provides an electronic file to the transfer agent requesting trades
   E. Monitors participant transfers through the ARU.

8. All of the following statements are activities 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.

9. All of the following parties are involved in every trade, **EXCEPT**:

   A. Recordkeeper
   B. Transfer agent
   C. Mutual fund company
   D. Trading partner
   E. Plan sponsor

10. Which of the following regarding the transaction cycle used in a daily valuation plan is/are **TRUE?**

    I. A participant places a trade with the automated response system then the recordkeeper sends information to the transfer agent.
    II. The transfer agent completes the buys and sells of mutual funds when a participant requests a trade.
    III. The trading partner may send net buy and sell orders through a central clearing and settlement organization.

    A. II only
    B. III only
    C. I and II only
    D. I and III only
    E. I, II and III

11. Which of the following statements regarding the transfer agent is/are **TRUE?**

    I. Each mutual fund selects or contracts with its own transfer agent.
    II. The transfer agent keeps track of shareholding in retail accounts.
    III. The transfer agent is the entity actually responsible for the buying or selling of the mutual fund shares.

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

12. Which of the following statements regarding mutual fund trading is/are TRUE?

    I. The trading deadline is the time by which all mutual fund trades must be placed each day.
    II. The settlement date is the day that the money from a sale is available for another purpose or the money for a purchase has been used to buy the shares.
    III. Mutual funds must be settled within five days of the trade date.

    A. II only
    B. III only
    C. I and II only
    D. I and III only
    E. I, II and III

## §11.14 Answers

1. **False.** The practice of combining trades from multiple plans to create a net trade transaction is known as omnibus level trading. §11.06[B]

2. **True.** The number of shares of each mutual fund held by the plan is its fund position. §11.06[F]

3. **True.** Funds offered through an alliance with the recordkeeping company offer flexibility in trading deadlines. §11.09

4. **True**. 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. § 11.09

5. **False**. All purchases and redemptions by a mutual fund are made on the basis of forward pricing. § 11.09

6. The correct answer is **B.** §11.08[A]

   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.

7. The correct answer is **E.** §11.04

   A. Incorrect. This is true because the trading partner does provide daily fund pricing information to the recordkeeper.
   B. Incorrect. This is true because the trading partner does monitor the dividend and capital gain income distributions.
   C. Incorrect. This is true because the trading partner does provide an electronic file to the recordkeeper with trade results.
   D. Incorrect. This is true because the trading partner does provide an electronic file to the transfer agent requesting trades.
   E. Correct. This is false because the trading partner does not monitor participant transfers through the ARU. They do not have record at the participant level on who requests a trade only at the plan level.

8. The correct answer is **C.** §11.08 [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.

9. The correct answer is **E**. §11.08

   A. Incorrect. This statement is true because the recordkeeper is involved in all trades.
   B. Incorrect. This statement is true because the transfer agent is involved in all trades.
   C. Incorrect. This statement is true because the mutual fund company is involved in all trades.
   D. Incorrect. This statement is true because the trading partner is involved in all trades.
   E. Correct. This statement is false because the plan sponsor is not involved in all trades.

10. The correct answer is **D**. §11.03

    Statement I is false, because a participant places a trade with the automated response system, and then the recordkeeper sends information to the transfer agent.
    Statements II and III are true.

    A. Incorrect because statement III is also true.
    B. Incorrect because statement II is also true.
    C. Incorrect because statement I is false.
    D. Correct because statements II and III are the only true choices.
    E. Incorrect because statement I is false.

11. The correct answer is **E**. §11.05

    A. Incorrect because statements II and III are also true.
    B. Incorrect because statements I and II are also true.
    C. Incorrect because statement III is also true.
    D. Incorrect because statement I is also true.
    E. Correct because statements I, II and III are true.

12. The correct answer is **C**. §11.09

    Statement I and II are true
    Statement III is false, because a mutual fund must be settled three business days from the trade date not five.

    A. Incorrect because statement I is also true.
    B. Incorrect because statement III is false.
    C. Correct because statements I and II are the only true choices.
    D. Incorrect because statement III is false.
    E. Incorrect because statement III is false.

# Chapter 12
## Processing Transactions



### §12.01 Learning Objectives

- List the steps taken to execute trades when processing contributions, distributions and loans in a daily valuation plan.
- Describe the four types of fund transfer requests for money already invested in a participant account.
- Identify common contribution processing problems that occur in a daily valuation plan.

### §12.02 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 to complete a transaction, from the initial request to the trade being completed or final check being cut.

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. Note: For this chapter, the terms units and shares are to be used interchangeably.

### §12.03 Transactions

A **transaction** is a trade processed as a result of contributions, dividends (and other income received), transfers of funds between investments, withdrawals and distributions from the plan. There are three parts to a transaction: the price per share, the dollar amount and the number of 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. Any transaction 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 the participant's vested benefits or if a participant requests a complete transfer out of an investment.

There are three parties that can initiate a transaction:

1. The participant, or an Investment Advisor on behalf of the participant, initiates a transaction when a participant requests a transfer, withdrawal, distribution or a rollover into the plan.
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. 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 number of processing steps may be less in situations where one firm plays more than one role. For instance, in some plans, the trustee provides the recordkeeping and also supplies 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.

### §12.04 Contributions

Employers withhold elective deferral contributions, after-tax employee contributions, designated Roth contributions or loan repayment amounts from employee paychecks and forward those dollars to the trust for investment according to each participant's directions. Some employers submit each contribution file as it completes its payroll processing, while others submit the data on a monthly basis, even though payrolls and deposits of the contributions into the trust occur more frequently.

Participant contributions and loan repayments 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. A cash account is sometimes set up to be used as a holding account so that deposits can be made as soon as administratively feasible after the pay date to comply with the legal deposit deadlines. The deposits are invested as soon as the data file can be reconciled and as long as the funds within the cash account are sufficient. Some employers allow the recordkeeper to request an automatic debit of the contribution from the employer's account into the plan account upon receipt and review of the data file to minimize any errors between the deposit amount and the data file.

On or up to three days before the day payroll is processed, the employer or payroll provider sends the recordkeeper either a paper copy or an electronic file of the contribution and loan repayment data. Using the Internet, many employers send files electronically to the recordkeeper's bulletin board or directly into the recordkeeping software. The more automated the process is, the better the chances are for error-free and cost-efficient processing.

This data identifies which employees have made contributions, how much each employee contributed and the type of employee contribution 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 the contributions and loan repayment amounts within one to five business days after receipt of the file, as long as the contribution totals reflected on the file equal the deposit for the period. The turnaround time for processing of the 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. At the end of each day, the recordkeeping system summarizes the trades across the recordkeeping system by fund and by plan and creates a **trade file.** The recordkeeper then sends the trade file with the investment splits to the trading partner.

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 transfer agent. Depending on the trading partner, some money market accounts may 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 trading partner that contains a confirmation of the number of shares purchased of each mutual fund, the price per share and the dollar amount of the purchases. 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 unit is refreshed, or updated, a participant can obtain the change in value of the 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 Exhibit 12-A, Section 12.09, Contribution Processing, illustrating four different ways contributions are processed. As can be seen, more time is needed to complete the transactions as more service providers are added to the process.

### §12.05 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 the participant's 401(k) funds but not of the participant's 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 through an automated response unit. In fact, many recordkeepers require that transfers be accomplished electronically and either do not accept paper forms or charge extra to process them.

Some 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. Fund companies have also imposed short-term redemption fees to discourage short term trading. **Short-term redemption fees** are fees imposed by a fund company when a shareholder redeems its shares within 7 days of purchase. The redemption fee may be up to 2 percent of the value of the shares redeemed shortly after their purchase.

SEC Rule 22c-2 also requires mutual fund companies to periodically collect and analyze information on frequent trades within their funds in an effort to assure that recordkeepers are appropriately monitoring trading activity and correctly imposing short-term redemption fees, again to prevent market timing. Market timing 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 the participant's 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, such as 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 the participant's 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. The corresponding purchases occur either the same day or 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 and the trade deadlines imposed on the recordkeeper. Through technological advances, it is common to trade both the sell and the corresponding buy the same day. 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, automated response units are updated. Significant time can be saved while greater level of service is being provided.

During this process, the data on the automated response units is 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.

## §12.06 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 unit.

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 trading partner and forwarded on to the transfer agent. The trades are placed and the trade file is 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 accounts. This process may take as little as five days or up to 20 days, depending on the number of institutions involved and the efficiency of each.

Please refer to Exhibit 12-B, Section 12.09, Distribution Processing, for two different flowcharts illustrating how a distribution transaction might be processed.

### §12.07 Loans to Participants

Many plans permit participants to take a loan from their accounts. As with other transactions, participants may request loans using a variety of media. Some plans require a written loan application to be submitted to the plan sponsor, while others allow the participant to initiate the loan using the automated response units.

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;
- Investments available within the sources; and
- Order in which the sources and investment funds are liquidated.

Based upon the plan's loan hierarchy and other written procedures, the recordkeeper places trades to obtain the needed cash. If the plan's written loan procedures do not include a hierarchy, operational practices must be established and followed consistently. 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 of the sale. 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 trading partner and on to the transfer agent. 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 20 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 offer paperless loans: loans that can be both requested via the automated response unit and 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.

Loan repayment information is provided to the plan sponsor through reports or e-mails so that loan payments are set up on the plan sponsor's payroll on a timely basis.

### §12.08 Common Contribution Processing Issues

Certain problems routinely surface during the processing of contribution information. Some of those problems are missing investment election forms, ineligible participants, participants already paid out and processing contributions when the amount on the file does not match the deposit.

#### [A] Missing Investment Election Form

The processing of contribution 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.

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 all participant contributions, not just the contribution 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 contribution file. 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] Contribution Amount Does Not Match Data File

Generally, any manual adjustments to the payroll made between the period that contribution reports are produced and the actual pay date will cause the contribution deposit amount to not match the 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 processing issues and the hours involved in troubleshooting these types of problems, most automated recordkeeping systems allow for an automatic transfer from the employer's payroll account. The actual transfer of funds through the transfer process occurs only after the participant records have been processed, so there can be no mismatch between the data file and the deposit.

Some recordkeepers require the employer to enter the participant information and each payroll's data electronically, via modem or the Internet, directly into the recordkeeper's software. By doing this, the recordkeeper is freed up from importing and auditing the employer's information. The information 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 contribution information is 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:

1. Unit sale. 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 fewer 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 the 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.

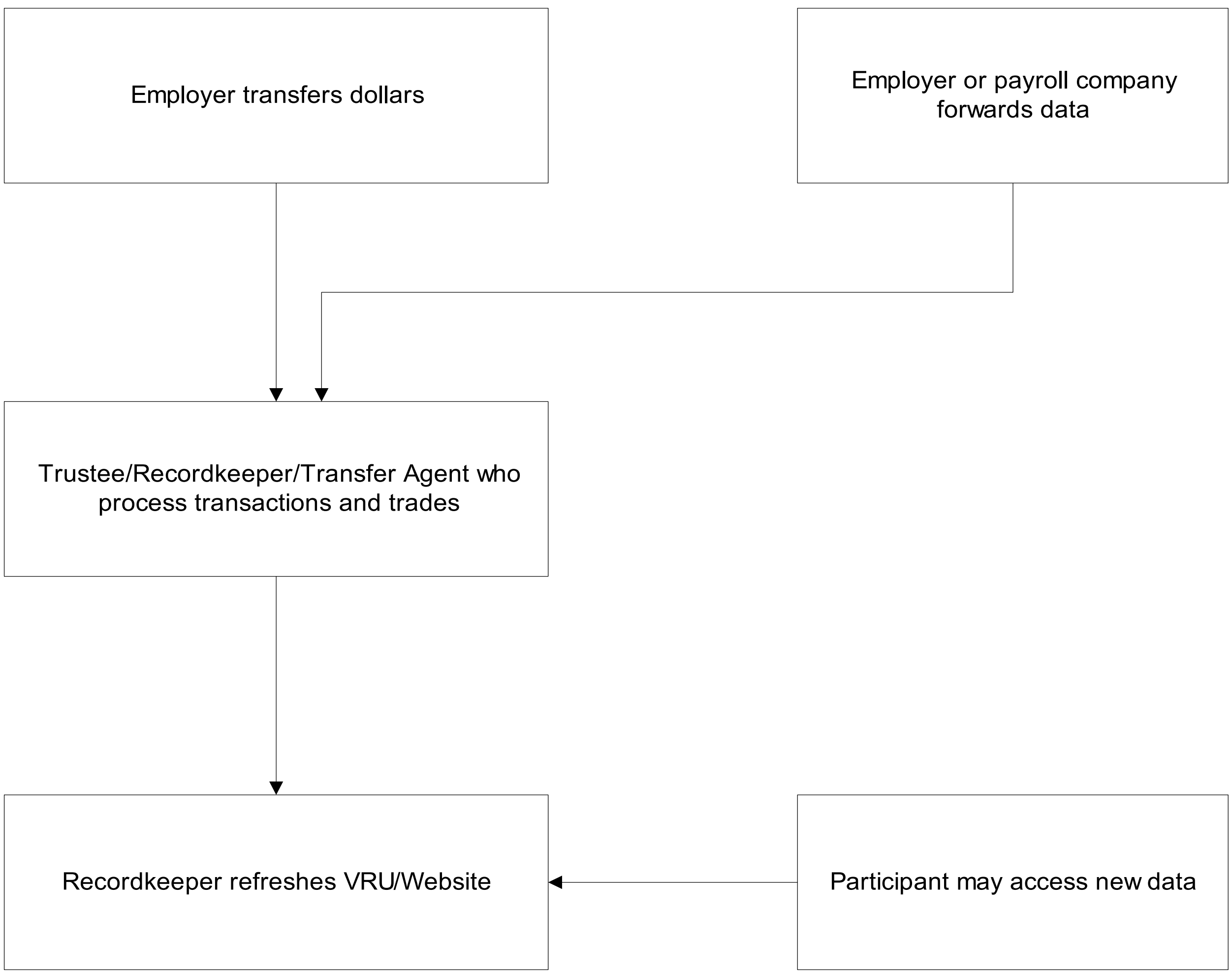
First, some plans permit an individual participant to have more than one loan outstanding at the same time. It is important in these situations for the recordkeeper to apply the separate loan repayments properly to each outstanding loan. The data submitted typically identifies any multiple loan repayments 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. If the plan sponsor's payroll system is not perfectly synchronized with the recordkeeper's loan records, the plan sponsor may discontinue payments too soon or continue deducting loan payments after the loan is fully paid. Generally, the recordkeeper makes manual entries to eliminate these differences from the participant's record and advises the plan sponsor to adjust the deposit accordingly.

## §12.09 Exhibits
## Exhibit 12-A: Contribution Processing

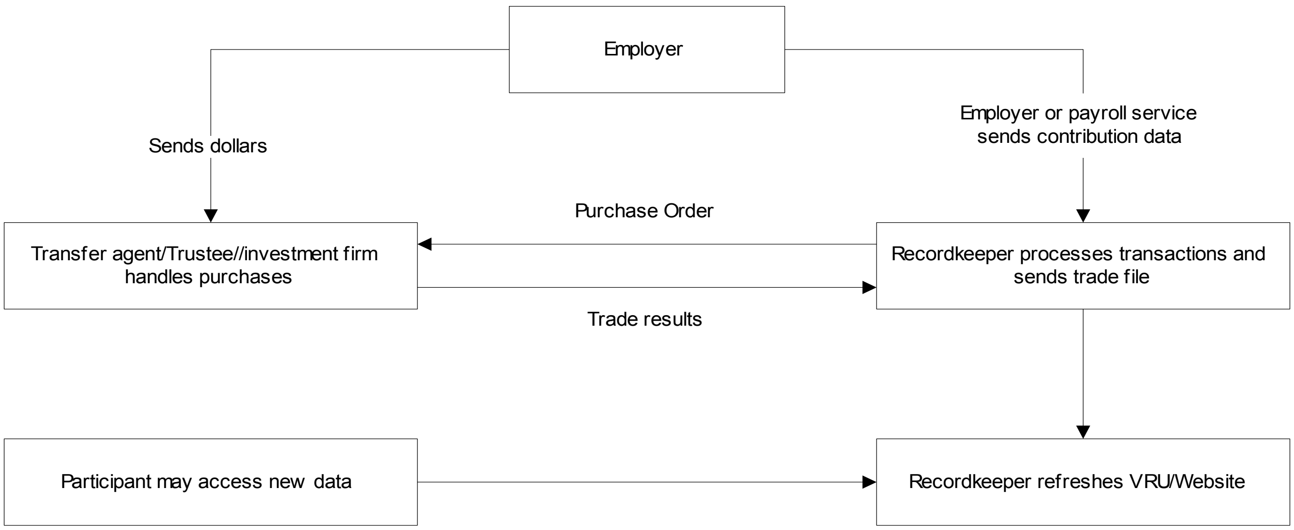
**Contribution Processing**
**Example #1**

Employer uses outside payroll service.  Recordkeeper, trustee, and transfer agent are a single entity.



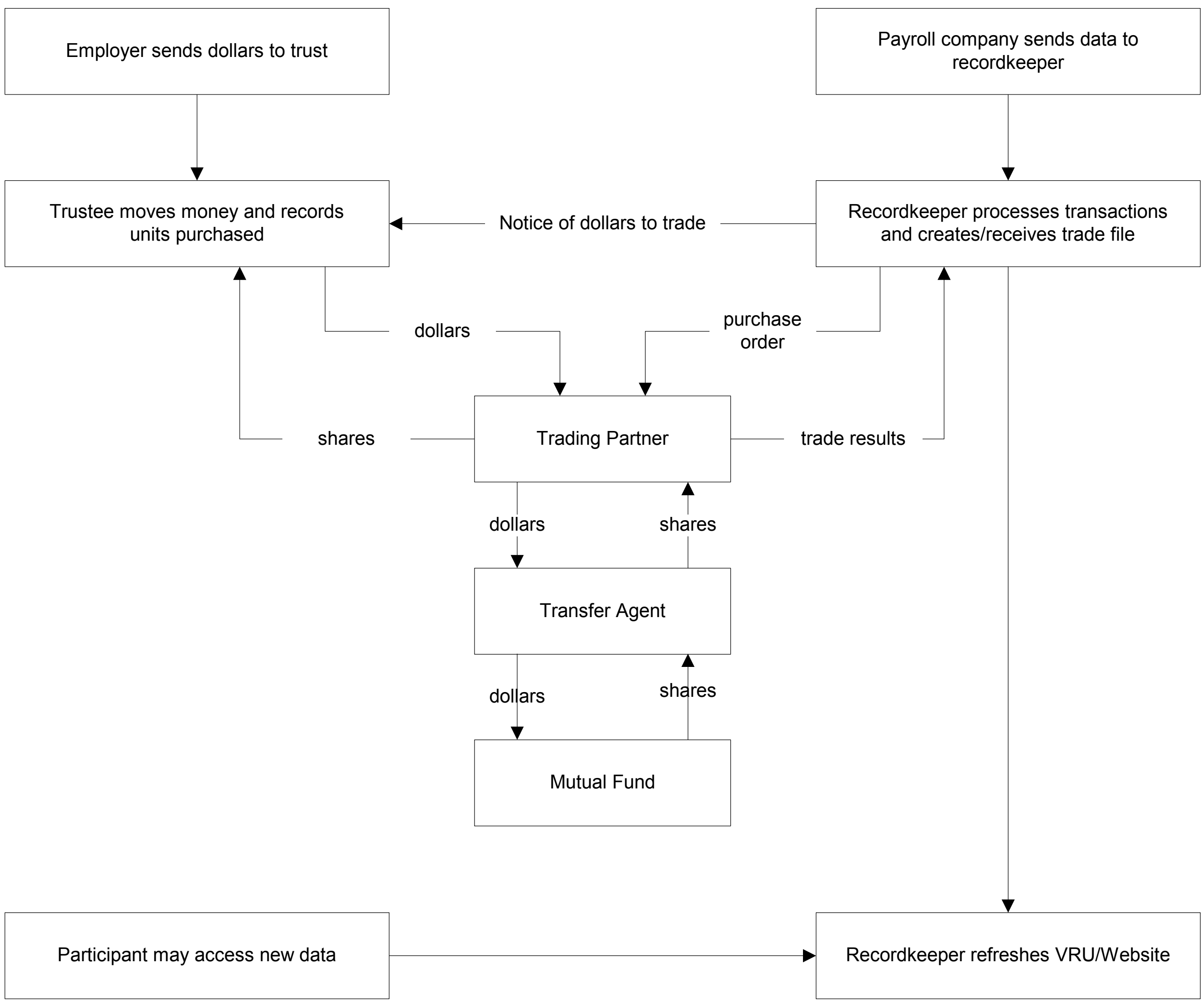
**Contribution Processing**
**Example #2 (Money sent to transfer agent/Trustee)**

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.



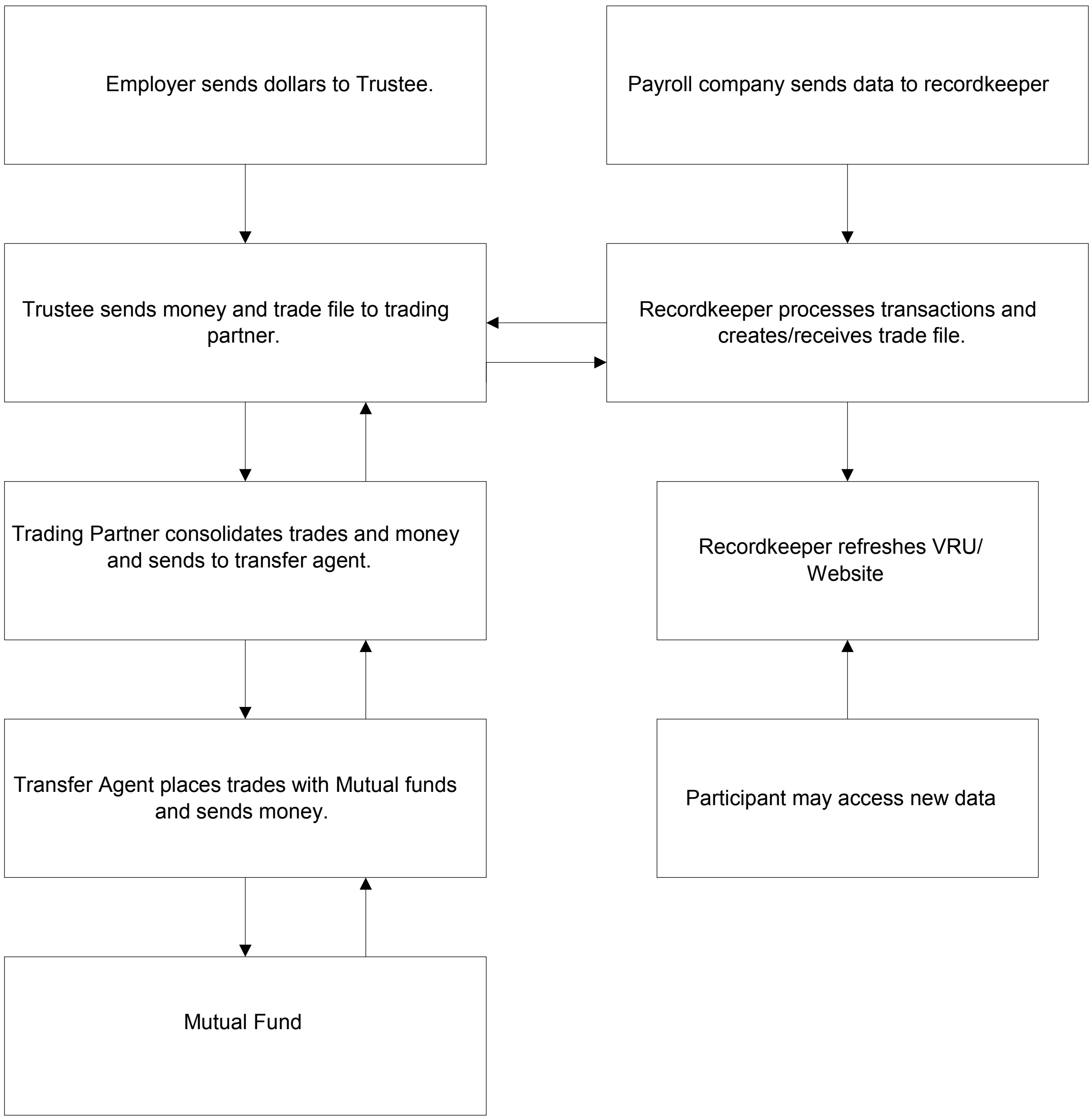
**Contribution Processing**
**Example #3**

This example has a separate trading partner who contracts with the transfer agent.



**Contribution Processing**
**Example #4**

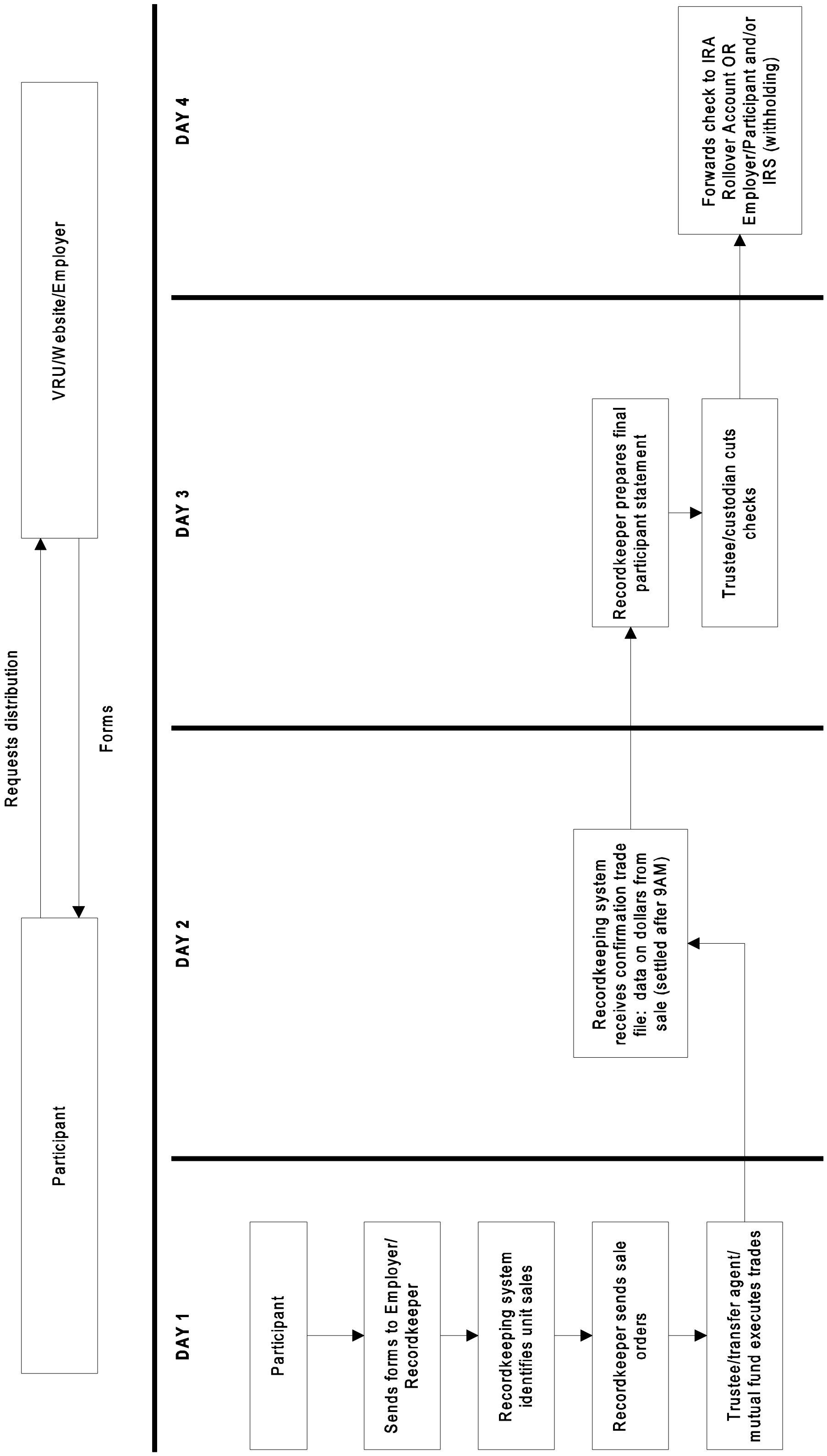
Employer has external payroll function. Recordkeeper, trustee, trading partner and transfer agent are all separate entities. All information from recordkeeper goes through Trustee.



## Exhibit 12-B: Distribution Processing

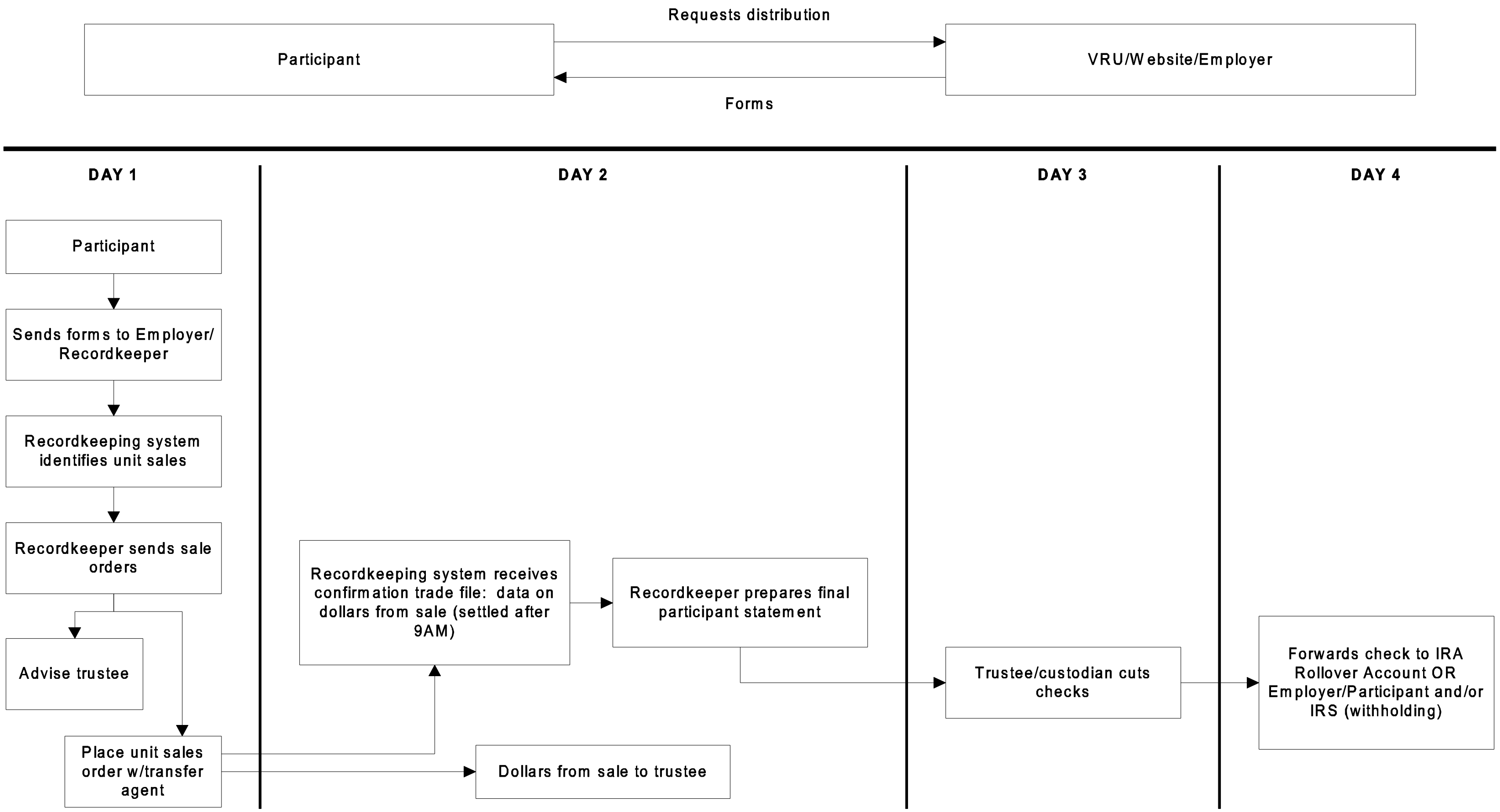
**Distribution Processing Example #1**

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.



## §12.10 Key Terms

**Dollar Certain:** The part of the transaction that is known and does not change is dollars.

**Dollar Certain Purchase:** The buying of shares with reference to the dollars to be invested.

**Dollar Certain Sale:** The selling of shares to result in cash proceeds from the sale of a specific dollar amount.

**Short Term Redemption Fees**: Fees imposed by a fund company when a shareholder redeems its shares within 7 days of purchase. The redemption fee may be up to 2 percent of the value of the shares redeemed shortly after their purchase.

**Trade File:** The file sent to the trading partner that summarizes the trade information.

**Trailing Contributions:** Contributions that are submitted to the recordkeeper after a participant has already taken a complete 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.

**Unit Certain Purchase:** Requires buying an exact number of shares.

**Unit Certain Sale:** Involves selling a precise number of shares of a fund.

### §12.11 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. After trades are executed, the recordkeeper receives confirmation and the shares purchased are then allocated to individual participants, with automated response units 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.

**§12.12 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 trading errors in their accounts.

______ 4. A dollar certain transaction is one where the dollars are the part of the transaction that is known and does not change.

______ 5. A unit certain transaction is one where the shares are the part of the transaction that is known and does not change such as when a distribution of 100% of the account balance occurs in daily valuation.

**[B] Multiple Choice**

6. 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

7. All of the following may result when correcting adjustments with a negative contribution, **EXCEPT**:

   A. The industry standard for handling gains or losses from processing negative contributions should be applied.
   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 unit sale may generate more or less cash than the original transaction.
   E. Manual adjustments in addition to system fixes may be required.

8. Which of the following statements regarding transfer requests is/are **TRUE?**

   I. A participant that requests a sale of 1000 shares of Fund A and that it is reinvested so that it purchases 500 shares of Fund B is requesting a percent-to-percent transfer.
   II. A participant that requests a transfer so that the account balance is invested 25% in fund A, 30% in Fund B and 45% in Fund C is requesting a realignment transfer.
   III. A participant that sells $5,000 from Fund E and requests that $3,000 of the proceeds be reinvested in Fund C and $2,000 in Fund A is requesting a dollar-to-dollar transfer.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

9. All of the following create contribution processing issues that occur in daily valuation, **EXCEPT**:

   A. A contribution received for a participant who requests a loan
   B. A contribution received from an ineligible participant
   C. A contribution received from a participant who terminated employment and has already been paid out
   D. A contribution deposit amount that is different than data file received
   E. A contribution received for a participant that has a missing investment election

10. Which of the following is/are dollar certain sales in a daily valuation plan?

   I. A total distribution
   II. Most hardship withdrawals
   III. Most loans

   A. I only
   B. III only
   C. I and II only
   D. II and III only
   E. I, II and III

11. Which of the following statements regarding processing loan payments is/are **TRUE**?

    I. Loan payments received electronically from the plan sponsor need to identify which loan the payment applies to when a participant has more than one outstanding at a time.
    II. Most participants make loan repayments from their personal checking accounts.
    III. The final loan payment generally will tie to the amount reflected as the final loan payment on the recordkeeping system.

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

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

    A. Purchasing a specified number of shares is a unit certain purchase.
    B. Selling a specified number of share is a unit certain sale.
    C. Buying shares with a specified dollar amount is dollar certain purchase.
    D. Selling shares to generate cash proceeds of a specified dollar amount is a dollar certain sale.
    E. Every transaction has only two parts, the shares and the dollars.

**§12.13 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. §12.05 [A]

2. **True.** A trailing contribution is when a contribution is made for a participant who has already taken a distribution from the plan. §12.08 [C]

3. **False.** Procedures should be in place to identify most trading errors in participant accounts. §12.08[D]

4. **True**. A transaction can be dollar certain, that is, the dollars are the part of the transaction that is known and does not change. The most common dollar certain purchase involves investment of contributions. §12.03

5. **True**. A transaction can be unit certain with the shares being the part of the transaction that is known. This type of trade occurs when a terminated participant is being paid out the participant's vested benefits or if a participant requests a complete transfer out of an investment. §12.03

6. The correct answer is **D.** §12.04

   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.

7. The correct answer is **A.** §12.08 [E]

   A. Correct. This statement is false because there is no industry standard for handling gains or losses from processing negative contributions.
   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 may be deposited to the trust account.
   D. Incorrect. This statement is true because correcting a negative contribution via a unit sale may generate more or less cash than the original transaction.
   E. Incorrect. This statement is true because when correcting a negative contribution manual adjustments in addition to system fixes may be required.

8. The correct answer is **D**. §12.05

   A. Incorrect because statements II and III are true.
   B. Incorrect because statement III is also true.
   C. Incorrect because statement I is false.
   D. Correct because statements II and III are the only true statements.
   E. Incorrect because statement I is false.

9. The correct answer is **A**. §12.08

   A. Correct. This statement is false because a contribution received for a participant who requests a loan does not affect contribution processing.
   B. Incorrect. This statement is true because a contribution received from an ineligible participant does create contribution processing issues.
   C. Incorrect. This statement is true because a contribution received from a participant who terminated employment and has already been paid out does create contribution processing issues.
   D. Incorrect. This statement is true because a contribution deposit amount that is different than data file received does create contribution processing issues.
   E. Incorrect. This statement is true because a contribution received for a participant that has a missing investment election does create contribution processing issues.

10. The correct answer is **D**. §12.03

   Statement I is false because it is necessary to sell all units/shares when a total distribution is being made thus the unit/shares are the known portion of the transaction not the dollars.
   Statements II and III are true.

   A. Incorrect because statements II and III are true.
   B. Incorrect because statement II is also true.
   C. Incorrect because statement I is false.
   D. Correct because statements II and III are the only true statements.
   E. Incorrect because statement I is false.

11. The correct answer is **A**. §12.08[F]

    Statement I is true.
    Statement II is false because most loans are repaid through payroll withholding.
    Statements III is false because generally the final loan payment will not tie to what the recordkeeping system reflects.

    A. Correct because statements I is the only true choice.
    B. Incorrect because statement III is false.
    C. Incorrect because statement II is false.
    D. Incorrect because statements II and III are false.
    E. Incorrect because statement II and III are false.

12. The correct answer is **E**. §12.03

    A. Incorrect. This statement is true because purchasing a specified number of shares is a unit certain purchase.
    B. Incorrect. This statement is true because selling a specified number of shares is a unit certain sale.
    C. Incorrect. This statement is true because buying shares with a specified dollar amount is a dollar certain purchase.
    D. Incorrect. This statement is true because selling shares to generate cash proceeds of a specified dollar amount is a dollar certain sale.
    E. Correct. This statement is false because a transaction has three parts the dollars, shares and price per share.

# Chapter 13
## Trading Errors and Corrections



### §13.01 Learning Objectives

- Identify when and how trading errors may occur in the daily valuation environment.
- Identify ethical concerns when correcting common trading errors in the daily valuation environment.
- List the benefits of having a service agreement between the service provider and the plan administrator.

### §13.02 Introduction

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; and
3. Trades that should not have been executed were.

For each trading problem category, the following sections outline ways to avoid trading errors, identify when trading errors have occurred, and explore how to correct the trading error and who may be liable.

Finally, trading accountability, error liability and ethics are discussed.

## §13.03 Examples

### [A] Trades That Were Executed Incorrectly

Examples of situations where trades were executed incorrectly include, but are not limited to:

- The sponsor's contribution file indicates a participant made an elective deferral of $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 allocations 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 automated response unit that are not processed (due to a system error, human error or trading partner error).
- A participant errs in initiating a transfer via the automated response unit and doesn't know it but, as a result of the error, 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.
- Trades are rejected for some reason (*e.g.*, insufficient cash to fund a buy).

### [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 withdrawal is processed for a participant who is later determined not to be eligible for the hardship withdrawal.
- Ineligible participants begin making elective deferral contributions.
- A billable fee is deducted from the plan rather than billed to the plan sponsor.

## §13.04 Procedures and Systems to Monitor Trades

The best kind of error is one that never occurs. Thus it is important to explore the capabilities of the 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 correct, intended to be traded that day and confirmation the following day can be validated.

### [A] Procedures 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 do not 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 invested in a timely manner (*e.g.*, a contribution was deposited but the recordkeeper did not receive the electronic file indicating which participants were contributing and their amounts in order to process the investment allocation).
- Track participant initiated trades made via the automated response unit 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: Is it the right participant? Are the amounts correct? Are there any pending trades? Have balances been validated prior to transaction entry? Does distribution check reflect correct amount?
- Establish daily cash management procedures to be sure cash is in the right place at the right time for trades to be executed and disbursements made.
- Continually monitor the validity of the census 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 (*i.e.*, incorrect prices result in incorrectly valued trades that must be corrected later).
- Provide reports to the employer for periodic review of data.

### [B] Procedures to Identify 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 quickly. On any given day, the recordkeeper needs to know what was sent the prior day to compare that to what was confirmed, so as to identify activity that remains outstanding. Reconciliation then occurs daily to be sure all fund positions balance with those as reported by the 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 for an ineligible participant, or goes to the wrong participant's account, positions still balance so a reconciliation that compares the totals of individual transactions will not highlight the mistake. 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).
- Check for trade rejects.
- 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 fund shares, cash and loan balances daily.

Participants may also discover errors as they review statements or activity online. Establish procedures to gather, verify and correct errors identified by participants.

## §13.05 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, in the same financial position as he or she would have been had the trades been 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 was not invested for two weeks—at a time when the market was going up. The contributions ultimately purchased fewer shares at a higher price and market gains were forfeited. Ethically, the lost market gains should be restored to participants. 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 from the incorrect trades can be nominal, having little financial impact on the participant. It may be far more expensive administratively to correct the error than it is worth. In those instances, it may be appropriate for the plan sponsor or trustee to decide whether the corrections are warranted. Retirement plan administration firms also may establish and publish a financial correction standard 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 the daily trading system.

### [A] Correcting Trades That Were Executed Incorrectly

When a trade is executed incorrectly, corrective trades need to be made so the end result is the same as if the original trade was done properly. The participant should be made whole as if the error did not occur.

Here are some examples of how to correct trade errors:

- A participant's contribution was actually $20, but $200 was submitted. As a result, 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, so that 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 using a wrong price on the sale (*i.e.,* the wrong number of shares were sold to produce a given dollar amount to be transferred). The number of sold shares must be corrected to reflect the proper 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 ensuring that the number of shares at the end of the process are as they should be. The cost of buying or selling these shares almost always is different than the original cost.

### [B] Correcting 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 take place, with adjustments made as necessary based on what should have happened had the trade occurred when it was supposed to.

Here are some examples of how to correct trade errors that should have been executed but were not:

- 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 had the transfer been made when the participant expected. Apply the financial 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 is forwarded to the trading partner for deposit, but the sponsor does not provide the recordkeeper with the deposit breakdown. If the recordkeeper is diligent in following up for the breakdown, there should not be a need for any corrective trades.

### [C] Correcting Trades That Should Not Have Been Executed

When it is discovered that a trade was executed when it should have not been, the trades need to be corrected as necessary so that the result is as if the trades had never occurred.

Here are some examples of how to correct trades that were executed when they should not 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 processed for a participant who is later determined not to be eligible for the hardship withdrawal. The shares sold must be repurchased after the participant has returned the money. The amount required to repurchase may be more or less than the original proceeds of the sale.
- Ineligible participants begin making elective 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 to pay the fee 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.

## §13.06 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 does not 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, because the sponsor's actions caused the failure to timely invest. 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 for the recordkeeper to 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 should have checked eligibility and did not, thereby allowing 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 in the next section of 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, neither the service provider nor the plan sponsor should benefit from the transaction. It may be reasonable for the plan sponsor to use any gains 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. The handling of these funds is subject to fiduciary rules that require plan assets be used for the exclusive benefit of participants; thus any gains resulting from transactions in error cannot be used to benefit the plan sponsor.

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.

## §13.07 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.

### [A] Litigation and Claims

Retirement plan administration firms and other service providers are vulnerable to litigation and claims by their clients and, on occasion, participants or beneficiaries. 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 for a service provider to manage expectations and control its liability is through a carefully drafted service agreement.

A majority of the claims against service providers 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 vary, depending on the basis of the claim, but may include any loss actually sustained by the plan, the plan sponsor, or a participant and any additional damages (including, in the case of negligence or professional malpractice, punitive 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 other violation of ERISA). 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, and jury trials are generally unavailable. An arbitration clause in a service agreement does not govern the resolution of these matters. While damages are available for a fiduciary breach, recovery for participation in a violation of ERISA by a nonfiduciary is limited to equitable relief, which may include the disgorgement of any profit or fees obtained from the plan, or nonmonetary relief, such as an injunction or specific performance.

### [B] 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.

#### 1. ERISA §404(c) Liability

Participant directed defined contribution plans are frequently designed to comply with ERISA §404(c), in order to shift the liability for loss due to investment performance from the plan fiduciary to participants. Both plan documentation and actual plan operations must conform to the Department of Labor regulations for the liability to be shifted from the normal plan fiduciaries to the participants.

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. Two concerns are paramount: (1) all fees charged to plan participants must be reasonable, and (2) participants must not be charged for settlor functions (*i.e.*, functions that are the responsibility of the plan sponsor rather than the plan, itself). 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, paying for things that the plan sponsor actually owes.

One method that may ensure that only proper fees are paid by the plan 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 the payment of some amount is not a prohibited transaction, ethics and good business practice may require the disclosure of such fees to the plan trustees and the affirmative decision by the trustees that the payment of such fees by the plan is appropriate. 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.

Trading responsibilities should address when trades will be placed. Service agreements may require that 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.

### 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 cash from a sale being collected 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 an automated 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.

## §13.08 Key Terms

**Service Agreement:** An agreement that designates the allocation of responsibilities among all of the parties involved in the operation of the plan.

## §13.09 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 exists.

- 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.

## §13.10 Review Questions

### [A] True or False

_______1. A service agreement should make the plan administrator responsible for all trading errors.

_______2. A participant should be able to keep any contribution made in error to the participant's account.

_______3. When correcting trading errors, reasonable and ethical common sense should prevail when determining who is accountable for the error.

_______4. A service agreement should include a statement that the plan administration firm's services cannot guarantee compliance with ERISA §404(c).

_______5. A benefit of a service agreement is that it creates a way to camouflage the revenue a service provider receives from mutual funds.

### [B] Multiple Choice

6. 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.

7. 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. Responsibility for selecting investment options in compliance with ERISA §404(c)

8. All of the following are ways to avoid trading errors, **EXCEPT**:

   A. Oversee the automated response unit 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

9. Which of the following statements regarding how trading errors may occur is/are TRUE?

   I. The use of fund prices that have not been audited may cause an incorrect number of shares to be sold on the sell side of a dollar transfer.
   II. A service fee is billed to the plan instead of to the plan sponsor causing participants' accounts to have lower values.
   III. A dividend is allocated twice causing a distribution to a participant to be higher than it should have been.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

10. All of the following are reasons that trading errors occur in daily valuation processing, EXCEPT:

    A. A fee processed for payment from the plan that is owed by the plan sponsor
    B. A fund over priced on a transfer
    C. A distribution processed upon receipt of request
    D. A dividend is allocated twice
    E. A distribution processed multiple times

11. Which of the following statements is/are ethical concerns when correcting trading errors?

    I. The time and cost involved to correct a trade may be more than the financial impact on the participant, thus a decision needs to be made whether to make a correction.
    II. A contribution that was not processed timely and the market declined during the delay resulting in more shares purchased then would have had it been traded timely, thus a decision needs to be made whether to make a correction.
    III. The end result of the correction should assure the participant is not negatively affected by the error.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

12. All of the following are ways to identify when trading errors occur, EXCEPT:

    A. Check for trade rejects
    B. Validate data to see whether ineligible participants made a contribution
    C. Reconcile participant salaries to Form W-2s.
    D. Reconcile fund positions and cash daily
    E. Identify pending activity for trades that should have been executed but were not

### §13.11 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. §13.07

2. **False.** Trading errors should be corrected. §13.05

3. **True.** When correcting trading errors reasonable and ethical common sense should prevail when determining who is accountable for the error. §13.06

4. **True**. Participant directed defined contribution plans are frequently designed to comply with ERISA §404(c), in order to shift the liability for loss due to investment performance from the plan fiduciary to participants. 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. §13.07 [B] 1

5. **False**. 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. §13.07 [B] 2

6. The correct answer is **A.** §13.05

   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.

7. The correct answer is **D.** §13.07

   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 responsibility for selecting investment options in compliance with ERISA §404(c) is an issue addressed by a service agreement.

8. The correct answer is **D.** §13.04

   A. Incorrect. This statement is true because overseeing the automated response unit 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.

9. The correct answer is **E**. §13.03

   A. Incorrect. Statements II and III are also true.
   B. Incorrect. Statements I and III are also true.
   C. Incorrect. Statement II is also true.
   D. Incorrect. Statement I is also true.
   E. Correct. All statements are true.

10. The correct answer is **C**. §13.03

    A. Incorrect. This is true because trading errors occur in daily valuation plans due to processing fees for payment from the plan that are owed by the plan sponsor.
    B. Incorrect. This is true because trading errors occur in daily valuation plans due to a fund being over priced on a transfer.
    C. Correct. This is false because trading errors do not occur in daily valuation plans just because a distribution is processed upon receipt of request.
    D. Incorrect. This is true because trading errors occur in daily valuation plans due to a dividend being allocated twice.
    E. Incorrect. This is true because trading errors occur in daily valuation plans due to a distribution being processed multiple times.

11. The correct answer is **E**. §13.05.

    A. Incorrect. Statements II and III are also true.
    B. Incorrect. Statements I and III are also true.
    C. Incorrect. Statement II is also true.
    D. Incorrect. Statement I is also true.
    E. Correct. All statements are true.

12. The correct answer is **C**. §13.04[B]

    A. Incorrect. This is true because checking for trade rejects is a way to identify when trading errors have occurred.
    B. Incorrect. This is true because validating data to see whether ineligible participants made a contribution is a way to identify when trading errors have occurred.
    C. Correct. This is false because the Form 1099R is not used when making trades.
    D. Incorrect. This is true because reconciling fund positions and cash daily is a way to identify when trading errors have occurred.
    E. Incorrect. This is true because identifying pending activity for trades that should have been executed but were not is a way to identify when trading errors have occurred.

## §13.12 Supplemental Education

**Publications:** Below is a listing of additional publications specific to topics found in this chapter. These resources are neither required reading nor do they provide additional information to be tested. They are listed for those who may want more detail on a topic. The listing includes only those publications that are free and may be found on the Web.

1. Articles relevant to this chapter can be found at the ASPPA Web site:

    "Practical ERISA 408(b)(2) Guidance for Service Agreements" by Laura S. Moskwa, CPC, QPA and Carlos Panksep in *The ASPPA Journal*, Spring 2011, Vol. 41. No 2.

# Chapter 14
## Conversion Decisions and Issues



### §14.01 Learning Objectives

- List data needed and the time frame involved when converting from one retirement plan administration firm to another.
- Describe the various decisions involved when converting from balance-forward to daily valuation.

- Describe a blackout notice and to whom and when it is provided.
- Explain the impact a conversion has on various transactions types, *e.g.*, contributions, transfers, withdrawals, both during and after conversion.

### §14.02 Introduction

The Department of Labor states, in the "Private Pension Plan Bulletin – Abstract of 2008 Form 5500 Annual Report" published December 2010, that "... in 89.4% of 401k plans, participants direct the investment of all or a portion of the assets in their account." As asset size increases and participants demand current asset information and investment flexibility, more plans convert to daily valuation. However, it is the retirement plan administration firm that comes under pressure to convert the plan records to the daily software quickly.

The transfer of participant data from balance-forward into daily valuation can be a difficult process that may take many months to complete. 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, review the conversion results on a sufficient sampling of participants and be sure assets reconcile after the conversion.

### §14.03 Conversion Decisions and Setting Expectations

When a plan sponsor decides to change from one service provider to another or convert from balance-forward to daily valuation, the process of transferring existing plan records to the new system marks the first real opportunity for the plan sponsor 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 unit 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. 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 participants' dates of birth and hire, salary, contribution amounts, transfer balances and amounts available for hardship withdrawal.

Other items are more commonly provided in hard copy, including the plan document, summary plan description, current participant loan documents, asset statements and Form 5500 reports. Although, if this information can be provided electronically, in a manner that is acceptable to the new recordkeeper, it is preferable to reduce the amount of hard document storage and allow multiple users access to the information at the same time.

It is critical to the success of the conversion and ongoing operation of the plan that all of the information requested be provided by the former retirement plan administration firm to the new firm responsible for recordkeeping.

### [B] Conversion Timelines

There are many tasks that must be performed by the plan sponsor, as well as by the new and prior retirement plan administration firms, to make a conversion successful. A conversion 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 Section 14.05, Exhibit 14-A, 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. The plan document should reflect all methods used.
- Distributions in daily plans are generally made more frequently than in balance-forward plans and use a current value. Language should be reviewed to make sure it allows for the faster distribution based on the 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 frequency should be addressed in the plan document.
- 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

Having standard procedures are an absolute necessity for the conversion operation to be efficient. This is especially true in the daily valuation environment. Many firms have created manuals for the 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. Daily valuation plans would report the profit sharing contribution only when deposited. 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.
- Similar to elective deferrals and loan payments, 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 gains 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 on December 31 due to the distribution. Looking at their December 31 statement, the participant thinks a loss has occurred in the asset. 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] Automated Response Unit Capabilities

The conversion team explains the options available to the participants and plan sponsor under the automated response units available to be used. Based on the cost of these systems and sophistication of the participants, the plan sponsor must decide which systems to offer and what options within the systems to make available.

Systems vary, but most automated response units have features to enable the participants to:

- Obtain 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 obtain other announcements about the plan.

The plan sponsor may not want to offer all of these features. For example, sometimes, the retirement plan administration firm does not have sufficient data to enable the recordkeeping system to 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, so the plan sponsor may want these options turned off. The plan sponsor must also understand how frequently the data is updated (or refreshed) and when transfer requests or election changes are processed.

There may be an additional cost to offer live operators, so the plan sponsor must evaluate the cost versus the benefit of having live response as opposed to automated response availability.

### [G] Participant Statement Format

The plan sponsor may be curious about what the participant statement looks like and what information is provided. Most recordkeepers offer a standard statement or choice of statement layouts.

Depending on the options available, decisions to be made may include:

- 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, provided the system can track this and the employer can provide the data?
- Does the plan sponsor want compensation, beneficiary designations, investment elections 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?
- Are options available for electronic delivery? If so, how will participants be accommodated who do not have Internet access?
- 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 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 represent a close approximation for the participant and are a good measure of performance, but they are not really the actual rate of return for the participant.

Some service providers include 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 and fund combination. These individualized calculations 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 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 frustrates 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.

### [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 on the specific match formula, the compensation definition used to calculate the match and the period over which compensation and elective deferrals are considered. This may require true-up calculations 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 based on the elective deferrals made for the entire plan year, but the payroll system calculates 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. The retirement plan administration firm and the plan sponsor should discuss who will pay the fees and how. It is important also to determine whether fees are paid in advance and how frequently fees are invoiced, as well as to have a written service agreement stating the specific fees that are to be charged by the retirement plan administration firm. It should also be determined whether fees should be paid from forfeitures or deducted from all participant accounts or if specific fees are paid out of a specific participant's account.

### [K] Loans to Participants

The plan sponsor must decide if participant loans are to be offered. If so, questions that must be answered in relation to the loan program include:

- How are loans initiated? Does the participant complete a written loan request form, call the IVR, log onto the Web site or verbally communicate with the plan sponsor?
- Who checks the loan limits, determines the applicable interest rate, and 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 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, 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? Who will initiate and authorize the payroll deduction process?
- Are loans limited to 50 percent 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?

## §14.04 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 period** is 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. A blackout can occur during a conversion from one retirement plan administration firm to another, conversion from balance-forward to daily valuation or during a fund liquidation.

The length of the blackout period during a conversion depends on how quickly the changes 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.

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 hardship withdrawals or other distributions to terminated participants are processed. Similarly, participants may not request fund transfers or participant loans.

Employers are required to provide participants and beneficiaries affected by a blackout period with an advance notice prior to the upcoming blackout period. There is a civil penalty imposed should a plan sponsor fail to provide this notice in a timely manner. There are some situations that do not require a blackout period notice, such as a suspension of activity in a participant's account as a result of a qualified domestic relations order (QDRO).

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 can exercise their affected rights immediately before the blackout period begins. Several exceptions to these notice rules 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 blackout notice rules:

- The notice beginning and ending dates may use the calendar week during which the blackout will begin and end, 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 Web site 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.
- A person's name or a department responsible for answering questions must be provided to the participant to contact for further information.
- 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, such as due to a QDRO provision, would not trigger the requirement for a blackout notice.
- Directors and executive officers are prohibited from dealing in employer securities that are held outside of the plan but were obtained in relation to their employment with the company during a blackout period in which participants and beneficiaries are restricted from trading employer securities that are in the plan. The prohibition generally does not apply to small, privately held companies.
- If there is a change in the blackout period, a supplemental notice must be provided to affected participants as soon as practicable.

### [B] Turnaround Times

During the blackout period, the time it takes to process transactions, including new contributions, or to generate and deliver reports 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. The plan sponsor provides the new retirement plan administration firm with an electronic file that tells its 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 is 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 its receipt of the first contribution file. To keep the blackout period to a minimum, a default investment may be selected for those participants who fail to make a selection. It is a common practice to have the plan sponsor submit a test contribution file to the retirement plan administration firm to enable it 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 that is accomplished, the plan sponsor wires or mails the appropriate contribution amount to the trustee, custodian or directly to the investment house or mutual fund. Other firms prefer to have the funds and the electronic file sent at the same time.

While the new retirement plan administration firm may begin processing employer matching contributions and elective deferrals 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 noninterest 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, prior service provider and new service provider to complete the transition as quickly as possible.

### [D] Investment Elections

Changes to investment elections that apply to future contributions 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 elections can be made in increments of fractional percentages, whole percentages or only in 5 percent or 10 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 reports are affected by the length of the blackout period.

The blackout period is dependent in large part on:

- The date the new retirement plan administration firm receives the electronic file from the prior retirement plan administration firm with the account balance information;
- The date the new 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. To include such information, the plan sponsor must be willing and able to provide this information upon conversion and on an ongoing basis.

### [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, who prepares the distribution checks and who remits the taxes, when applicable. 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 the method to request a distribution must be agreed upon (in writing or electronically via automated response units). 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 or on the automated response units. 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.

## §14.05 Exhibits

### Exhibit 14-A: 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. |

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|---|---|
| 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 until 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 + 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 | Automated response unit set up tested by retirement plan administration firm. |
| Qtr + 64 | Client tests automated response unit and approves. |
| Qtr + 70 | Client and new retirement plan administration firm conduct employee meetings to address automated response unit, new employee statement and daily features. |
| Qtr + 71 | New retirement plan administration firm activates automated response unit. Participants can request transfers, changes to investment elections and obtain other information. |
| Qtr + 72 | New retirement plan administration firm processes automated response unit 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. |

## §14.06 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, obtain loans or obtain 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.

## §14.07 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 automated response units, participant statement format, investment decisions, calculation 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 Web site that participants may access to get the specific beginning and ending dates.

### §14.08 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.

______ 3. During the blackout period participant termination distributions are not processed.

______ 4. Changes to investment elections that apply to future contributions can be implemented during the blackout period.

______ 5. Contributions are processed during the blackout period.

### [B] Multiple Choice

6. 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 automated response unit
   D. A timeline to keep all parties on the same track
   E. Form 5500 reports

7. 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 needed?
   E. What is the match formula stated in the plan document?

8. 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

9. 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. Automated response unit capabilities to offer
   E. The architectural design of the retirement plan administration firm's office

10. Which of the following statements regarding the blackout notice issued during a plan conversion is/are **TRUE**?

    I. The notice may be provided by electronic means.
    II. Furnishing a notice to the last known address of a participant or beneficiary is sufficient to comply with the notice requirements.
    III. Calendar days, and not business days, are to be used when counting days regarding a blackout period.

    A. II only
    B. III only
    C. I and II only
    D. I and III only
    E. I, II and III

11. All of the following affect the length of time it takes to do a conversion and end the blackout period, **EXCEPT**:

    A. How long it takes for the new recordkeeper to receive the data from the prior recordkeeper
    B. How long it takes the plan sponsor to process payroll
    C. Whether the valuation is performed on a cash or accrual basis
    D. Whether the valuation reconciles to the assets
    E. Whether the account balance information is provided electronically or on paper

12. All of the following are features in the plan document that should be reviewed, as a result of a balance-forward to daily conversion, to determine if the language needs to be revised, **EXCEPT**:

    A. The earnings allocation method
    B. The date matching contributions are allocated
    C. The optional forms of benefit payments
    D. The frequency of investment transfers
    E. The valuation date

## §14.09 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. §14.04 [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. §14.04 [A]

3. **True**. All sale transactions are put on hold until the blackout period ends. This includes transfers, hardship withdrawals, termination distributions and new loan requests. §14.04 [A]

4. **True**. Changes to investment elections that apply to future contributions can be received and put into effect during the blackout period. §14.04 [D]

5. **True**. Plan contributions do not come to a halt just because a plan's recordkeeping is in transition from one service provider to another. §14.04 [C]

6. The correct answer is **C.** §14.03[A] and [B]

   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 automated response unit 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.

7. The correct answer is **A.** §14.03 [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.

8. The correct answer is **D.** §14.04 [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.

9. The correct answer is **E.** §14.03

   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 automated response unit capabilities to offer are important considerations when changing administrative firms.
   E. Correct. This statement is false because the architectural design of the retirement plan administration firm's office is generally not an important consideration when changing administrative firms.

10. The correct answer is **E.** §14.04 [A]

   A. Incorrect. Statements I and III are also true.
   B. Incorrect. Statements I and II are also true.
   C. Incorrect. Statement III is also true.
   D. Incorrect. Statement II is also true.
   E. Correct. All statements are true.

11. The correct answer is **B.** §14.04[E]

    A. Incorrect. This is true because how long it takes for the new recordkeeper to receive the data from the prior recordkeeper does affect the length of time it takes to do a conversion and end the blackout period.
    B. Correct. This is false because how long it takes the plan sponsor to process payroll does not affect the length of time it takes to do a conversion and end the blackout period.
    C. Incorrect. This is true because whether the valuation is performed on a cash or accrual basis does affect the length of time it takes to do a conversion and end the blackout period.
    D. Incorrect. This is true because whether the valuation reconciles to the assets does affect the length of time it takes to do a conversion and end the blackout period.
    E. Incorrect. This is true because whether the account balance information is provided electronically or on paper does affect the length of time it takes to do a conversion and end the blackout period.

12. The correct answer is **C.** §14.04[C]

    A. Incorrect. This is true because the earnings allocation method does need to be reviewed when converting from balance-forward to daily.
    B. Incorrect. This is true because the date matching contributions are allocated does need to be reviewed when converting from balance-forward to daily.
    C. Correct. This is false because the optional forms of benefit payments do not need to be reviewed when converting from balance-forward to daily.
    D. Incorrect. This is true because the frequency of investment transfers does need to be reviewed when converting from balance-forward to daily.
    E. Incorrect. This is true because the valuation date does need to be reviewed when converting from balance-forward to daily.

### §14.10 Supplemental Education

**Webcourses:** ASPPA offers webcourses on the RPF-1 and RPF-2 materials. These webcourses provide introductory training for new employees and help prepare RPF-1 and RPF-2 exam candidates for the most challenging topics covered on the respective examinations. Webcourses offer many benefits to individual and companies alike:

- Self-paced: Review information at your own pace.
- Flexibility: View the courses from any location with an Internet connection.
- Continuing education: Earn continuing education credit for ASPPA credentials.

There are seven webcourses for RPF-1 and seven webcourses for RPF-2. Each set can be purchased on the ASPPA Web site. Each webcourse is divided into two modules. To register for the webcourses visit www.asppa.org/webcourse.

Webcourses relevant to this chapter:

- Conversions: Decisions and Issues; Types and Methods (four modules)

# Chapter 15
## Conversion Types and Methods



### §15.01 Learning Objectives

- List the three types of investment strategies used during daily to daily conversions.
- Explain common reasons for a difference between the ending balance from the prior trustee and the amount of assets received by the new trustee during a conversion.
- State the five major reasons that balance-forward to daily conversions are the most challenging to complete.

### §15.02 Introduction

There are three types of defined contribution conversions:

1. Daily valuation to daily valuation;
2. Balance-forward to daily valuation; and
3. Balance-forward to balance-forward.

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 recordkeeping method currently being used and the investment strategy employed.

The two recordkeeping methods are daily valuation and balance-forward. The three types of investment strategies used during conversion are: total asset liquidation, mapping of funds and recordkeeping only conversion 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 recordkeeping method is converted and the investment strategy is decided. In addition, plans converting from balance-forward to daily often involve the transition from the trustee directed to participant direction.

## §15.03 Recordkeeping Methods

A plan already using daily valuation recordkeeping must, by its very operation, be maintained on an automated response unit to allow participants of a defined contribution plan to direct the investment of their account balances. All professional daily valuation recordkeeping systems account for participant balances in a matrix that matches two attributes to each account; money types and funds. 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 funds reflect the participant investment choices recorded in the account.

Saying a plan uses balance-forward recordkeeping 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. In very small plans, records may be maintained with pencil and paper on ledgers. Those plans that are not automated usually do not offer participant investment direction.

Whatever the recordkeeping method, it is this 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 system to a daily valuation system. A balance-forward conversion often involves the introduction—for the first time—of participant direction of investments.

## §15.04 Investment Strategies

There are three types of investment strategies used during conversions. They are total asset liquidation, mapping of funds and recordkeeping only conversions.

1. Total Asset Liquidation

This investment conversion involves:

- Liquidation of all assets;
- Transfer of the resulting cash to the new trustee or custodian; and
- The deposit of the cash to a money market fund.

Generally, the cash is held in a 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. However, if the period of time for the reconciliation of all data is just a day or two, the cash may sit uninvested until it is reinvested in the new funds.

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 transferred assets. Income must be allocated to the type of money that generated it.

2. Mapping of Funds

Fund mapping liquidates all assets and immediately invests the proceeds into the new fund options that are most similar to the old options. 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 15-1. 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, bond fund to bond 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 valuation with the same retirement plan administration firm. Assets may be re-registered with a different custodian, but not liquidated.

### §15.05 Daily to Daily Conversions

Conversion of a plan from one service provider to another already using daily valuation is easier and more quickly accomplished than a plan using balance-forward recordkeeping. This is due to:

- The plan sponsor and the participants already being educated and comfortable with daily valuation;
- The valuation is available almost immediately from the prior retirement plan administration firm; and
- The prior retirement plan administration firm's valuation is performed on a cash basis.

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 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 prior retirement plan administration firm completes its valuation work and sends the electronic valuation file to the new retirement plan administration firm, reflecting the participants' account balances by source and fund on a cash basis (rather than on an accrual basis).

Step 4. The new retirement plan administration firm uploads the account balances onto its daily software.

Step 5. The conversion money market funds are liquidated and invested based on the participants' new investment directions.

While the new recordkeeper is waiting on the prior retirement plan administration firm to send the participant balance information, ongoing participant contributions must be invested. The contributions can be processed on the new daily system when the cash is received by the trustee/custodian. The cash is then invested into funds based on the participant investment elections.

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 participant 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 participants' balances 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 difference:

- The prior trustee deducted its fees from the assets before transfer but the expense did not get reflected on the valuation report. Thus, fewer assets were actually received by the new trustee than shown on the prior plan administration firm's valuation 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 service providers reflect the forfeiture amount as a fictitious participant, named Forfeiture Management Account or Mr. Forfeiture, on the valuation. Others track the amounts forfeited separately from the valuation report. If forfeitures are tracked separately, then the valuation report does not tie to the total assets received, causing a balancing issue.
- Assets being liquidated may carry surrender fees or contingent deferred sales charges that may reduce assets.
- The plan may have received contributions and/or 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 participant account balances, the conversion balances are uploaded to the daily software, by participant and by source.

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 automated response unit 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 automated response unit.

### [B] Mapping of Funds

The second investment conversion method is the mapping method, where the prior funds are sold and the cash immediately invested in the corresponding new funds. For example, suppose the plan has investments in the ABC Index Fund. The ABC Index Fund 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 prior funds is mapped to a fund with investment objectives similar to the prior one.

The mapping is communicated to the participants so they know what the new funds are and how their monies are to be reinvested. The participants do not make new investment elections during the conversion process.

Let's analyze this process in more detail. The following steps occur:

- The prior trustee liquidates the funds prior to the end of the valuation period;
- The cash is wired to the new trustee, together with a written report indicating the separate liquidation value of each fund; and
- The new trustee invests the funds based on the mapping instructions from the plan sponsor.

A conversion management 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 participant 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 prior funds are reinvested and posted to the appropriate fund in the conversion management account. The plan can be updated and priced every day just as though it is already out of the conversion period.

When the participant 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 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.

After the participant 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 automated response unit can be turned on and participant statements created. The plan is then considered out of the conversion period and back to being live.

### [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 participant account balance information by source and fund, 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.

## §15.06 Balance-Forward to Daily Conversions

A balance-forward to daily conversion is the most challenging to complete due to 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 automated response units, 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 must be clear, 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. In some cases, the client and the financial advisor must be enlisted to help obtain the data that will be needed to keep the plan moving forward.

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 are similar to activities described for the daily to daily conversions, but the processes themselves may take 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 difference exists, the assets must be reconciled. Depending on the nature of the discrepancies, decisions are made as to who makes the corrections.

A balance-forward plan that has allowed participant investment direction can follow the same three investment strategies when converting to daily valuation as described in the daily to daily conversions. A balance-forward plan that is trustee directed and is adding a 401(k) feature along with participant direction at the same time it is converting to daily valuation presents additional issues. They include:

- Educating participants about investment options and collecting their investment election forms;
- Educating participants about the benefits of saving for their retirement;
- Timing of existing asset liquidations;
- Consideration of assets that are not easily liquidated; and
- Lengthening of the conversion time line from 60 to 90 days due to the length of time it takes to complete the balance-forward valuation.

Due to the complexity of these issues, they will be discussed in a higher level course.

### §15.07 Balance-Forward to Balance-Forward Conversion

A plan using a balance-forward recordkeeping method that is in a conversion process and is keeping its balance-forward recordkeeping method is generally just changing retirement plan administration firms. The assets may or may not be changing. There are several reasons why a plan sponsor may decide to have a new service provider administer the plan. They include:

- Faster turnaround time;
- Quality of the services;
- Cost of the services;
- Additional services offered; and
- Personal relationships.

A balance-forward to balance-forward conversion where the trustees direct the investments will be easier than those that offer participant direction. Due to the length of time it takes to complete a balance-forward valuation, the conversion period will be longer than that of a daily-to-daily conversion.

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.

### §15.08 Review of Key Concepts

- There are three types of defined contribution plan conversions:
  1. Daily to daily;
  2. Balance-forward to daily; and
  3. Balance-forward to balance-forward.

- There are two types of recordkeeping methods:
  1. Daily valuation recordkeeping; and
  2. Balance-forward recordkeeping.

- There are three types of investment strategies in a conversion:
  1. Liquidate all assets and deposit the cash in a holding account;
  2. Map assets to new funds; and
  3. Recordkeeping only conversion while maintaining current investments.

- 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 for five major reasons:
  1. Accrual to cash method of accounting;
  2. Dollar accounting to share accounting;
  3. Educating the plan sponsor and participants on the differences between balance forward and daily recordkeeping;
  4. High level of cooperation needed from the prior retirement plan administration firm for a smooth transition; and
  5. Handling of assets that will not be valued daily.

- 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.

- Moving from a trustee-directed to a participant-directed investment plan may add as much as 60 to 90 days to the conversion process.

### §15.09 Review Questions

#### [A] True or False

______ 1. One reason that 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 that 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.

______ 3. The two recordkeeping methods used in defined contribution conversions include actuarial valuations and daily valuations.

______ 4. One reason that converting from a trustee-directed to a participant-directed plan is challenging is because of having to educate participants about investment options and collecting their investment election forms.

______ 5. A plan sponsor with a plan using balance-forward valuations may decide to have a new service provider administer the plan to receive faster turnaround time and improve the quality of the services.

#### [B] Multiple Choice

6. All of the following need to be explained to the plan sponsor when converting a plan from balance-forward to daily recordkeeping, **EXCEPT**:

   A. Share accounting changes to dollar accounting
   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

7. All of the following are issues that arise when a balance-forward plan adds a 401(k) feature and participant direction at the same time it converts to daily valuation, **EXCEPT**:

   A. Participants must be educated about saving for their retirement.
   B. Participants must be educated about investment options.
   C. Existing assets may need to be liquidated
   D. The conversion period may be extended 60 to 90 days due to the time it takes to complete the balance-forward valuation.
   E. Participant compensation will be increased.

8. Which of the following statements regarding investment strategies used during daily to daily conversions is/are **TRUE**?

    I. Under the total asset liquidation method all assets are liquidated and typically deposited into a conversion money market fund until the prior service provider completes its valuation work and provides the new service provider with the participant account balance information.
    II. Under the mapping of funds method, all assets are liquidated and immediately reinvested into new funds with investment objectives that are similar to the prior funds.
    III. Under the recordkeeping only method, the number of shares reflected at the end of the valuation period must reconcile to the number of shares of each fund received by the Trustee.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

9. Which of the following statements regarding the recordkeeping methods used in conversions is/are **TRUE**?

    I. Balance-forward recordkeeping allows for the participants' accounts to be updated on a daily basis.
    II. Daily valuation recordkeeping tracks by participant their money types and investment choices.
    III. Daily valuation recordkeeping may be used when a plan allows the participants of a defined contribution plan to direct the investments of their account balance.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

10. All of the following statements regarding reasons the ending balance is different than the value of assets transferred during a conversion, are **TRUE, EXCEPT**:

    A. The old trustee was paid their fee from plan assets after the valuation date but before they were transferred to the new trustee.
    B. Forfeitures were tracked as a participant account.
    C. Loan payments were received from participants after the valuation date but before the transfer of assets.
    D. The plan may have received contributions from participants after the valuation date but before the transfer of assets.
    E. Assets were liquidated after the valuation date and realized gains or losses were not reflected.

11. Which of the following is/are investment strategies used during daily to daily conversions?

    I. Mapping of funds
    II. Recordkeeping only
    III. Asset Liquidation

    A. II only
    B. III only
    C. I and II only
    D. I and III only
    E. I, II and III

12. Which of the following is/are reasons for the ending balance to be different than the value of the assets transferred during a conversion?

    I. Fewer assets were received because the trustee withheld their fee from the assets after the valuation date but before transfer of the assets.
    II. Participants changed their investment elections for future contributions.
    III. The plan sponsor paid the trustee out of corporate assets.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

## §15.10 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. §15.05[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. §15.05[A]

3. **False.** The two recordkeeping methods used in defined contribution conversions are balance-forward valuations and daily valuation. §15.02

4. **True.** Educating participants about types of investments, their objectives, risk and return, or what is important given a particular age can be a challenging and overwhelming to participants who have never had the opportunity to invest their assets. In addition, tracking down investment election forms creates additional administrative work. §15.06

5. **True.** There are several reasons why a plan sponsor may decide to have a new service provider administer the plan including faster turnaround time, quality of the services, cost of the services, additional services offered and personal relationships. §15.07

6. The correct answer is **A**. §15.06

   A. Correct. This statement is false because when converting from balance- forward to daily the accounting method changes from dollars to shares.
   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.

7. The correct answer is **E**. §15.06

   A. Incorrect. This statement is true because participants must be educated about saving for their retirement so they can make an informed decision regarding their elective deferral amount.
   B. Incorrect. This statement is true because participants need to understand the investments being offered under the plan and the risk versus return on their choices.
   C. Incorrect. This statement is true because existing assets may need to be liquidated if the participants will be given other options to invest within.
   D. Incorrect. This statement is true because the length of time it takes to liquidate existing assets and complete the balance forward valuation does extend the conversion period in a balance forward to daily conversions when adding a 401(k) feature with participant direction.
   E. Correct. This statement is false because the compensation level of the participant is not increased because the employer implements a 401(k) feature or participant investment direction.

8. The correct answer is **E**. §15.05

   A. Incorrect. Statements II and III are also true.
   B. Incorrect. Statements I and III are also true.
   C. Incorrect. Statement II is also true.
   D. Incorrect. Statement I is also true.
   E. Correct. All three statements are true.

9. The correct answer is **D**. §15.03

   A. Incorrect. Statement I is false.
   B. Incorrect. Statement III is also true.
   C. Incorrect. Statement I is false.
   D. Correct. Statements II and III are true.
   E. Incorrect. Statement I is false.

10. The correct answer is **B.** §15.05 [A]

    A. Incorrect. This statement is true because paying a trustee fee after the valuation date but before transfer of the assets will reduce the assets from what is reflected on the valuation and cause a difference to be reconciled.
    B. Correct. This statement is false because tracking forfeitures as a participant account will reflect those assets on the valuation report.
    C. Incorrect. This statement is true because receiving loan payments after the valuation date but before transfer of the assets will increase the assets from what is reflected on the valuation and cause a difference to be reconciled.
    D. Incorrect. This statement is true because receiving contributions from participants after the valuation date but before transfer of the assets will increase the assets from what is reflected on the valuation and cause a difference to be reconciled.
    E. Incorrect. This statement is true because assets liquidated after the valuation date but before transfer of the assets will increase create a realized gain or loss from what is reflected on the valuation and cause a difference to be reconciled.

11. The correct answer is **E**. §15.04

    A. Incorrect. Statements I and III are also true.
    B. Incorrect. Statements I and II are also true.
    C. Incorrect. Statement III is also true.
    D. Incorrect. Statement II is also true.
    E. Correct. All three statements are true.

12. The correct answer is **A**. §15.05[A]

    A. Correct. Statement I is the only true statement.
    B. Incorrect. Statement II is false.
    C. Incorrect. Statement III is false.
    D. Incorrect. Statements II and III are false.
    E. Incorrect. Statements II and III are false.

### §15.11 Supplemental Education

**Webcourses:** ASPPA offers webcourses on the RPF-1 and RPF-2 materials. These webcourses provide introductory training for new employees and help prepare RPF-1 and RPF-2 exam candidates for the most challenging topics covered on the respective examinations. Webcourses offer many benefits to individual and companies alike:

- Self-paced: Review information at your own pace.
- Flexibility: View the courses from any location with an Internet connection.
- Continuing education: Earn continuing education credit for ASPPA credentials.

There are seven webcourses for RPF-1 and seven webcourses for RPF-2. Each set can be purchased on the ASPPA Web site. Each webcourse is divided into two modules. To register for the webcourses go to www.asppa.org/webcourse.

Webcourses relevant to this chapter:

- Conversions: Decisions and Issues; Types and Methods (four modules)

# Chapter 16
## Mergers and Terminations



### §16.01 Learning Objectives

- List the reasons plan sponsors might merge two retirement plans.
- Explain the difference between a frozen and a terminated qualified plan.
- Describe the ramifications of a partial termination and what causes one to occur.
- Describe the general requirements for terminating a qualified retirement plan.
- Describe the implications of terminating a plan covered by the PBGC.

### §16.02 Introduction

Plan sponsors may decide to terminate or merge certain retirement plans in their companies as a result of an acquisition or merger with another company. They may discontinue a plan due to a major downturn in their business and thus cannot afford to make contributions. The decision to terminate, merge or convert plans enables employers to eliminate expenses associated with maintaining the plans.

Plan termination is the final stage in the life of a qualified retirement plan. Whether voluntary or involuntary, 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 outdated and often costly plans. Also, when companies are acquired and multiple qualified retirement plans exist between the buyer and the target, the buyer may be forced by law under the successor plan rules to merge the plans rather than terminate one or more of them.

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 target'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 the transaction 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 target company. The employees do not change employers. They continue to work for the target. The target has different ownership now, but the target's 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 target has become a related employer to the buyer (*i.e.*, a member of a controlled group, affiliated service group or management group).

If it is determined that the target and the buyer are related employers, the two companies are treated as one big employer for application of many plan rules. As a result, the buyer's plan may be regarded as a successor plan to the target's plan. If the target plan is a 401(k) plan, this relationship between the plans after the corporate transaction may preclude the termination of the 401(k) plan and the distribution of its benefits to the participants. As a result, it may be necessary to maintain the two plans. If there is no 401(k) plan sponsored by either company in the transaction, there is more flexibility in determining if the target's plan can be terminated.

If the target's plan is a 401(k) plan, and the buyer sponsors a defined contribution plan (except an employee stock ownership plan (ESOP), simplified employee pension (SEP), or SIMPLE plan), the 401(k) plan cannot be terminated but must be continued or merged into the buyer's plan. If the target and the buyer are not related employers, then merging the plans creates a multiple-employer plan with all of the complexity of this type of arrangement.

In an asset sale, the buyer purchases assets (and assumes liabilities) owned by the target company. The shareholders of the target continue to own the company and the items owned by the company are simply sold for cash or other assets. Furthermore, the target company will continue to sponsor any plans unless affirmative action is taken by the buyer to assume those plans. If the target's employees will continue to work in the sold portion of the business, they will cease to be employees of the target and will begin working for the buyer as its employees.

In the event of an **asset sale**, the seller negotiates whether the buyer will adopt the plan as a successor sponsor. If the buyer declines to do so, then the seller may continue the plan for its remaining employees (if there are any) and simply reflect the employees who go to work for the buyer as having terminated employment (and generally qualified for payment of their benefits from the target plan). Alternatively, the seller can agree to spin-off the portion of the plan attributable to the employees who go to work for the buyer. The spin-off plan can then be merged into the buyer's plan.

If the buyer assumes the plan, the buyer becomes the new plan sponsor. In this case, the buyer can either maintain the acquired plan and its own plan (assuming it had one before the transaction) or merge the two plans together. The successor plan rules in relation to 401(k) plans would also apply in this situation, preventing the termination of one of the plans after they are sponsored by the same employer.

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 seller agrees to transfer the plan and the buyer decides to merge the two plans and act as the continuation of the prior employer, generally there is no legal requirement that participants become 100% vested, and they are not eligible for a distribution from the merging plan.

## §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, because 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 principal difference between a frozen plan and an active plan is that no future benefits or contributions accrue in a frozen plan. Freezing a plan (other than a profit sharing plan) does not force 100 percent vesting of the participant accounts.

### [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, such that all trust assets have been distributed or transferred, the plan no longer exists.

There is a related, but different, concept called a partial plan termination. A **partial termination** is not really a termination of the plan, but rather is a possible vesting event for affected participants. According to qualified plan regulations, if a significant group of employees is 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 are deemed to be 100 percent vested in their funded benefits.

Determining whether a partial plan termination has taken place involves a study of the relevant facts and circumstances. No legislative rule dictates what constitutes sufficient change in the covered employees to invoke these partial plan termination rules; however, the IRS has indicated that a loss of less than 20% of the eligible employees is generally not sufficiently significant to cause there to be a partial plan termination, while the loss of more than 40% almost assuredly does. Between 20% and 40% is a facts and circumstances determination.

**Example 16-1. Partial termination**. Consider a group of employees who are less than 100% vested and who lose their jobs because their employer closes their division. Absent the partial plan termination rules, the affected employees would be entitled to distribution of less than 100% of their total benefits (*i.e.,* because they were not fully vested) and forfeiture of nonvested benefits would occur. However, under the partial plan termination rules, the affected employees, if they represented a large enough group of individuals, would become 100% vested in their account balances or funded accrued benefits, and a forfeiture might be avoided.

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. Because a partial plan termination is judged on a facts and circumstances basis, it is not a black-and-white situation, and the IRS could take a position that is different than the employer's. Typically, a plan sponsor will consult with an ERISA attorney for advice about partial plan termination issues. A plan sponsor may apply to the IRS for a decision as to whether a partial plan termination has occurred.

### §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.
- 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. The IRS requires that the plan be fully up to date, even if an ongoing plan would have more time to adopt any amendments that have been made necessary due to changes in the law.
- Make all affected participants 100 percent vested.
- Plans subject to the minimum funding requirements (money purchase and defined benefit plans) are usually amended to cease benefit accruals or discontinue contributions.
- Plans subject to the minimum funding requirements (money purchase and defined benefit plans) must provide an ERISA §204(h) notice to affected parties, at least 45 days for large plans and at least 15 days for small plans, before benefit accruals can be ceased or contributions discontinued.
- 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. The plan sponsor may also submit for a favorable determination letter on the plan document. If the plan is selected for audit after the plan termination is complete, this provides protection that the plan document has been updated, to the date of termination. However, it does not provide protection for the operation of the plan.
- 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.
- After an IRS favorable determination letter is received, the process to distribute benefits must begin. Participant must be informed about the in-service distribution options available and provided the distribution taxation notices.
- 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 filed through the plan year in which all plan assets have been distributed.

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. 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.

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 distributions prior to the participant's age 59½ 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 individual retirement account or another retirement plan to preserve the tax-deferred status of the rolled over funds.
- Participants who do not elect a lump sum distribution or rollover may have the option to receive an annuity purchased by the plan to provide their benefit. 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 statutory limits for participants in certain defined benefit plans. As an example, the maximum guaranteed monthly payment for plans terminating in 2011 is $4,500, expressed as a single life annuity payable at age 65. Defined benefit plans covered by the PBGC must pay annual premiums 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 that cover only owners and their spouses; and
- Plans sponsored by professional service employers (*i.e.*, physicians, accountants and architects) that have never had more than 25 participants.

### [A] Defined Benefit Plans Not Covered by the Pension Benefit Guaranty Corporation (PBGC)

The procedure to terminate a defined benefit plan that is not covered by the PBGC is the same as that 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 their benefits in the form of a monthly annuity that begins payments 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.

Termination of defined benefit plans covered by the PBGC may be initiated either:

1. Voluntarily by the employer; or
2. Involuntarily by the PBGC.

There are two types of voluntary terminations approved by the PBGC:

1. <u>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 be fully funded: That is, the assets in the plan must be 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. <u>Distress Termination</u>

A **distress termination** may apply if the employer is in liquidation or reorganization proceedings under bankruptcy law or the employer can prove to the PBGC that plan termination is necessary for the employer to pay its debts or to avoid burdensome pension costs. The plan must apply to the PBGC to accomplish a distress termination. The statutory criteria for distress terminations are strict. If a distress termination is approved, various PBGC regulations and procedures then govern the benefit amount calculations and how those benefits are paid.

## §16.07 Notice Requirements upon Termination of a PBGC-Covered Defined Benefit Plan

Various notices to plan participants, as well as to the 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 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 summary plan description, the date that benefits cease to accrue and must advise the participants that a Notice of Plan Benefits is forthcoming. The Notice of Intent to Terminate 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 the participant's and beneficiary's 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 may nullify the termination. After notification, the PBGC has 60 days to review the termination for compliance with certain specified requirements in the law and PBGC's 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 and so notifies 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 or all of the assets (and assumes some or all of the liabilities) of the seller.

**Distress Termination:** A voluntary termination of a defined benefit pension plan whereby the plan of an employer that is experiencing 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 termination of a defined benefit pension plan that is initiated by the PBGC.

**Partial Termination:** It is not really a termination of the plan, but rather is a possible vesting event for affected participants. Certain employees become 100% vested in their account as a result of a partial termination.

**Pension Benefit Guaranty Corporation (PBGC):** The government agency that is responsible for insuring benefits of participants of certain defined benefit plans.

**Plan Termination:** A complete cessation of the plan and liquidation of the trust.

**Standard Termination:** A voluntary termination of a defined benefit pension plan whereby the plan has sufficient assets to pay all accrued benefits.

**Stock Sale:** The buyer acquires some or all of the stock of the target employer.

## §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.

- 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. Administrative actions must continue until the termination is complete.

- The procedure for plan termination includes:

    - A resolution terminating the plan;
    - A possible amendment to bring the plan document into compliance with current laws and regulations;
    - A vesting increase to 100 percent full vesting for all affected participants;
    - A Notice of Intent to Terminate to all participants of a plan subject to minimum funding standards, which should be accompanied by a separate notice 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 of benefit amounts 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 the plan sponsor demonstrates its own severe financial distress that necessitates terminating the plan.

## §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.

______ 4. A reason plans merge together is that qualified retirement plans are time-consuming for their human resource employees to administer.

______ 5. Two defined contribution plans may merge together to obtain a higher annual additions limit then available for the two separate plans.

### [B] Multiple Choice

6. 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 owner(s) of the plan may agree to accept less in benefits.

7. 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 that the plan will be submitted to the IRS for a determination letter for approval to terminate
   D. In-service distribution options available
   E. Distribution taxation notices

8. All of the following actions are 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

9. Which of the following statements about partial terminations is/are **TRUE**?

   I. A partial termination may occur when a significant group of employees is not longer covered under the plan.
   II. A partial termination can cause future accruals to cease for all participants.
   III. When a partial termination exists the affected employees are deemed to be 100% vested in their funded benefits.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

10. All of the following are similarities between a frozen plan and a terminated plan, **EXCEPT**:

    A. Both require all participants to become 100% vested
    B. Both plan documents must continue to be qualified
    C. Both cease benefit accruals in a defined benefit plan
    D. Both discontinue contributions to participants in a defined contribution plan
    E. Both file the appropriate Form 5500

11. Which of the following is/are reasons a plan sponsor might merge two retirement plans?

    I. After a merger of two companies more than one plan exists and the plan sponsor is forced by law under the successor plan rules to merge the plans
    II. Cost to administer the plan
    III. Convert an outdated plan to a different type plan

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

12. Which of the following statement regarding a partial termination is/are **TRUE**?

    I. A partial termination will occur if less than 20% of the employees terminate employment.
    II. A partial termination will occur if over 40% of the employees terminate employment.
    III. A partial termination is a vesting event.

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

### §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 [A]

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 [B]

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 [B]

4. **True**. There are many reasons for plan mergers. One is that qualified retirement plans are time-consuming for their human resource employees to administer, even when retirement plan administration firms do the bulk of the work. §16.03

5. **False**. The annual additions limit is an overriding limit whether there is one plan or two and therefore is not a reason two plans would merge. §16.03

6. The correct answer is **B.** §16.06[B]

   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 owner(s) of the plan may agree to accept less in benefits.

7. 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 available in-service distribution options are 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.

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.

9. The correct answer is **C**. §16.04[B]

   I. Statement I is true because a partial termination may occur when a significant group of employees are no longer covered under the plan.
   II. Statement II is false because only participants who are no longer covered by the plan are affected, not all participants.
   III. Statement III is true because when a partial termination occurs the affected participants are deemed to be 100% vested in their funded benefits.

   A. Incorrect. Statement III is also true.
   B. Incorrect. Statement II is false.
   C. Correct. Statements I and III are the only true statements.
   D. Incorrect. Statement II is false.
   E. Incorrect. Statement II is false.

10. The correct answer is **A**. §16.04

   A. Correct. This statement is false because a frozen plan does not require 100% vesting however a terminated plan must force 100% vesting.
   B. Incorrect. This statement is true because a frozen plan and a terminated plan must continue to have a qualified plan. A terminated plan must be qualified up to the date of termination.
   C. Incorrect. This statement is true because both plans do cease benefit accruals in a defined benefit plan.
   D. Incorrect. This statement is true because both do discontinue making contributions to participant in a defined contribution plan.
   E. Incorrect. This statement is true because both must file Form 5500. A terminated plan will file a Form 5500 until all assets have been distributed.

11. The correct answer is **E**. §16.03

    A. Incorrect. Statements II and III are also true.
    B. Incorrect. Statements I and II are also true.
    C. Incorrect. Statement III is also true.
    D. Incorrect. Statement I is also true.
    E. Correct. Statement I, II and III are true.

12. The correct answer is **D**. §16.04[B]

    A. Incorrect. Statement I is false.
    B. Incorrect. Statement II is also true.
    C. Incorrect. Statement I is false.
    D. Correct. Statements II and III are the only true statements.
    E. Incorrect. Statement I is false.

## §16.12 Supplemental Education

**Publications:** Below is a listing of additional publications specific to topics found in this chapter. These resources are not required reading nor do they provide additional information to be tested. They are listed for those who may want more detail on a topic. The listing includes only those publications that are free and may be found on the Web.

1. An article relevant to this chapter can be found at the ASPPA Web site:

   "Partial Plan Terminations of Qualified Plans" by Marcia S. Wagner and Jon C. Schultze in *The ASPPA Journal*, Winter 2011, Vol. 41, No1.
   www.asppa.org/errata

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A publication of the ASPPA Government Affairs Committee
November 10, 2010 :: No. 10-39



# 10 – Year COLA Summary

## 10-Year COLA Summary

| | 2011 | 2010 | 2009 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Plan/IRA Limits** | | | | | | | | | | |
| 401(k), 403(b) and SARSEP maximum deferal [402(g)] | 16,500 | 16,500 | 16,500 | 15,500 | 15,500 | 15,000 | 14,000 | 13,000 | 12,000 | 11,000 |
| 457 maximum deferral | 16,500 | 16,500 | 16,500 | 15,500 | 15,500 | 15,000 | 14,000 | 13,000 | 12,000 | 11,000 |
| Catch-Up for 401(k), 403(b), SARSEP and 457 | 5,500 | 5,500 | 5,500 | 5,000 | 5,000 | 5,000 | 4,000 | 3,000 | 2,000 | 1,000 |
| SIMPLE election maximum defferal | 11,500 | 11,500 | 11,500 | 10,500 | 10,500 | 10,000 | 10,000 | 9,000 | 8,000 | 7,000 |
| Catch-Up for SIMPLE | 2,500 | 2,500 | 2,500 | 2,500 | 2,500 | 2,500 | 2,000 | 1,500 | 1,000 | 500 |
| DB - annual benefit | 195,000 | 195,000 | 195,000 | 185,000 | 180,000 | 175,000 | 170,000 | 165,000 | 160,000 | 160,000 |
| DC - annual contributions | 49,000 | 49,000 | 49,000 | 46,000 | 45,000 | 44,000 | 42,000 | 41,000 | 40,000 | 40,000 |
| IRA limit | 5,000 | 5,000 | 5,000 | 5,000 | 4,000 | 4,000 | 4,000 | 3,000 | 3,000 | 3,000 |
| IRA catch up | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 500 | 500 | 500 | 500 |
| **Compensation Limits** | | | | | | | | | | |
| Maximum compensation | 245,000 | 245,000 | 245,000 | 230,000 | 225,000 | 220,000 | 210,000 | 205,000 | 200,000 | 200,000 |
| SEP annual compensation floor | 550 | 550 | 550 | 500 | 500 | 450 | 450 | 450 | 450 | 450 |
| **Highly Compensated Employees** | | | | | | | | | | |
| Any employee compensation | 110,000 | 110,000 | 110,000 | 105,000 | 100,000 | 100,000 | 95,000 | 90,000 | 90,000 | 90,000 |
| **Key Employees** | | | | | | | | | | |
| Officer Compensation | 160,000 | 160,000 | 160,000 | 150,000 | 145,000 | 140,000 | 135,000 | 130,000 | 130,000 | 130,000 |
| 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 | 106,800 | 106,800 | 106,800 | 102,000 | 97,500 | 94,200 | 90,000 | 87,900 | 87,000 | 84,900 |
| Medicare | no limit | no limit | no limit | no limit | no limit | no limit | no limit | no limit | no limit | no limit |

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## 10-Year COLA Summary (Continued)

| | 2011 | 2010 | 2009 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|---|---|---|---|---|
| **FICA and SECA tax rates** | | | | | | | | | | |
| OASDI (Er and Ee, each) | 6.20% | 6.20% | 6.20% | 6.20% | 6.20% | 6.20% | 6.20% | 6.20% | 6.20% | 6.20% |
| Medicare (Er and Ee, each) | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% |
| Combined rate (Er and Ee, each) | 7.65% | 7.65% | 7.65% | 7.65% | 7.65% | 7.65% | 7.65% | 7.65% | 7.65% | 7.65% |
| OASDI (self-employed) | 12.40% | 12.40% | 12.40% | 12.40% | 12.40% | 12.40% | 12.40% | 12.40% | 12.40% | 12.40% |
| Medicare (self-employed) | 2.90% | 2.90% | 2.90% | 2.90% | 2.90% | 2.90% | 2.90% | 2.90% | 2.90% | 2.90% |
| Combined rate (self-employed) | 15.30% | 15.30% | 15.30% | 15.30% | 15.30% | 15.30% | 15.30% | 15.30% | 15.30% | 15.30% |
| **ESOP Distribution** | | | | | | | | | | |
| Normal dist. Period (years) | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 |
| Threshold account balance IRC 409(o)(1)(C) | 985,000 | 985,000 | 985,000 | 935,000 | 915,000 | 885,000 | 850,000 | 830,000 | 810,000 | 800,000 |
| One year extension threshold IRC 409(o)(1)(C)(ii) | 195,000 | 195,000 | 195,000 | 185,000 | 180,000 | 175,000 | 170,000 | 165,000 | 160,000 | 160,000 |
| 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 | 4,500.00 | 4,500.00 | 4,500.00 | 4,312.50 | 4,125.00 | 3,971.59 | 3,801.14 | 3,698.86 | 3,664.77 | 3,579.55 |
| Age 64/ 93% | 4,185.00 | 4,185.00 | 4,185.00 | 4,010.63 | 3,836.25 | 3,639.58 | 3,535.06 | 3,439.94 | | |
| Age 63/ 86% | 3,870.00 | 3,870.00 | 3,870.00 | 3,708.75 | 3,547.50 | 3,415.57 | 3,268.98 | 3,181.02 | | |
| Age 62/ 79% | 3,555.00 | 3,555.00 | 3,555.00 | 3,406.88 | 3,258.75 | 3,137.56 | 3,002.90 | 2,922.10 | 2,895.17 | 2,827.85 |
| Age61/ 72% | 3,240.00 | 3,240.00 | 3,240.00 | 3,105.00 | 2,970.00 | 2,859.54 | 2,736.82 | 2,663.18 | | |
| Age 60/ 65% | 2,925.00 | 2,925.00 | 2,925.00 | 2,803.13 | 2,681.25 | 2,581.53 | 2,470.74 | 2,404.26 | 2,382.10 | 2,326.71 |
| Age 59/ 61% | 2,745.00 | 2,745.00 | 2,745.00 | 2,630.63 | 2,516.25 | 2,422.67 | 2,138.70 | 2,256.30 | | |
| Age 58/ 61% | 2,565.00 | 2,565.00 | 2,565.00 | 2,458.13 | 2,351.25 | 2,263.81 | 2,166.65 | 2,108.35 | | |
| Age 57/ 53% | 2,385.00 | 2,385.00 | 2,385.00 | 2,285.63 | 2,186.25 | 2,104.94 | 2,014.60 | 1,960.40 | | |
| Age 56/ 49% | 2,205.00 | 2,205.00 | 2,205.00 | 2,113.13 | 2,021.25 | 1,946.08 | 1,862.56 | 1,812.44 | | |
| Age 55/ 45% | 2,025.00 | 2,025.00 | 2,025.00 | 1,940.63 | 1,856.25 | 1,787.22 | 1,710.51 | 1,664.49 | 1,649.15 | 1,610.80 |

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# Appendix B:
## A Guide to IRC Sections Affecting Retirement Plans

IRC §401(a) - Requirements for qualification

- (4) & (5) - General nondiscrimination rules
- (9) - Required distributions
- (10) - Top-heavy rules must be stated in plan document
- (11) - Requirement for a joint and survivor annuity and pre-retirement survivor annuity (QJSA and QPSA)
- (17) - Compensation limits
- (25) - Actuarial assumptions must be specified
- (26) - Minimum participation requirements
- (27) - Contributions to profit sharing plans need not be based on profits
- (28) - Employee Stock Ownership Plan (ESOP) requirements
- (31) - Optional direct transfer of eligible rollover distributions

IRC §401(b) - Retroactive changes in plan

IRC §401(c) - Rules relating to self-employed individuals and owner-employees

IRC §401(d) - Plans benefiting owner-employees

IRC §401(h) - Medical benefits for retirees

IRC §401(k) - Cash or deferred arrangement

IRC §401(l) - Integrating plan benefits with Social Security (Permitted Disparity)

IRC §401(m) - Nondiscrimination test for employer matching contributions and after-tax employee contributions

IRC §402(a) -Taxability of beneficiary of exempt trust

| | |
|---|---|
| IRC §402(b) | -Taxability of beneficiary of non-exempt trust |
| IRC §402(c) | - Rules applicable to rollovers from exempt trusts |
| IRC §402(d) | - Tax on lump-sum distributions |
| IRC §402(f) | - Written explanation to recipients on distributions eligible for rollover treatment |
| IRC §402(g) | - Limit on elective deferrals |
| IRC §402(h) | - Rules for Simplified Employee Pensions (SEP) |
| IRC §403(a) and (b) | - Tax-sheltered annuity (TSA) rules |
| IRC §404 | - Deduction of contribution rules |
| IRC §408 | - Individual Retirement Accounts (IRA) |
| IRC §410(a) | - Minimum participation standards |
| IRC §410(b) | - Minimum coverage requirements |
| IRC §411(a) | - Vesting schedules |
| IRC §411(b) | - Accrued benefit requirements |
| IRC §411(d)(6) | - Anti-cutback rules |
| IRC §412 | - Minimum funding standards |
| IRC §413 | - Collectively-bargained plans |
| IRC §414(a) | - Service for predecessor employer |
| IRC §414(b) | - Employees of controlled group corporations |
| IRC §414(c) | - Employees under common control |
| IRC §414(d) | - Governmental plans |
| IRC §414(m) | - Affiliated service group |

| | |
|---|---|
| IRC §414(n) | - Employee leasing |
| IRC §414(p) | - Qualified Domestic Relations Order (QDRO) |
| IRC §414(q) | - Highly Compensated Employee (HCE) |
| IRC §414(r) | - Qualified Separate Lines of Business (QSLOB) |
| IRC §414(s) | - Nondiscriminatory definition of compensation |
| IRC §414(u) | - Veteran's Rights under Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) |
| IRC §414(v) | - Catch-up contributions for individuals age 50 or over |
| IRC §415(b) | - Defined benefit limitations |
| IRC §415(c) | - Defined contribution limitations |
| IRC §416(g) | - Top-heavy plan defined |
| IRC §416(I) | - Key Employee definition |
| IRC §417(a) | - Restrictions on cash-out payments |
| IRC §417(b) | - Other special rules and definitions regarding survivor annuities |

# Appendix C:
## Acronyms and Abbreviations

The following list of acronyms and abbreviations are used in ASPPA's educational course materials. They may help the reader interpret a co-worker's instructions or comments more quickly. Unfortunately, the list doesn't include all of the acronyms and abbreviations that exist, nor does it accommodate special meanings that individual firms may have adopted! The list is divided into three abbreviation subcategories: general, defined benefit and abbreviated law names.

### General Abbreviations

| | |
|---|---|
| A-Org | A-Organization |
| ABP | Average Benefit Percentage Test |
| ACA | Automatic Contribution Arrangement |
| ACP | Actual Contribution Percentage |
| ACR | Actual Contribution Ratio |
| ADP | Actual Deferral Percentage |
| ADR | Actual Deferral Ratio |
| ARU | Automatic Response Unit |
| ASG | Affiliated Service Group |
| Audit CAP | Audit Closing Agreement Program |
| ASPPA | American Society of Pension Professionals & Actuaries |
| BRF | Benefit, Right or Feature |
| B-Org | B-Organization |
| CODA | Cash or Deferred Arrangement |
| DFE | Direct Filing Entities |
| DFVC | Delinquent Filer Voluntary Compliance |
| DOL | Department of Labor |
| DRO | Domestic Relations Order |
| EACA | Eligible Automatic Contribution Arrangement |
| EBSA | Employee Benefits Security Administration |
| EFAST | ERISA Filing Acceptance System |
| EPCRS | Employee Plans Compliance Resolution System |
| ERPA | Enrolled Retirement Plan Agent |
| ESOP | Employee Stock Ownership Plan |
| ETF | Exchange Traded Funds |
| FAS | Financial Accounting Standard |
| FASB | Financial Accounting Standard Board |
| FSO | First Service Organization |
| GIC | Guaranteed Investment Contract |
| HCE | Highly Compensated Employee |
| IPS | Investment Policy Statement |
| IRA | Individual Retirement Account or Annuity |

| | |
|---|---|
| IRS | Internal Revenue Service |
| LLC | Limited Liability Company |
| LLP | Limited Liability Partnership |
| NAV | Net Asset Value |
| NHCE | Nonhighly Compensated Employee |
| NOIT | Notice of Intent to Terminate |
| NRA | Normal Retirement Age |
| NRB | Normal Retirement Benefit |
| NRD | Normal Retirement Date |
| NSCC | National Securities Clearing Corporation |
| PIN | Personal Identification Number |
| PLR | Private Letter Ruling |
| POP | Public Offering Price |
| QACA | Qualified Automatic Contribution Arrangement |
| QDIA | Qualified Default Investment Alternative |
| QDRO | Qualified Domestic Relations Order |
| QJSA | Qualified Joint and Survivor Annuity |
| QMAC | Qualified Matching Contribution |
| QNEC | Qualified Nonelective Contribution |
| QOSA | Qualified Optional Survivor Annuity |
| QPSA | Qualified Preretirement Survivor Annuity |
| QSLOB | Qualified Separate Line of Business |
| RASD | Retroactive Annuity Start Date |
| RIA | Registered Investment Advisor |
| RMD | Required Minimum Distribution |
| SAR | Summary Annual Report |
| SARSEP | Salary Reduction Simplified Employee Pension |
| SAS 70 | Statement of Auditing Standards No. 70 |
| SCP | Self-Correction Program |
| SDBA | Self-Directed Brokerage Account |
| SEC | Securities and Exchange Commission |
| SEP | Simplified Employee Pension |
| SIMPLE | Savings Incentive Match Plan for Employees |
| SLOB | Separate Line of Business |
| SMM | Summary of Material Modification |
| SPD | Summary Plan Description |
| SSRA | Social Security Retirement Age |
| TSA | Tax-Sheltered Annuity |
| TWB | Taxable Wage Base |
| UBTI | Unrelated Business Taxable Income |
| VCP | Voluntary Correction Program |
| VFC | Voluntary Fiduciary Correction |

## Defined Benefit Plan Abbreviations

| | |
|---|---|
| ABO | Accumulated Benefit Obligation |
| AFTAP | Adjusted Funding Target Attainment Percentage |
| APR | Annuity Purchase Rate |
| EAAL | Entry Age Accrued Liability |
| EAN | Entry Age Normal |
| EBAR | Equivalent Benefit Accrual Rate |
| FFL | Full Funding Limit |
| FIL | Frozen Initial Liability |
| MEA | Maximum Excess Allowance |
| MOA | Maximum Offset Allowance |
| MVAR | Most Valuable Accrual Rate |
| NAR | Normal Accrual Rate |
| PBGC | Pension Benefit Guarantee Corporation |
| PBO | Projected Benefit Obligation |
| PUC | Projected Unit Credit |
| PVAB | Present Value of Accrued Benefit |
| PVB | Present Value of (future) Benefits |
| UAL | Unfunded Accrued Liability |

## Abbreviation of Law Names

| | |
|---|---|
| EGTRRA | Economic Growth and Tax Relief Reconciliation Act of 2001 |
| ERISA | Employee Retirement Income Security Act of 1974 |
| FICA | Federal Insurance Contributions Act |
| FUTA | Federal Unemployment Tax Act |
| GATT | General Agreement on Tariffs and Trade |
| GUST | GATT, USERRA, SBJPA, TRA '97 |
| IRC | Internal Revenue Code |
| OASDI | Old Age Survivors Disability Insurance |
| OBRA '87 | Omnibus Budget Reconciliation act of 1987 |
| PPA '06 | Pension Protection Act of 2006 |
| RPA '94 | Retirement Protection Act of 1994 |
| RRA | Revenue Reconciliation Act |
| USERRA | Uniformed Services Employment and Reemployment Rights Act of 1994 |

# Index

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