# The Automatic 401(k)

***401(k) Plans Come of Age***

Why do you sponsor a 401(k) plan? Maybe it's part of your strategy to attract talent, or to encourage key employees to stay. If you are like most plan sponsors, you run the plan to help your employees save and invest for a financially secure retirement.

Yet sometimes it seems like your employees don't get it. You see it in lagging participation levels, inadequate deferral rates, and poor investment decisions.

You've tried to get your employees to take action. But when your efforts don't get results, the retirement readiness of your employees suffers. Plus, the plan can fail nondiscrimination testing, leaving you to deal with the headache of restricting or returning excess contributions to higher paid employees.

It doesn't have to be this way. A highly effective solution—the "Automatic 401(k)"—is sweeping the defined contribution landscape. For employees offered such a plan, participation is automatic. Your employees are enrolled at a pre-set contribution rate into an investment fund you select. Employees are in the plan unless they opt-out. Automatic enrollment relieves you of the effort it takes to fight employee inertia. Now, inertia works in your employees' favor.

Between 2004 and 2005, the percentage of 401(k) plans with automatic enrollment jumped from 10.5 percent to 17 percent.[1] Benefits experts predict automatic plan design will soon be the norm.[2]

The reason for the success of automatic 401(k) plans? They remove impediments that too often stand in the way of employee participation—from the "analysis paralysis" over investment decisions, to simply getting sidetracked and not taking action to sign up and start saving.

The time may be right to join the march toward a simpler and better 401(k). You have the experiences of early automatic 401(k) adopters as well as the Pension Protection Act of 2006 (PPA) to guide you. The following information will help prepare you to upgrade your plan to meet your needs and put your employees on a steady course to retirement security.

## Elements of an Automatic 401(k) Plan

### Automatic Enrollment

When it comes to savings behavior, employee inertia is well-documented. Too many employees just don't get around to signing up for the plan. With automatic enrollment, they don't have to. The plan sponsor simply enrolls employees automatically at a set deferral rate. Employees are in the plan unless they get decide to opt-out.

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[1] Profit Sharing /401(k) Council of America. *49th Annual Survey of Profit Sharing and 401(k) Plans.* 2006.

[2] *Automatic Plan Designs: Taking it up a Notch.* Plan Sponsor Magazine, April 2007.

This relatively simple solution results in remarkable participation gains. A study by Vanguard showed a 17-percentage point increase in participation in plans that adopted automatic enrollment.[3] Other studies show similar findings.

When plan sponsors first tested the waters of automatic enrollment back in the late 1990s, they focused their efforts on new hires. Since then, sponsors have learned the benefits of annual "re-enrollment" to increase participation rates across all employees. Surveys and other evidence confirm that opt-out rates are low and employee response is positive.

**Lessons Learned**

- Employee response to automatic enrollment is extremely positive.
- Applying automatic enrollment to existing employees as well as new hires results in higher participation gains.

**Automatic Contribution Increases**

Even though early adopters were pleased with participation gains, some of them discovered an unintended consequence. The same inertia that kept employees from enrolling in the plan was keeping them from changing the default deferral rate. Sponsors had set the rates low (typically three percent). But average contribution rates were not as high as they could be because employees who would have signed up on their own at higher rates were staying at the lower default rate.

The answer? Automatically increase the deferral rate each year. (For example, an employee's automatic contribution rate could increase by one or two percent each year the employee stays with the company, or each time the employee gets a raise.) Again, employees can opt out, but most don't. If the plan does not provide automatic annual increases for all employees, it could allow employees to sign up for them.

Also, plan sponsors have increasingly been setting the initial deferral rate at a higher percentage of pay (as opposed to only three percent, for example). Some set it to align with employer matching contributions. A recent survey suggests that employees tend to find higher deferral rates acceptable. The survey concluded that most participants would accept an initial deferral rate as high as six percent.[4]

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[3] Vanguard. *Automatic Enrollment: Client Experience.* July 2001.

[4] T. Rowe Price. *Best Practices for a Better Retirement Plan: The Case for Automated Services.* 2006.

**Lessons Learned**

- Don't fear a higher initial deferral rate. Consider setting it at the maximum percentage of employee contributions that you match.
- Set the deferral rate to increase automatically each year.

**Automatic Investment**

When adopting automatic enrollment, plan sponsors select a default investment. This is an important feature. Many participants will simply remain in the default investment rather than make their own selection.

Early on, many plan sponsors took a cautious approach, opting for principal preservation (money market or stable value funds, for example). They were concerned about fiduciary liability—participant lawsuits over investment losses if, for example, the employer selected a default investment that involved stocks, and if the stock market declined.

Today, many sponsors are increasingly concerned about encouraging employees to stay parked in a low-risk default fund for many years. The Department of Labor expressed a similar theme in the preamble to its plan investment regulations, noting that over long time horizons, diversified portfolios that include equities have historically generated higher returns than portfolios consisting only of fixed-income investments.[5] This, plus new protections for fiduciaries under the Pension Protection Act of 2006 (PPA) have helped turn the tide. Recent adopters of automatic enrollment have tended to select equity-based default investments rather than principal preservation funds and the Department of Labor regulations encourage this.[6]

**Lessons Learned**

- A low-risk default investment fund can be high-risk for retirement income adequacy if employees stay in it for many years.
- Many sponsors now favor diversified equity-based default investments over principal preservation funds; the Department of Labor regulations encourage this.

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[5] Department of Labor. Default Investment Alternatives Under Participant-Directed Individual Account Plans; Final Rule, 72 Federal Register Reg. 60452, 60470 (Oct. 24, 2007).

[6] Deloitte Consulting LLP. *Annual 401(k) Benchmarking Survey, 2005/2006 Edition.*

## Pension Law Clears Hurdles to Automatic Defaults

The PPA addressed several concerns that had left many plan sponsors on the sidelines. For one, PPA clarified that automatic enrollment meeting certain requirements is permitted even in states where wage laws generally require an employee's written authorization for payroll deductions. It also allowed plans to give automatically enrolled employees the option to revoke automatic enrollment within 90 days and get their money back tax penalty-free.

> PPA overrides state laws that otherwise might be interpreted to preclude automatic enrollment. It also gave a green light to diversified equity-based default investments.

PPA cleared away one of the biggest barriers to automatic 401(k) plan adoption. The law directed the Department of Labor to publish regulations on acceptable investment defaults that would help shield sponsors from increased fiduciary liability. The Department's final regulations confirm that plan sponsors using certain common types of diversified default investments that include stocks can do so without increasing the risk of fiduciary liability for investment losses (compared to a 401(k) without default investments), as long as the sponsors meet certain conditions. The investment defaults that get this protection, dubbed Qualified Default Investment Alternatives (QDIA), include, in particular, balanced funds, lifecycle funds, or managed accounts. (See *Don't Lose Sleep over Automatic Investments* for a more specific discussion of default investment funds.)

### Employee Notification Requirements

PPA requires written notification to let employees know they will be automatically enrolled in the plan, at what percentage of pay, and to which investment options the contributions will be directed. Employees must be informed that they can override any of these defaults and choose their own contribution amount and investments, do nothing and stay at the defaults, or opt-out altogether. Plans that meet certain conditions can give participants 90 days to opt-out and get their money back without the 10 percent tax penalty that usually applies to early 401(k) withdrawals. Plan sponsors need to give written notice not only when automatic enrollment first occurs, or in some cases, 30 days in advance, but also annually thereafter.

> PPA allows plans to let automatically enrolled employees opt-out within 90 days and get their contributions back without tax penalty.

### New Nondiscrimination Testing Safe Harbor

PPA offers a new automatic enrollment alternative to bypass nondiscrimination tests. Prior to PPA, a plan sponsor had two ways to avoid testing: the matching safe harbor and the non-elective contribution safe harbor.

Under the existing matching safe harbor, plan sponsors have to match 100 percent of rank-and-file employee contributions on the first three percent, and then 50 percent on the next two percent.[7] The current non-elective contribution safe harbor requires plan sponsors to provide at least a three percent employer contribution for all eligible rank-and-file employees, regardless of whether the employee contributes. The employee is immediately vested in the employer contribution under both approaches.

Plan sponsors qualify for the new PPA 401(k) safe harbor option if their plans meet the following requirements:

- They use automatic enrollment and the automatic (default) contribution rate starts at no less than three percent in year one of an employee's participation, rising to at least four percent in year two, five percent in year three, and six percent in year four and beyond. The maximum is 10 percent.

- An employer matches 100 percent of rank-and-file employee contributions on the first one percent of pay, and 50 percent from there up to a maximum of six percent.
    - As an alternative, the employer can provide a three percent non-matching contribution to all rank-and-file employees.

- The vesting period on employer contributions is two years or less.

- Employees receive required notices regarding the right to opt-out and to elect a different deferral rate or investment, and an explanation of the default investment.

> PPA established a safe harbor for 401(k) plans using automatic enrollment as a new alternative to nondiscrimination testing.

## The Time is Right

PPA gave the plan sponsor community the green light it was waiting for to adopt automatic defaults. The law removes most legal and regulatory barriers that have held plan sponsors back from automatic 401(k) plan implementation.

The automatic 401(k) offers welcome relief to sponsors that have tried to convince their employees to participate in the plan and adequately save for retirement. Financial education no longer needs to shoulder the daunting task of changing behavior. It can now do what it is supposed to do—educate

[7] These are non-highly compensated employees. In very general terms, highly compensated employees are defined generally by the Internal Revenue Code as those earning $100,000 or more or owning more than five percent of the company.

employees about smart strategies for achieving retirement security, delivered to them as they are building their nest eggs.

Think about your plan goals. Do you want to increase participation, raise contribution rates, or get employees to better appreciate the value of your plan? Do you want to improve nondiscrimination testing results, or do away with testing altogether? Would allowing higher paid employees to contribute more make your life easier? Most of all, do you want to help your employees save enough to secure a comfortable retirement? If so, adding automatic features to your 401(k) plan makes sense.

The PPA officially cleared the way for automatic plan design. Early adopters have taught us what works and what to look out for. Today's environment sets the stage for you to confidently adopt automatic design features, knowing they are right by law and by experience, and knowing that it's a positive thing to do for your people.

The automatic 401(k), an older and wiser version of its earlier self, holds real promise for improving the retirement prospects of today's workers. Combined with continued financial education, the 401(k) is coming into its own as a source of retirement income security for the 21st century.

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## Resources

Retirement Made Simpler
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Default Investment Alternatives under Participant Directed Individual Account Plans; Final Rule.
Federal Register. 29 CFR, Part 2550. October 24, 2007.
http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf

Deloitte Consulting LLP. Annual 401(k) Benchmarking Survey, 2005-2006 edition.
http://deloitte.net/dtt/cda/doc/content/us_consulting_hc_401ksurveyresults_020806.pdf
#search=%22automatic%20enrollment%20deloitte%22

Pension Protection Act
Section 902.
http://www.dol.gov/ebsa/pdf/ppa2006.pdf

## Don't Lose Sleep over Automatic Investments

***Federal Law Offers Fiduciary Relief to Automatic 401(k) Plan Sponsors***

All investors face the risk of losing money. It's enough to keep some people up at night. The risk is especially troubling to 401(k) plan sponsors, some of whom may be concerned that participants might sue them if their investments lose money. Sponsors can rest easier by following regulatory guidelines to reduce their exposure. But, until passage of the Pension Protection Act of 2006 (PPA), this "fiduciary liability" relief did not apply to sponsors of automatic 401(k) plans.

Pension law offers a measure of fiduciary relief from potential liability for investment losses if participants have control over their own investments. This relief is limited; plan sponsors and other fiduciaries still have a fiduciary duty to prudently select and monitor each investment option. But some plan sponsors have been concerned that their fiduciary liability might be greater if they automatically enrolled employees into default investments selected by the sponsor. It hasn't been clear that participants have exercised "control" over their investments in automatic 401(k) plans if they remain in the plan's default investment.

PPA removes that ambiguity. As long as the sponsor follows certain conditions, participants will be deemed to have exercised control over certain default investments. Sponsors that automatically enroll employees will qualify for the same kind of fiduciary relief they get when participants exercise control over their investments by making affirmative choices.

It gives sponsors, under certain conditions, the official green light to include diversified equities in default investment funds. (Plan fiduciaries still have a legal duty to prudently select and monitor default investments.) The Department of Labor notes that traditionally, a majority of sponsors have chosen low-risk default funds, such as money market or stable value funds, to protect themselves from the risk of loss-related lawsuits. A trend moving away from conservative default investments started before PPA, and it will accelerate now that PPA gives sponsors greater confidence to select default funds that include a mix of diversified equities and more conservative investments. This is important, since automatically enrolled plan participants tend to stay in the default investment.

## The Specifics

Fiduciary relief is available to automatic 401(k) plan sponsors as long as they meet specific conditions defined by Department of Labor regulations. (This document does not attempt to describe all of the specific conditions; for a full listing, visit: http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf.) Sponsors need to offer participants the chance to direct their own investments. If participants fail to do so, and are defaulted into a "Qualified Default Investment Alternative" (QDIA), sponsors can qualify for fiduciary relief similar to the relief that applies when participants affirmatively elect their investments.

## Qualified Default Investment Alternatives

Under the Department of Labor regulations, three main types of investments qualify as Qualified Default Investment Alternatives (QDIAs)—lifecycle funds, balanced funds, and managed accounts.

A **lifecycle** fund or model portfolio, also known as a target retirement date fund, is an investment mix that seeks both long-term appreciation (through diversified equity investments, such as stocks) and principal preservation (through fixed-income investments, such as bonds or stable value funds). A participant's age, expected retirement date, or life expectancy determine the investment mix. The mix becomes more conservative as the participant gets closer to retirement, usually by shifting assets from stocks to fixed-income investments.

> If participants are defaulted into a QDIA, plan sponsors can get fiduciary relief similar to the relief they get when participants affirmatively choose investments.

A **balanced fund** or model portfolio is a similar mix of diversified equity and fixed-income investments. A target level of risk for plan participants as a whole determines the investment mix. The mix doesn't vary with the age or other individual circumstances or preferences of particular participants.

Under a **managed account**, an investment manager provides an investment management service under which it allocates the assets of a participant's individual account. The goal is to achieve a diversified mix of equity and fixed-income investments that seek both long-term appreciation and principal preservation. The manager uses investment alternatives available in the plan and adjusts the mix based on an individual's age, target retirement date, or life expectancy. The mix becomes more conservative with increasing age.

The Department of Labor regulations also treat QDIAs as capital preservation (such as stable value) funds for up to 120 days after the participant's first elective contribution or to the extent the plan invested in those funds before December 24, 2007 (if the funds meet certain requirements).

Not every fund, portfolio, or investment management service that satisfies the definition of QDIA is acceptable. The Department of Labor points out that fiduciaries still have a legal duty to prudently select and monitor the particular QDIA that the plan provides and could be liable for losses that result from a failure to do so. DOL also indicates that it will not necessarily consider the selection of other default investments imprudent. In fact, the Labor Department states that, even though stable value investments are not QDIAs (except for 120-day exception and the pre-December 24, 2007 "grandfather" exception), plan sponsors may conclude that stable value investments are appropriate default investments for their employees.

QDIAs can be made up of funds or assets handled by an investment manager, a plan sponsor acting as a fiduciary, or a plan trustee.[8] Generally, the funds cannot include the employer's securities (with limited exceptions), and they need to be diversified to minimize the risk of large losses.

Regulations accommodate diversified default investment alternatives that seek both long-term and appreciation capital preservation.

## Additional Requirements

Beyond selecting qualified default funds, plans must give participants written notice before the default investment kicks in and again, at least 30 days before the start of each plan year. The initial notice must be given at least 30 days in advance of the first elective contribution unless the plan gives automatically enrolled employees a 90-day opportunity to opt-out and get their contributions back tax penalty-free. The notice needs to be written in a manner calculated to be understood by the average plan participant and needs to:

- Explain the circumstances under which elective contributions will automatically be made, the percentage of pay, and the participant's right to opt-out or choose to contribute at a different percentage;
- explain the participant's right to direct the investment of asset in his or her account;
- explain the circumstances under which a participant's contributions will be invested in the QDIA;
- describe the QDIA, including its investment objectives, risk and return characteristics, and fees and expenses;
- explain how a participant can move investments out of the QDIA, including any applicable restrictions, fees, or expenses that apply in connection with such a transfer; and,
- explain where participants can get investment information about the plan's other investment options.

[8] ERISA section 3(38) defines "investment manager."

Under the regulations, plan sponsors have to notify participants before contributions go into the default investment, and before the start of each plan year.

The regulations require sponsors to give participants fund prospectuses or other investment materials the plan receives regarding QDIAs. Further, participants need to have the opportunity, at least every three months, to transfer any portion of their QDIA investments to other plan investment alternatives. In fact, participants invested in QDIAs need to have the same opportunities to direct their investments (including how often they can direct) that the plan gives to other participants. During the first 90 days after a participant's first elective contribution, a transfer out of a QDIA or a withdrawal of all contributions by a participant opting out of the plan may not be subject to any restrictions, fees, or expenses (such as surrender charges or redemption fees). Also, the plan must offer a broad range of investment alternatives (as defined in regulations—most 401(k) plans already offer a broad range).

## Implications

A goal of PPA is to increase retirement savings by encouraging more sponsors to add automatic features to their 401(k) plans. Before the law's enactment, automatic 401(k) sponsors were at a potential disadvantage with respect to fiduciary liability because they provided default investments. Now that relief is available, policymakers and benefits analysts expect PPA will open the floodgates to automatic plan adoption. The result will be more employees than ever building their capacity to support a comfortable standard of living in retirement.

Plan sponsors still have fiduciary responsibility for prudently selecting and monitoring QDIAs and other investment options, including consideration of the associated fees and expenses.

When choosing a QDIA or any other investment alternative, plan sponsors are still responsible for prudently selecting and monitoring the specific investment fund, portfolio, or service, including careful consideration of the associated fees and expenses. But you don't need to lose sleep over putting participants into funds that are appropriate for long-term investing.

Like many plan sponsors, you may find little reason not to adopt automatic 401(k) plan features. Talk with your plan service provider about your options. If your provider does not offer automatic 401(k) plan support, you might want to explore one that does.

PPA and the Department of Labor regulations are encouraging more plan sponsors to move toward long-term default funds that include diversified equity investments.[9] This may give participants a

[9] See preamble to the QDIA regulations. http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf

better shot at financial security in retirement, while plan sponsors still protect themselves from additional fiduciary liability. This should help us all sleep a little better at night.

Consider how remaining in a principal-preservation fund over the long term could affect a saver's outcomes.* Assume a 30-year-old employee with no retirement savings is automatically enrolled in a low-risk investment that earns three percent a year on average. If he contributes $2,000 a year (adjusted for inflation), he will have an estimated $200,256 when he turns 65. But if the same 30-year-old contributes $2,000 a year to a fund that earns an average of 7 percent a year, his total savings by age 65 would be $426,107.[10]

**This estimate is based on historical average returns and is not a predictor of future returns.*

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[10] The example is based on retirement income estimates using a calculator at www.ipers.org.

## Resources

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Federal Register. 29 CFR, Part 2550. October 24, 2007.
http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf

Meeting Your Fiduciary Responsibilities.
US Department of Labor. September 2006.
http://www.dol.gov/ebsa/pdf/fiduciaryresponsibility.pdf

Pension Protection Act
Sections 624, 902.
http://www.dol.gov/ebsa/pdf/ppa2006.pdf

## Automatic 401(k) Plans: What Your Employees Need to Know

If you haven't yet hopped on the automatic 401(k) bandwagon, chances are you soon will. Analysts predict that automatic 401(k) plans will be the norm within the next few years. (For an overview, see *"Automatic 401(k): The 401(k) Plan Comes of Age."*)

If you are getting ready to set up an automatic 401(k) plan, you have the Pension Protection Act of 2006 (PPA) and our resources to guide you. This resource covers the notification rules that PPA established for automatic 401(k) plans.

## Employers Take Note

Employers that sponsor automatic 401(k) plans are required to give employees a notice telling them they can opt-out of the plan or override the default contribution percentage and default investments. The notice also needs to specifically describe the default investment.

The law directs plan sponsors to provide this notice in a manner "calculated to be understood by the average plan participant." In other words, make it easy to understand. Avoid legal or investment jargon that makes the notices difficult to follow.

**Content of Notice Relating to Automatic Enrollment and Default Investment**
Employers must give each eligible employee written notice of their rights and obligations under the automatic 401(k) arrangement and explain their right to opt-out of the plan or change the default contribution amount.[11] For most 401(k) plans, the notice also has to identify how the default contributions will be invested if the employee doesn't make an explicit choice.

Plans must give participants written notice before the default investment kicks in and again, at least 30 days before the start of each plan year. The initial notice must be given at least 30 days in advance of the first elective contribution unless the plan gives automatically enrolled employees a 90-day opportunity to opt-out and get their contributions back tax penalty-free.

> Under the regulations, plan sponsors have to notify participants before contributions go into the default investment, and before the start of each plan year.

A 401(k) plan sponsor that allows participants to choose among various investment options can comply with certain rules that limit legal responsibility for the participant's decisions (in case the investments lose money). This relief is limited because the sponsor or other plan fiduciaries still

[11] Plan sponsors can be liable for civil penalties for failure to provide the notice in a timely fashion. [See ERISA section 502(c)(4), 514(e)(3).]

have a fiduciary duty to prudently select and monitor each investment option. But some sponsors have been concerned that if they used automatic enrollment and chose default investments for their employees, they would lose this limited fiduciary liability protection in cases where employees went along with the default investment instead of making an affirmative choice of their own. PPA addressed this, to allow sponsors and other plan fiduciaries to get the same limited protection from fiduciary liability for certain default investments that they could get for investments that participants affirmatively choose. (As in the case of investments other than default investments, plan fiduciaries have a legal duty to prudently select and monitor default investments.)

To get this limited relief, you need to establish a Qualified Default Investment Alternative (QDIA) and follow notification and other rules. (For more on QDIAs, including a description of the other conditions you need to meet to get this relief, see *"Don't Lose Sleep over Automatic Investments."*) The Department of Labor has issued regulations on QDIAs and the notice requirement, effective December 24, 2007.

Follow Department of Labor PPA guidance to qualify for limited fiduciary liability relief with respect to participant investments in the default fund.

Beyond selecting qualified default funds, plans must give participants written notice before the default investment kicks in and again, at least 30 days before the start of each plan year. The initial notice must be given at least 30 days in advance of the first elective contribution unless the plan gives automatically enrolled employees a 90-day opportunity to opt-out and get their contributions back tax penalty-free. The notice needs to be written in a manner calculated to be understood by the average plan participant and needs to:

- Explain the circumstances under which elective contributions will automatically be made, the percentage of pay, and the participant's right to opt-out or choose to contribute at a different percentage;
- explain the participant's right to direct the investment of assets in his or her account;
- explain the circumstances under which a participant's contributions will be invested in the QDIA;
- describe the QDIA, including its investment objectives, risk and return characteristics, and fees and expenses;
- explain how a participant can move investments out of the QDIA, including any applicable restrictions, fees, or expenses that apply in connection with such a transfer; and,
- explain where participants can get investment information about the plan's other investment options.

You cannot satisfy the notice requirement simply by incorporating it into your plan's Summary Plan Description or Summary of Material Modifications. The notice must be a separate written communication and must be easy to read and understand. (There is forthcoming a model notice to be published by the U.S. Department of Treasury and the IRS.)

## Join the Trend

The popularity of automatic features in 401(k) plans continues to grow. PPA gives plan sponsors plenty of reasons to move forward. Department of Labor projects that automatic 401(k) plans may cover 50 percent to 65 percent of the 401(k)-eligible population in the near future.[12] These employees will be put on a better path to a financially secure retirement. Will your employees be among them?

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[12] See page 60470 in Federal Register Volume 72, No. 205, October 24, 2007.

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Pension Protection Act
Section 902.
http://www.dol.gov/ebsa/pdf/ppa2006.pdf

## What to Look For in an Automatic 401(k) Plan Service Provider

You've read all about automatic 401(k) plans. You've considered the implications of adding automatic features, and have come to the decision that it's the way to go. You've made a strong business case to management, and they've agreed that it's time to move forward. So now what?

Your next step is finding the right service provider. Chances are your current 401(k) plan vendor supports automatic features. Alternatively, you may choose to, or need to, work with a separate vendor. For small- and mid-size employers it's important to find a provider that will offer a turnkey approach. Like most employers of this size, you may have only a few people for all human resources and benefits functions. Your provider needs to do the heavy lifting, and many of them are equipped to do just that. The challenge you have is finding the right one.

Take note that choosing a service provider for your 401(k) plan constitutes a fiduciary action, so you need to undertake any provider-related decision with great care. This publication focuses mainly on assessing a provider's ability to administer automatic plan features. The fiduciary decisions regarding selection, retention, or replacement of plan service providers involve many other important considerations not covered in this publication—such as quality, accuracy, and reliability of recordkeeping and other administrative services; ability to assist with participant communications and respond to participant questions; assistance with legal and regulatory compliance; level of fees and expenses; and other considerations.[13]

### Sizing It Up

Large plans have led the way in adopting automatic 401(k) plan features. Their plan service providers typically have ample staff and technological capability to manage the transition and ongoing administration. Plus, large employers often have dedicated in-house benefits professionals to manage the 401(k) plan.

This isn't usually the case with small- and mid-size plans. The service teams may be smaller and the company's investment in technology may be less than that of large providers. Plus, you may be a staff of one on your side of things. So, put time and effort into finding a provider that can meet your needs with minimal input from you. It will save you time and effort in the long run.

[13] U.S. Department of Labor. Meeting Your Fiduciary Responsibilities. September 2006. www.dol.gov/ebsa/pdf/fiduciaryresponsibility.pdf.

## Checking Them Out

Here are some questions to ask when interviewing potential automatic 401(k) plan service providers, whether it's your existing provider or one you haven't yet worked with:

1. **Is your plan in the provider's core market?**
   If the provider mostly works with smaller employers, make sure it has the experience and the staff to serve your plan's needs. If the provider works mostly for very large companies and devotes most of its staff time and resources to the large plans, get assurance that you won't be short-changed.

2. **What has the provider's experience been with automatic 401(k) implementation?**
   Ask how many plans they have experience with in implementing automatic features, which features in particular, and ask about outcomes to date. Look for things like participation rate increases and nondiscrimination testing outcomes. Find out if they have experience in enrolling existing employees, and their process for it. Ask if they can support automatic deferral increases.

3. **How does the provider handle specific administrative functions?**
   Look for technology capabilities to streamline the auto-enrollment process, to return contributions to employees who opt-out within the 90-day window allowed by the Pension Protection Act of 2006, and to automatically enroll existing employees who are not participating.

4. **What audit procedures exist to ensure accuracy of the automatic features?**
   Find out their process for ensuring they are automatically enrolling the right employee groups at the right levels.

5. **What specific features does the provider have in place to ensure compliance with the Pension Protection Act of 2006 and related regulations?**
   Ask about the provider's approach to updating plan documents and receiving regulatory approvals. Find out if the provider manages the notification requirements related to automatic enrollment. Ask what process the provider will undertake to return contributions to employees who opt-out within the allowable timeframe.

6. **What assurances can the provider offer that its team will do most of the heavy lifting?**
   If your resources are limited (and whose aren't?), you want to hear from the provider that the work that falls to you will not be overly burdensome.

7. **Can you talk to their existing clients?**
   Ask current automatic 401(k) clients of your size if they are satisfied with the provider. Find out if their workloads have increased. Ask if they feel they have a reliable point of contact with the provider.

## Summing It Up

By their nature, automatic 401(k) plans are not difficult to administer. In fact, they can greatly reduce the administrative headaches that come with failing nondiscrimination tests, returning contributions to highly compensated employees, and chasing down non-participants to focus them on enrolling in the plan. However, to make sure automatic features are not overly burdensome, you need to find a service provider that is well-equipped to manage the changes and the ongoing administration with little involvement from you. By asking these questions, you'll be well on your way to finding a provider that will meet your needs.

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http://www.dol.gov/ebsa/pdf/ppa2006.pdf

# Informed Participation: The Path to Retirement Security

Are your employees more likely to know the winner's name of the latest hit reality TV show than the meaning of asset allocation? If so, you aren't alone. 401(k) plan sponsors have long sought to educate their employees about retirement planning and saving. The goal of financial education in the workplace has largely been to change behavior, to make savers and investors out of often disinterested, unaware, or overwhelmed employees. But alone, financial education hasn't been highly successful in driving behavior change.

Automatic 401(k) plan design helps bridge the divide. (For an overview, see: *The Automatic 401(k): 401(k) Plans Come of Age."*) A well-structured automatic 401(k) plan helps solve many long-standing participation challenges. By simply doing nothing, employees become plan participants. Their contributions begin when or shortly after they are hired, and accumulate automatically over time, ideally in a default investment with growth potential.

But automatic plan design won't solve every challenge. It gets people past the barriers of procrastination and inertia, but it doesn't inform them. Financial education does. It may also help reduce your exposure to fiduciary liability, and addresses the staggering lack of financial literacy among American workers.

Automatic plan design sets a new paradigm for financial education in the workplace. Since the goal of getting employees into the plan can be met largely through automatic enrollment, sponsors can focus on what participants need to know about the value of the plan, and how to use it to achieve financial security in retirement.

## A Look Back

The "do-it-yourself" nature of 401(k) plans gave rise to financial education in the workplace beginning in the mid 1990's. As employers started to recognize the need for financial education, the Department of Labor issued guidance on permissible education practices. Much of the early focus was on advising plan sponsors on how to avoid the fiduciary liability that can come with offering specific investment advice.

In recent years, sophisticated investment guidance has replaced generic financial education. Plan sponsors now offer a range of educational materials and resources, from personalized statements and asset allocation modeling tools to certain kinds of investment advice.

## Best Practices Emerge

Successful financial education programs share common traits. First, they don't rely on a one-size-fits-all approach. Programs geared to employees based on certain characteristics, such as participation status, income level, primary language, and others are more effective than those that

rely on generic information. The more personalized the message and the materials, the more successful the program.

Second, successful programs are continuous. Simply offering a one-time seminar or sending out a single communication won't accomplish much. Rather, the program should have an extended time horizon and make use of all available communication channels. Many plan sponsors use posters, voice messaging, e-mail, home mailings, seminars, asset allocation tools, company Intranet sites, and other channels to educate, reinforce key concepts, and drive action.

One-on-one financial counseling appears to be the most highly regarded by employees, and the most useful. Surveys document the common refrain of, "Tell me what to do." One-on-one counseling can range from providing basic information on types of investments and setting financial goals to offering specific investment advice. Until recently, however, plan sponsors have largely avoided offering investment advice because of fiduciary liability concerns. The Pension Protection Act of 2006 (PPA) may change that.

## Pension Law Permits Investment Advice

PPA provides a measure of fiduciary liability protection to plan sponsors that make investment advice available to plan participants. Sponsors can arrange for participants to receive the advice through a fiduciary adviser (as defined in the law) or an independent-expert-certified computer model that meets various legal requirements.

The protection hinges on several factors:

- The fiduciary adviser must be named a fiduciary of the plan because the adviser provides investment advice, and must be a registered investment adviser, a bank or similar financial institution, insurance company, or a registered broker dealer (or an affiliate or employee of these entities).
- The adviser must clearly disclose the following:
  - That the adviser is a fiduciary of the plan.
  - Fees or other compensation.
  - Past performance and rates of return of the investment options.
  - How participant information will be used or disclosed.
  - Other information specified in the law.

Fees and other forms of compensation the adviser receives cannot vary depending on which investment options participants select. The plan sponsor remains responsible for the prudent selection and periodic review of the adviser it selects. The protection also requires satisfaction of other conditions not summarized here.

Will PPA encourage more plan sponsors to make specific investment advice available? The jury is still out. But the law recognizes the importance of informing employees about retirement planning and saving, and the Department of Labor has explicitly pointed to the important role employers can play in providing financial education to workers.

## The Bottom Line

You may feel you simply lack the resources to launch and sustain a thoughtful financial education campaign. Fortunately, you don't have to do it alone. You have a variety of helpful materials available at www.RetirementMadeSimpler.org. Also, good plan service providers offer robust communication campaigns. With good support from your plan provider and the materials available through this campaign, you can educate and inform your employees in a way that won't significantly add to your workload.

The path to financial security in retirement is paved with informed decisions. Financial education helps your employees better understand the value of the 401(k) plan and engages them in planning their own financial future. When coupled with inertia-busting automatic plan design, employees are put on a path to financial security. That's a result everyone can appreciate.

## Resources

Retirement Made Simpler
www.RetirementMadeSimpler.org

Pension Protection Act
    Section 601.
    http://www.dol.gov/ebsa/pdf/ppa2006.pdf

401(k) Learning Center
http://apps.nasd.com/investor_Information/Smart/401k/000100.asp

## Automatic 401(k) Case Study:

***A Reluctant Trend-Setter Puts Employees on the Path to Retirement Security***

They say they aren't the kind of company that seeks to set trends. In fact, they see themselves as pretty conservative.

Yet this specialty pharmaceutical company was among the first to add automatic features to its 401(k) plan. It was back in 1997 or 1998; they can't quite recall the year they started.

The company's motivations were simple. They were passing the nondiscrimination tests each year, but by increasingly slim margins. Further, their people just weren't making good use of the plan. The company sponsored a defined benefit pension at the time, along with an employee stock ownership plan, neither of which employees had to contribute to. Taking a long view of the benefits program, the company recognized the growing importance of the 401(k) plan. But their employees didn't.

Fast forward 10 years. The company sails through its nondiscrimination tests, and employee participation and contribution rates are at an all-time high. The secret? There isn't one, really. It's a simple matter of automatic 401(k) features and focused communication.

### Company Snapshot

| | | | |
|---|---|---|---|
| **Type:** | Publicly-Traded | **Participation Rate:** | 95% |
| **Industry:** | Specialty Pharmaceuticals | **Automatically Enrolls:** | New hires |
| **U.S. Employees:** | 3,700 | **Contribution Rate:** | 3% |
| **401(k) Plan Assets:** | $494.2 million | **Contribution Increases:** | Automatic if employee chooses |
| | | **Default Investment:** | Balanced Fund |

### How They Do It

**Automatic Enrollment**
New employees are automatically enrolled in the 401(k) after their first 30 days on the job. The company goes the extra step of requiring employees to sign a notice confirming they understand the nature of the plan. They have no trouble getting the forms back, even among a sizable off-site sales force.

Recently, the company acquired another entity. They decided to treat the acquired company's employees as new hires and automatically enrolled them into the 401(k) plan.

**Default Contribution Rate**
The company has kept the initial employee contribution rate at three percent since first adopting automatic enrollment. The employer match is 100 percent of employee contributions, up to four percent of salary.

"We've thought about raising the default rate over the years," comments a senior human resources manager. "But our people have a good track record of adjusting their contributions to meet their circumstances, so we've kept it at three percent."

The company focuses specific communications on participants that remain at the three percent default rate, and it appears to be successful. The average contribution rate across all employees is an impressive 8.5 percent. Beginning this year, employees have the option to set automatic contribution increases.

**Default Investment Fund**
The contributions of automatically enrolled employees are directed to a balanced fund. Participants who stay in the default fund receive targeted communications, just like those who stay at the default contribution rate. Currently, 87 participants have left their default investment fund untouched.

**Administration Issues**
The company changed 401(k) service providers several years ago, but it was a non-event as far as administering the automatic defaults.

The current service provider simply transmits a file to the company's payroll office twice a month. The file lists new hires from the prior 30 days were not included in the previous transmission and payroll keys them into the system at a three percent contribution rate. The file also includes information on changes in contribution rates and new loans.

The service provider sends the company a periodic "report card" on plan statistics, to give the company a snapshot of participation, contribution rates, investments, and account balances. "We've found the report card to be very useful," explains the HR manager. "We use the information to see where to target our communications."

On the subject of communications, the company finds that automatic features call for more communication, rather than less. The first challenge they found was explaining an automatic 401(k) plan to people who never heard of it. With a mere five percent opt-out rate, it seems like they figured out an effective way to do it.

Other plan statistics point to additional automatic 401(k) successes for the company. For example, the national average account balance in plans of this size is $56,000.[14] The average account balance in our case study company is $97,000. Every age group in the plan has higher average account balances than the national average.

## Advice from the Reluctant Trend-Setter

"Our company has a conservative culture. We didn't intend to be a trend-setter with our 401(k) plan. We just believed at the time that the features made a lot of sense for us and for our people. We felt comfortable about our plan from a regulatory perspective, and we've never questioned our decision to automate.

"We are happy with the results in increased participation and contribution rates. We team with our service provider to target communications to specific groups to address any participation concerns we see.

"I didn't realize that our plan's averages are so much higher than the norm. We didn't intend to lead the automatic 401(k) revolution, but based on our results, we're happy we did."

[14] Fidelity Investments. *Building Futures Volume VII.* 2006. The research data are based on 9.1 million participants across 11,721 plans. The report breaks down results by plan size. See the full report at http://buildingfutures.fidelity.com/pdfs/full_version.pdf.

## Automatic 401(k) Case Study:

***Power Company Amps up Retirement Plan***

For years, the U.S. arm of a global utilities company worried about lackluster 401(k) plan participation. The plan had a great line-up of investment options and a generous employer match. But the company's 8,600 employees weren't taking advantage of it.

Out of concern for their employees' retirement security, the company began considering the idea of adding automatic features to the 401(k) plan. They hesitated, though. The company didn't see many other employers adopting automatic features. They weren't interested in being among the first. Then came what a financial executive of the company refers to as "the tipping point."

"We started seeing more and more companies automatically enrolling their employees," she explained. "We are liability-conscious, but when we saw the trend, our comfort level went up with it."

The automatic features have been in place for just over a year, but the company is already pleased with the results. "Our participation rate is up for both our union and non-union employees. Plus, we use a managed account approach for the investment default, so we feel our people are appropriately invested based on their individual needs."

### Company Snapshot

| | | | |
|---|---|---|---|
| **Type:** | U.K.-based<br>Publicly-traded | **Participation Rate:** | Non-union 92%<br>Union 84% |
| **Industry:** | Electric Utility | **Automatically Enrolls:** | New hires as well as existing with $0 account balances (or an annual basis for employees who are non-participants). |
| **U.S. Employees:** | 8,600 | **Default Contribution Rate:** | 6% |
| **401(k) Plan Assets:** | $1.6 billion | **Contribution Increases:** | Automatic if employee chooses |
| | | **Default Investment:** | Managed account |

## How They Do It

**Automatic Enrollment**
The company automatically enrolls all non-union employees and half of the non-union population. New employees are enrolled 45 days following their date of hire.

The company originally intended to limit automatic enrollment to new hires. Recently, though, it added annual enrollment for employees with zero account balances. "We automatically enroll employees only if they have no account balance. We don't want to capture employees who are not currently contributing but have account balances. That would mean moving their existing balances into the default account, which would cause an unintended change to their investment allocation."

The overall opt-out rate hovers at around 20 percent. It isn't clear yet why employees opt out. Even at this rate, though, the overall participation rate is a healthy 92 percent for non-union employees, and 84 percent for union employees.

**Default Contribution Rate**
The company set the default contribution rate at six percent to align with the employer matching contribution. "We thought it made sense to set [the default contribution rate] at a level for employees to get the full match."

Participants can sign up for their contributions to increase automatically each year. The default increase is one percent a year, up to 15 percent of pay. Participants can choose a different rate for the automatic increases if they want.

**Default Investment Fund**
The company's 401(k) plan participants have a range of investment options, including several lifecycle funds. (These funds are invested based on an employee's expected retirement date.) However, the company didn't think the lifecycle funds were the right investment default for their employees. "Our people have a solid defined benefit pension, and they also tend to retire early. We felt the lifecycle default wasn't particularly useful."

Instead, the company decided to implement managed accounts. The managed account firm pulls age, years of service, and expected pension payout data from information the plan service provider makes available. Each participant's 401(k) account is then invested across funds available in the plan based on this specific information.

**Powerful Advice**

The company has no complaints about the implementation process, and is pleased with the results so far. The additional cost from paying the employer matching contribution to more participants is trivial, since automatic enrollment tends to capture lower earners.

The company does offer the following advice: Make sure your 401(k) plan investment provider has the systems in place to support the automatic features. Also, set up audit procedures to make sure that the correct population is being automatically enrolled.

In other words, this power company advises you to avoid any unexpected shocks.

***Sample E-mail: Automatic 401(k) launch***
***Send to all 401(k)-eligible employees following voicemail from key leader***

| | |
|---|---|
| To: | All personnel |
| From: | CEO or senior HR executive |
| Subject: | Retirement saving just got easier! |

By now, you've heard about the enhancement we have made to our 401(k) plan. Starting [date], each person we hire will automatically join the plan. To extend this "easy enrollment" benefit to our current people, we will automatically enroll anyone who's not already in the plan.

We have added this feature because our 401(k) plan is a powerful way to build a secure retirement. It's an important and valuable benefit, and we understand that it can be a challenge to enroll because you have so many other things going on.

This enhancement will not affect your 401(k) participation if you currently contribute to the plan. It will affect you if you are not currently participating. Here's how:

- You will receive a written notice roughly a month before we automatically enroll you.
    - We will indicate what percent of your pay will automatically go into the plan, as well as into which investment fund your money and our matching contributions will go.
    - You can choose a different amount of pay to contribute, change your investment, or decline participation.
- You have 90 days after we enroll you to decide not to participate.
    - Simply notify us [by sending an email to…/calling…/going online to…] and we will return your contributions through your paycheck. You will lose any employer matching contribution we made up to that point.

This is a great opportunity to jump-start your retirement saving. It is never too early to start. Plus, you'll get the benefit of our matching contribution [which is X for every dollar you contribute up to Y percent of your pay].

It's still important for you to pay attention to your 401(k) account. Educate yourself about saving and investing, and review your investments from time to time—especially when your circumstances change. Use the tools and information we provide to help you make decisions about planning and saving for retirement. [Identify materials and location: newsletter, statements, Web site, seminars, etc.]

[We have more information about the new enrollment benefit and about the 401(k) plan in general (identify how and where to access details – SPD/SMM, Intranet, etc.).]

We encourage you to make the most of your participation in our 401(k) plan. We believe enrolling all of our people in the plan while allowing them to decline participation is a responsible step in the process.

***Sample Voice Mail Script: Automatic 401(k) launch***
*Time: One minute, 25 seconds*

- If your organization is able to reach employees through voice mail, consider this sample message as one means to communicate about the addition of automatic features to your 401(k).
- It's a good idea to follow-up with an e-mail message with additional detail. (See: "E-mail Script" for a sample message).
- Customize items in [red] to reflect your specific circumstances.

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This is [CEO or Senior HR Executive] with some great news about your future retirement security.

Starting [date] each person we hire will automatically join our 401(k) plan. [To extend this "easy enrollment" benefit to our current people, once each year we will automatically enroll anyone who's not already in the plan.]

You may ask why we're doing this. We have two reasons. The first is that we care about the retirement security of all of our people, and we felt the barriers to signing up for the plan were keeping too many of you out. Our 401(k) is a valuable benefit, and we want everyone to take advantage of it.

Also, many other companies now automatically enroll their employees to help them save for retirement. We've studied their experiences, and found that so many more people participate as a result—and they're glad they did!

Now, to the extent there are people who really don't want to save through our 401(k), they have every right to opt out. And each participant can change the amount they're saving and their investments [at any time/applicable plan provision].

I'm so pleased to share this news with you. Keep an eye out for information that will explain this benefit in more detail.

We encourage you to make the most of your participation in our 401(k). We believe enrolling all of our people in the plan is a responsible step in the process. Thanks, everyone.

***Sample Benefits Web Page Content: Automatic 401(k) launch***

Here's how automatic enrollment works:

- We automatically enroll all of our full-time eligible new hires in the plan.

- Once a year, we automatically enroll full-time eligible employees who are not contributing.

This means our new people don't have to worry about 401(k) paperwork. And, our existing people who haven't gotten around to enrolling can cross it off their lists.
If you really don't want to save through our plan, you can decline automatic enrollment. But if you do nothing, here's what will happen:

- [X%] of your paycheck will go into the savings plan
- We will match your contribution [formula]
- We will invest your contributions and the employer match in [fund]
- You can set your contribution to go up one percentage point a year by [how to sign up]
- You can change your contribution amount or how your money is invested [here], or by calling [xxx-xxx-xxxx].

Saving for retirement is one of the biggest financial responsibilities you may ever have. By starting early and saving at least as much as the company matches, you'll be off to a good start.
But there's more to retirement planning than just the saving part.

Think about things like when you want to retire and what you'll want to do once you get there. This will help you set a savings goal.

A [retirement planning calculator] can help you come up with a dollar amount and a plan for how to reach your goal. In other words, how much should you save each month? What is a good investment strategy based on your goal?

With automatic enrollment, and help from the materials you can access through [site source], saving for retirement may be easier than you think!

**Attention Job Movers: Have You Thought About Your Retirement Savings?**
**Your Company Has**

Allen Smith recently started his fourth job since joining the workforce, and he's only 35. "I really like my line of work," explains Allen. "I've been lucky to find ways to build my career and earn more with each job move."

Allen now feels like he's found the right fit for his career goals. But he also realizes he's been overlooking an important benefit over the years—401(k) plans. "I never got around to signing up at my other jobs. Besides, I never really thought of saving for retirement as something I needed to do. After all, I'm pretty young."

While Allen didn't have his eye on the retirement planning ball when he took his latest job, his company did. Like all other recent hires at his company, Allen is automatically saving for retirement.

"We hire a lot of mid-career professionals," says Amy Williams, vice president of human resources. "We don't have a traditional pension, so we see how important the 401(k) is for a lot of our people, whether they stay here until retirement or rollover their accounts to another employer down the road."

Williams and her team spent several frustrating years trying to get their people focused on signing up for the 401(k). "Most of them had the right intentions; they just didn't get around to filling out the paperwork."

After a lot of thought and research, Williams got the go-ahead to implement automatic enrollment. "Now when new people join us, we automatically enroll them in the 401(k). We set them up to contribute four percent of pay, which we match. The money goes into an investment fund based on their expected retirement date. If people don't want to participate, they can tell us that. But this way, if they don't get around to the paperwork, it actually benefits them."

Allen admits he wasn't focused on the 401(k) when he accepted the job. "Frankly, I just didn't pay attention to it. But now I do—I got my first statement a few weeks ago. I have $1,500 in my account. Not bad for not even knowing I was saving."

The statement inspired Allen to pay more attention to retirement planning. He recently used a retirement planning calculator online that opened his eyes. "I've got a lot of saving to do. I just doubled my contribution, and set it up so every time I get a pay raise, my 401(k) contribution goes up, too."

For all of us Allen's out there, automatic enrollment provides a chance for a financially secure retirement, even if we aren't always focused on it.

*You can find out more about XXX Company's 401(k) plan at [www.xxx.com](http://www.xxx.com).* [Insert your company's benefits page address here.] *You can also calculate your retirement needs and change your 401(k) options from this site.*

## When a Bad Dream Reflects Reality: Time to Wake Up to Your Retirement Saving Needs

It happened again. Julia was running late for another meeting. Only this time, she was the presenter. How did this always happen?

She races into the office, runs up the hallway, and flies through the door to the meeting—only to find she is still wearing her pajamas!

But then she wakes up, and realizes it was all a bad dream.

Do you ever have dreams like Julia's? Maybe it isn't a meeting and you aren't wearing your robe and slippers, but the theme is the same—you find yourself unprepared for something important, and by the time you realize it, it's too late.

For millions of working Americans, this isn't a gnawing dream, but a harsh reality. What they're unprepared for is retirement. And, like in Julia's dream, they may realize it only after it's too late.

Employers across the country are trying to wake their employees. They are automatically signing them up to save for retirement. In the old-style 401(k) plan, you typically need to enroll to participate. But people forget, or don't get around to it, or are put off by decisions that may seem confounding.

With the new-style 401(k) plan, dubbed the "automatic 401(k)," your plan sets the initial decisions for you. You're in the plan unless you turn down enrollment. Once you're in, your employer often matches some or all of your contribution. Your contributions go into an investment fund or funds, which you can change at any time.

The automatic 401(k) is one important way employees can start saving for retirement before it's too late. There's more to funding your retirement than automatic enrollment, but it's a good start. Here are some other actions to take:

- Figure out how much you'll need to live on, based on what you make and what your retirement expenses may be, and how long retirement may last (check out free online retirement calculators, like the ones at: http://www.retirementmadesimpler.org/ResourcesAndResearch/index.shtml#topic9.

- Look at what retirement income sources will be available to you. If you may have earned a pension, contact human resources at your current or former jobs to get an estimated payout. Look up your estimated Social Security benefits online at www.ssa.gov. The difference between what you'll have and what you need is your savings target.

- Look at your 401(k).  Are you saving enough?  Are you investing to target the return you need to hit your goal?

Sometimes, all we need is someone to wake us from a bad dream.  If you're reading this, your employer is doing just that.  It's up to you to take it from here.

*You can find out more about XXX Company's 401(k) plan at [www.xxx.com](www.xxx.com).* [Insert your company's benefits page address here.]   *You can also calculate your retirement needs and change your 401(k) options from this site.*