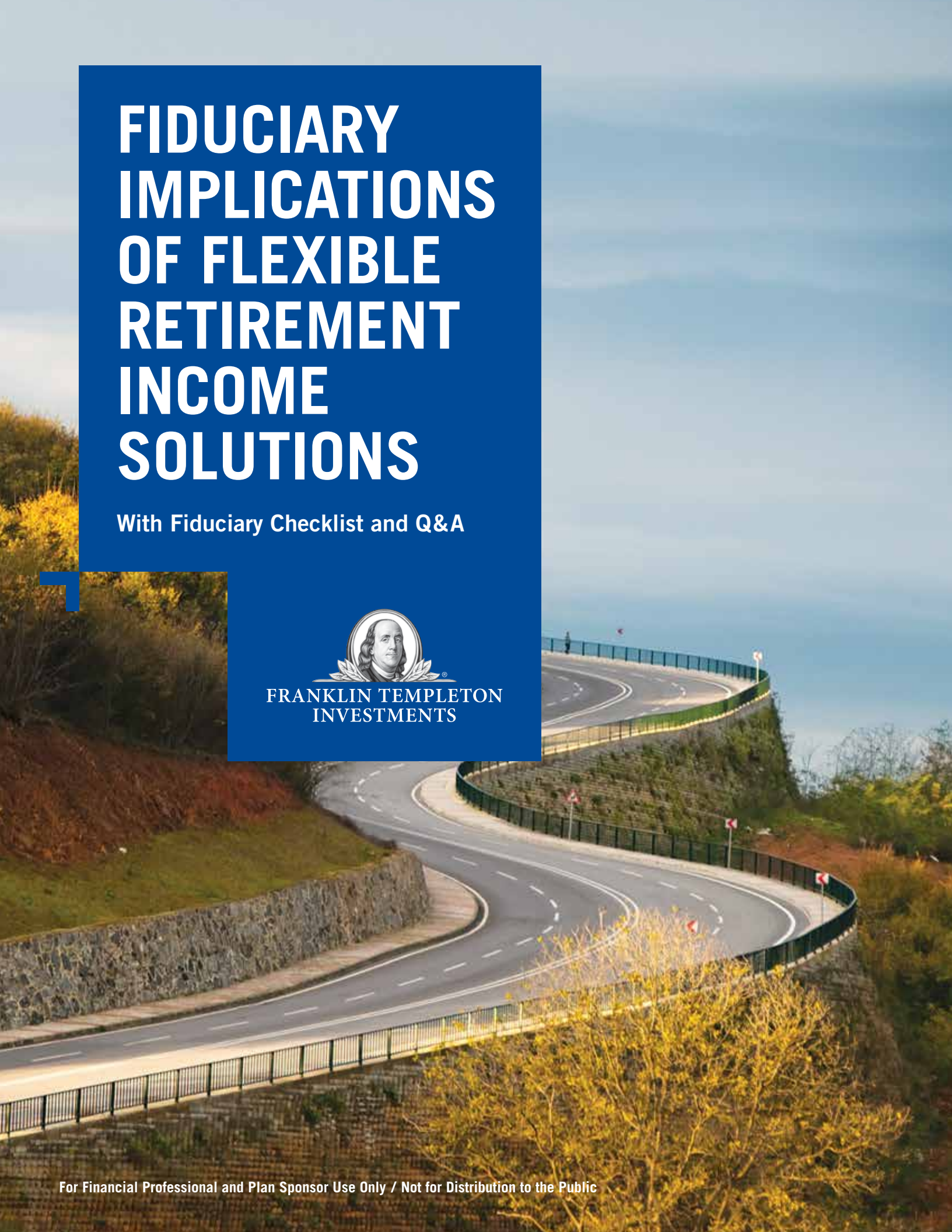
FIDUCIARY IMPLICATIONS OF FLEXIBLE RETIREMENT INCOME SOLUTIONS

With Fiduciary Checklist and Q&A



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Executive Summary

Although comprehensive retirement income solutions may be top of mind, partial solutions used on their own, or in combination with other retirement income investment solutions, can efficiently target specific goals while potentially preserving needed liquidity, portability and flexibility.

- **Fiduciary roles and responsibilities in evaluating, selecting and overseeing retirement income investment solutions may not be well understood.** In order to address these concerns, we provide a FIDUCIARY CHECKLIST and a Q&A that can help to define prudent practices and processes regarding retirement income investment solutions within DC plans.

- **Interest in addressing retirement income needs with defined contribution (DC) plans is an evolutionary step in retirement savings.** While DC plans have largely supplanted defined benefit (DB) plans, the functional goal of employer-sponsored retirement remains—that is, to provide a means for participants to save for retirement and then finance their retirement spending over time.

- **DC plan sponsors that add retirement income features to their plans are not taking on the same liabilities associated with sponsoring a DB plan.** The contingent liability of accumulating assets sufficient to fund retirement remains with the employee participating in a DC plan, even when retirement income investment solutions are added to the plan.

- **Meeting ERISA's fiduciary duties can be straightforward and reasonable if done properly and in the best interest of the employee plan participants.** While there are some special considerations associated with selecting and monitoring retirement income investment solutions, the essential process is largely consistent with current best practice. See our checklist on page 3 for specific examples.

The last 10 years have brought much change in the U.S. retirement system, including the emergence of many "new" ideas—like automatic enrollment, target date funds and simplified investment option menus—as improved standard practice within employer-sponsored retirement plans. However, the evolution continues, as many of these improvements have aided enrollment, contribution and accumulation, while leaving gaps in addressing ultimate outcomes in retirement.

As DC plans continue to evolve, better plans will likely move beyond the current menu of accumulation options and automation-related innovations in order to address retirement income challenges faced by their participants in a thoughtful and integrated manner. Moreover, careful fiduciaries will ensure that the processes used to evaluate retirement income solutions are defensible and well documented. Although the process of selecting and monitoring retirement income solutions might carry challenges, the value of helping participants generate a reliable retirement income stream can make the effort well worthwhile.

Varied Income Needs Flexible Solutions

Careful consideration may suggest that there is no single retirement income investment solution that perfectly matches the wide range and variability of participant needs. In our view, this is no accident.

Diligent fiduciaries who have followed best practice innovations over the last decade have grown accustomed to plan enhancements that address broad needs with simplified, generalized and "automatic" features largely intended to address plan participation and participant inertia. Principal examples include automatic enrollment, automatic escalation and qualified default investment alternatives (QDIAs, often target date funds). While these innovations have done much to improve plan participation and can work exceptionally well for earlier-career participants focused on accumulation, they may be less capable of fulfilling needs for participants approaching (or already in) retirement.

Retirement income solutions that, for example, translate a participant's DC plan balance into a fixed income stream guaranteed for the life of the participant may seem ideal. However, the end result of a career-long financial history is that almost all participants have a personal mosaic of assets and expenses—a unique financial thumbprint that extends beyond the boundaries of the DC plan. Participants may be part of a household, and those combined finances may include a spouse's assets, future earnings from participants' own "encore careers", traditional bank and brokerage accounts, Rollover IRAs, pension income, and real estate—both in the form of a primary residence and traditional investment properties.

The scope and extent of this variety translate to equally varied income needs. Lower-wealth participants may value the ability to access what retirement assets they do have (i.e. liquidity) in the event of an emergency or unexpected expense. Wealthier participants may have many sources of income and may have little need for a regular plan-sourced income stream, instead preferring to optimize long-term return for estate building purposes. All participants may choose to make strategic decisions with regard to filing for Social Security benefits that will affect both the timing and extent of income needs in retirement. Rigid and all-too-restrictive retirement income solutions can struggle to accommodate these varied participant needs.

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On Retirement Income Investment Options

There is a broad number of investment solutions that may offer more flexibility to accommodate changes in income needs over time—some of which can be traded daily to provide flexibility.

Traditional Income-Oriented Mutual Funds. Although not frequently marketed to DC plans for purposes of generating income, there is a substantial number of income-oriented funds with long track records that are often used by individual investors for personal income planning outside of DC plans. Provided that plan policies (and corresponding plan documents) are updated to allow fund-triggered plan distributions, traditional income-oriented mutual funds can provide a partial solution to address retirement income needs.

Managed Payout Mutual Funds. Generally designed to provide regular monthly payments, managed payout funds may also include a targeted distribution rate that is typically updated annually, depending on market conditions. The potential advantage compared to traditional income-oriented funds is that managed payout funds may focus on maintaining a steady payout and reducing volatility of the income stream.

Defined Maturity Mutual Funds. One strategy frequently employed in personal retirement income planning is the use of "bond ladders"—portfolios of fixed income securities with different maturity dates to provide a chain, or "ladder", of principal payments to generate an expected schedule of income. For a great many reasons, constructing a diversified traditional bond ladder within a DC plan is impractical.

However, defined maturity bond funds allow participants to construct diversified, similarly laddered portfolio by investing in a sequence of funds with different payout years (i.e. a 2018 fund, a 2019 fund and a 2020 fund would provide a three-year ladder of income). One additional feature is that defined maturity funds are generally used in concert with other investments (for example, a conventional target date fund), allowing participants to add an income component to a traditional DC plan portfolio while maintaining flexibility and liquidity.

Qualified Longevity Annuity Contracts (QLACs). QLACs are deferred annuity contracts that can be offered within DC plans, albeit subject to certain allocation restrictions.[1] Similar to defined maturity mutual funds, QLACs are an explicitly non-comprehensive solution intended to be used in concert with other plan investments. A participant nearing retirement pays a lump sum premium to receive a lifetime income stream generally starting at age 80 or 85.[2] The key advantage is that, unlike the other investment solutions already profiled, QLACs directly address longevity risk given that annuity payments last at least as long as the participant lives.[3] Selection of an insurance company QLAC provider carries additional responsibilities, although safe harbor provisions may limit fiduciary risk.[4]

1. QLAC allocation may not exceed 25% of the participant's DC plan balance or $125,000, whichever is less.
2. QLAC payments must start by age 85.
3. QLACs may be structured to include spousal benefits.
4. Detailed in 29 C.F.R. § 2550.404a-4 and Department of Labor Field Assistance Bulletin 2015-02.

FIDUCIARY CHECKLIST: IN-PLAN RETIREMENT INCOME SOLUTIONS

The following is a general checklist of items that a plan fiduciary should consider when selecting retirement income investment solutions for their plans. This list should be analyzed and expanded as appropriate to fit the facts and circumstances of each unique situation.

- ☐ **Document the entire process.** Equal attention should be paid to documentation of investment solution and provider monitoring over time. Documentation should clearly articulate the information considered by the employer fiduciary and demonstrate how the fiduciary decisions being made are in the best interest of the plan participants.

- ☐ **Identify the proper individuals that have fiduciary responsibility to lead the selection process.** This could be the plan's existing investment fiduciaries. However, an employer may consider adding additional resources, such as employees with specialized knowledge in the area, an outside non-fiduciary consultant, or an outside non-discretionary investment advisor (often called a 3(21) investment advisors which are named after the section in ERISA defining investment advice). Plan sponsors may also consider outsourcing the entire selection process to an outside discretionary investment manager (often called a 3(38) investment manager) who would control the entire process.

- ☐ **Identify investment solutions based on an analysis of plan participant needs.** Demographic, salary and savings differences amongst the workforce can lead to the use of different types of solutions. Employer fiduciaries should equally study the overall tendency for certain workforces to switch jobs throughout a career more often than other workforces which could require an emphasis on certain features like portability. Participant needs at retirement can be diverse so it's crucial to consider a spectrum of retirement income solutions.

- ☐ **Evaluate the long-term security of the retirement income investment solution.** Because in many instances the obligation to generate income is shifted to the provider of the retirement income product, the financial and managerial health of the provider needs to be analyzed and compared to that of other providers offering similar investment solutions. This extends to all providers, whether their products contain or do not contain annuities.

- ☐ **Evaluate and benchmark any cost associated with the retirement income investment solution.** It should be noted that there is no requirement under ERISA for employers to choose the least expensive option available and oftentimes doing so can itself be a fiduciary breach. Instead, a prudent product and provider selection process should identify a retirement income investment solution that is best for the plan participants—not necessarily the least expensive.

- ☐ **Careful attention must be paid to the portability of retirement income solutions.** ERISA requires that fiduciaries ensure that any contractual arrangements can be terminated within a reasonable time period. If the selection of a retirement income investment solution would mean that a plan participant loses the benefit of portability, plan fiduciaries must investigate and document why this is in the best interests of the employee plan participants. Portability issues can arise at both the plan level (e.g. a change in record keepers) and at the participant level (e.g. issues around the changing of jobs).

- ☐ **Consider a full range of investment solutions that can help address the needs of retired participants—including "conventional" investment products**. Evaluation of retirement income solutions need not be restricted to investments specifically branded for "retirement income" or that provide an annuity-based income guarantee. In fact, traditional investment options that generate regular dividend income may be used as part of a retirement income strategy. Alternatively, flexible systematic withdrawal provisions (if made available by the plan's administrator) can be used with an even broader range of conventional investments.

- ☐ **Evaluate your plan documents to determine if any adjustments may be required.** Many plan documents incorporate restrictions on participants' ability to withdraw balances over time. Changes to the plan document and summary plan descriptions that allow participants to request scheduled partial distributions and adjust those distribution amounts over time can greatly increase the utility of DC plans for participants seeking income in retirement. Such decisions to change a plan's design can be considered a settlor function (as opposed to a fiduciary function) and therefore can involve unique legal issues such as ensuring costs associated with settlor decisions are not paid from plan assets. It is recommended that the employer fiduciary seek trusted counsel to navigate these sometimes tricky issues.

- ☐ **Changes to Investment Policy Statements (IPS) must be addressed.** This should include changes to ensure the IPS addresses and allows selection of retirement income investment solutions. This should also include necessary changes to the plan document and summary plan description to ensure that the retirement income investment solution does not violate any plan requirements.

- ☐ **Develop a clear and comprehensive employee communication plan.** Develop a plan participant communication that clearly describes the retirement income investment option and discloses any associated risks.

- ☐ **Establish a prudent and regular process to monitor the product overtime.** Once a retirement income investment option is selected, ERISA and recent United States Supreme Court case law make it clear that a fiduciary must have an ongoing documented review process. This process does not have to be as rigorous as the selection process, but should include at a minimum a regular review of the quality of product offered, the cost of the product and the continued evaluation of the health of any annuity providers.

QUESTIONS & ANSWERS: IN-PLAN RETIREMENT INCOME

Q: Why are employers considering retirement income investment solutions for their defined contribution plans?

American employers and employees have been part of an immense experiment over the last 30 years as the primary form of retirement benefit has shifted from defined benefit plans to defined contribution plans. Under the previously dominant defined benefit model, the responsibility to fund and manage the assets needed to pay for an employee's retirement benefit was squarely on the shoulders of the employer. However, the gradual and long-standing shift to DC plans has resulted in a migration of responsibility for funding and investment allocation away from plan sponsors and complicating the process for participants. This is compounded by the fact that DC plans when originally created by employers in the 1980s were never meant to be the primary vehicles for retirement income. Instead, they were originally designed as supplemental savings vehicles.

Prior best practices around DC plans suggested that employees were equipped to handle the burden of funding and managing their retirement nest egg on their own or in consultation with a personal financial advisor. However, due to recent regulatory developments concerning the fiduciary implications of Individual Retirement Account (IRA) rollovers as well as simple real-world experiences of many retirees in the current DC-dominated era, opinions have started to change. Moreover, as employers have more broadly considered the ultimate objectives of the plans they sponsor, the need to provide support to participants—either with investment allocation (through target date funds), plan participation (with auto-enrollment features) or retirement income—has become an emerging standard.

Skeptics might perceive renewed interest in plan-centered retirement income as retracing the past, and as a retreat and retrenchment away from the limited guarantees of traditional DC plans. However, we contend this is simply a stage of evolution that has come about with greater interest in end outcomes for participants. As Mark Twain is famously misquoted, "History doesn't repeat itself, but it does rhyme." In this case, renewed focus on in-plan retirement income rhymes with past wisdom that the ultimate, functional goal of retirement savings is to provide a means for participants to finance their retirement spending over time.

From a more technical perspective—and without regard to retirement income investment solutions that may be introduced—the DC model ensures that the contingent liability for accumulation assets sufficient to provide an adequate retirement income stream ultimately remains with plan participants. Under this precept, plan sponsors can remain open to providing retirement income planning assistance without taking on the explicit responsibilities borne by DB plan sponsors.

Q: Is offering retirement income investment solutions within a DC plan an obligation under ERISA?

The passage of the Employee Retirement Income Security Act of 1974 ("ERISA") created retirement plan vesting and funding standards, as well as a scheme of stringent fiduciary duties that employers sponsoring retirement plans must meet to act in the best interest of employee plan participants. Simply put, there is no obligation for employers to offer retirement income investment solutions.

However, it's worth noting that there also is no requirement that employers provide a retirement plan. Still, despite the absence of an explicit mandate, many employers have voluntarily adopted retirement plans as a recruitment tool to hire and retain top talent, as well as a corporate tax savings vehicle.

Going further, employers often elect to incentivize employee savings through contribution matching and assist allocation decisions with target date funds, managed accounts and basic investment education even though this involvement is largely voluntary. This may seem like a technical point since employers may feel a burden to enact incentives and select investment products that can

help ensure the money and effort associated with sponsoring a retirement plan is leading to desired outcomes, but the simple fact is that modern DC plans often extend well beyond specific ERISA obligations.

The same is true for retirement income investment solutions; many employers see retirement income as a logical next step in their efforts to equip their workers with the financial resources needed to transition into retirement when they choose to do so. Note that if an employer chooses to include retirement income considerations within their plan's scope, the selection and monitoring of retirement income-focused investment solutions are subject to ERISA's fiduciary duties. However, the additional effort may be well worthwhile.

Q: What are the potential benefits for the employer and employee?

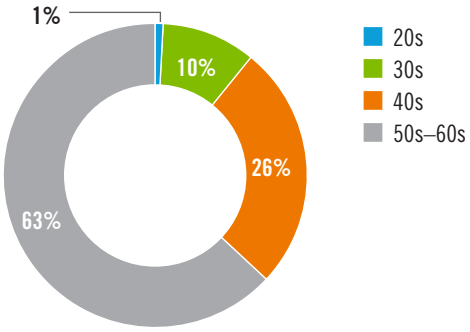
While there is no explicit requirement to add retirement income investment solutions, plan sponsors are considering their options for several reasons. From a participant outcome perspective, DC plan balances are often employees' largest retirement asset and may be the only potential source of retirement income other than Social Security benefits. When viewed through this lens, the importance of generating a more sustainable stream of retirement income from DC plan assets is readily apparent. Due to U.S. Department of Labor action addressing rollovers to IRAs, more plan participants may continue to hold retirement assets in their employer-sponsored retirement plans long after their employment ceases.

In other words, the traditional expectation that employees will roll over their accounts may change under new regulations. Moreover, demographic trends suggest that increasing numbers of "Baby Boomer" plan participants will make the transition into retirement in coming years. The intersection of a likely increase in numbers of retirees and the potential for reduced rollover outflow from DC plans reinforces the urgency to assist plan participants through the transition into retirement and beyond.

- The possibility of ballooning numbers of retirees remaining in DC plans aside, the potential importance of implementing retirement income within DC plans can be interpreted by a simple asset-weighted measure of plan participant balances by age. Participants in their 50s and 60s make up a substantial 37% of all participants. However, well over half (63%) of DC plan assets are held for the benefit of participants age 50 and older.

- Proprietary research from Franklin Templeton Investments suggests that anxiety about retirement peaks far earlier than many expect, between ages 45 and 55.[5] This finding, recorded over multiple years in their annual RISE survey, suggests that participant uncertainty about their ability to generate retirement income affects far more than near-retirees. In fact, it may be a concern for many of employers' most experienced employees. Conscientious employers who understand how this preoccupation can sap productivity may seek to address these concerns to maximize workforce productivity.

401(k) plan assets by age



Source: Employee Benefit Research Institute and The Investment Company Institute, as of December 31, 2015. Most recent data available. Percentages may not equal 100% due to rounding.

- For the employer, helping plan participants to generate a retirement income stream from DC plan balances can provide an important (but possibly less obvious) benefit. The effect of employees not having sufficient retirement savings can have substantial, indirect consequences for employers. Employees who have not accumulated enough in savings to retire or lack a plan to generate retirement income from their DC plans may work until

5. The Franklin Templeton Retirement Income Strategies and Expectations (RISE) survey was conducted online among a sample of 2,013 adults comprising 1,009 men and 1,004 women 18 years of age or older. The survey was administered between January 5 and 18, 2017, by ORC International's Online CARAVAN®, which is not affiliated with Franklin Templeton Investments. Data is weighted to gender, age, geographic region, education and race. The custom-designed weighting program assigns a weighting factor to the data based on current population statistics from the U.S. Census Bureau.

"Proprietary research from Franklin Templeton Investments suggests that anxiety about retirement peaks far earlier than many expect, between ages 45 and 55."

a later age, which may result in higher payroll costs and higher health care expenses. Moreover, the lack of upward mobility for younger employees can push talented workers to competitors where opportunities may seem more plentiful.

Q: Once the decision has been made to make retirement income investment solutions available within a DC plan, what are the fiduciary obligations that must be met by the employer?

As noted above, the selection of a retirement income investment solution for a retirement plan is a fiduciary act and therefore subject to ERISA's stringent fiduciary duties. However, despite the high standards expected of the employer fiduciary, meeting ERISA's fiduciary duties can be straightforward and reasonable if done properly and in the best interest of the employee plan participants.

Of course, plan fiduciaries are subject to an ERISA fiduciary standard mandating the plan be operated solely for the benefit of employee plan participants. This fiduciary standard, or "prudent man standard," requires the employer fiduciary perform duties solely in the interest of employee plan participants with the care a prudent person acting under like circumstances would use. In keeping with the fiduciary covenant, any person who exercises discretion in the management and administration of the plan or in the investment of the plan assets must do so in the interest of the employee plan participants and beneficiaries, in accordance with the plan documents, and invest assets in a diversified manner such that the risk of loss to the participant is minimized.

Strategies for fiduciary compliance include but are not limited to the following:

- Adherence to conflicts of interest policies;
- Monitoring and review of ERISA requirements as well as plan documents;
- Monitoring of plan costs;
- Obtaining services of expert advisors;
- Ensuring proper management and administration of plans including appropriate analysis, discussion and deliberation in matters relating to the plans.

With respect to investments or an investment course of action, an employer fiduciary is considered to have acted prudently if:

- The employer fiduciary gives "appropriate consideration" to the facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved. This includes the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and
- The fiduciary acts accordingly.

The Department of Labor and the courts measure prudence by analyzing the process used to select an investment (e.g., the scope and diligence of the fiduciaries' evaluation of the investment). Therefore, any investment decision should not only comply with the plan's investment policy, but should also be based on sound investment principles. In addition, the process should be well documented.

Conclusion

While DC plans have largely supplanted defined benefit (DB) plans, the functional goal of employer-sponsored retirement remains—that is, to provide a means for participants to finance their retirement spending over time. Given the enduring persistence of that objective, the attempt to explicitly address retirement income needs within the context of a DC plan should be considered as an evolutionary—not revolutionary—step in employer-sponsored retirement plan savings.

In fact, fiduciary duties and obligations associated with retirement income investment solutions are—in principle—much the same as with any investment options selected for the plan. Plan fiduciaries must maintain a thorough and documented process for the selection and ongoing monitoring of plan investment options.

However, beyond the simple satisfaction of core ERISA fiduciary standards, employers seeking to maximize the broader value of retirement income solutions for their participants will often choose to weigh other factors and needs. Although "retirement income" is often assumed to mean a singular, guaranteed, annuity-based solution, no regulatory requirement demands or instructs that plan sponsors must necessarily follow that path and obliterate all longevity risk. Indeed, concluding that retirement income "solutions" need not necessarily resolve all unknowns is a welcome finding for plan sponsors reluctant to significantly extend the length of their engagement with participants "from hire to grave."

Perhaps more importantly, flexible retirement income solutions may also lower the resistance to action among plan sponsors that would be otherwise intimidated by the magnitude and burden of their fiduciary responsibilities in taking a first step to improving outcomes for their participants in retirement. That opens opportunity to a wider set of retirement income investment solutions that may also offer greater flexibility—used either alone or in concert—to address the varying needs of plan participants, especially during the unknowns of the transition into early retirement.

THOMAS E. CLARK JR., JD, LLM

Tom is a partner of The Wagner Law Group, a law firm specializing in ERISA & Employee Benefits, Estate Planning, and Employment, Labor & Human Resources Law. He leads the firm's St. Louis office. His expertise encompasses all aspects of employee benefits programs, including the design, implementation and compliance of retirement plans, health and welfare plans, and executive and incentive compensation arrangements. He also has a robust practice assisting covered service providers in meeting their ERISA compliance needs. Earlier in his career, Tom worked for the law firm of Schlichter, Bogard & Denton including on such landmark cases as Tibble v. Edison, which was decided by the U.S. Supreme Court in 2015. He has also been an adjunct law professor the last five years at Washington University School of Law, his alma mater, where he earned his juris doctorate and masters in tax law.

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One Franklin Parkway
San Mateo, CA 94403-1906

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