Fiduciary Hot Topics

Q4 2022

Plan Sponsors Get Three Additional Years to Adopt Some of the Amendments Required by The CARES Act and The SECURE Act Notice 2022–23

- Originally, plan sponsors had until the end of the first plan year beginning on or after January 1, 2022, to execute amendments required by the Coronavirus Aid, Relief and Economic Security Act ("CARES Act") and the Setting Every Community up for Retirement Enhancement Act ("SECURE Act"). Because the Internal Revenue Service has yet to issue regulatory guidance in regards to some of the provisions within these pieces of legislation it is postponing this date for three years, until the end of 2025 for those provisions.

- The due date is fixed at December 31, 2025, regardless of whether the plan year is the calendar, or fiscal, year. Government plans have somewhat more time.

- As a quick reminder, the CARES Act became law in March 2020, at the beginning of the pandemic. At 2.2 trillion dollars it was, at that time, the largest stimulus package ever enacted by Congress.

- The CARES Act gave plan sponsors the option to allow participants adversely impacted by the pandemic greater access to their retirement accounts. This included in-service distributions up to $100,000; doubling loan limits plus allowing the suspension of loan payments and minimum required distributions for 2020. Although many sponsors adopted these provisions, a large number took a long-term view and decided not to give participants immediate access to their retirement savings.

- The SECURE Act became law in December 2019.

- The provisions in The SECURE Act included allowing long-term part-time workers to defer into 401(k) plans and access to plan accounts for birth and adoption expenses. In addition the SECURE Act moved back the date for required minimum distributions from IRAs and retirement plans to age 72 from age 70 ½. This was in recognition of increasing life expectancies.

- The only provision of the CARES Act eligible for the three-year extension is the suspension of minimum required distributions for 2020.

- Most of the provisions in the SECURE Act are eligible for the extension including:

  - The increase in the age for minimum required distributions to 72;

  - The modification of minimum required distribution rules for beneficiaries;

  - Permitting long-term part-time employees to elect to defer;

  - Allowing penalty free withdrawals for birth and adoption expenses; and

  - The increase in the maximum automatic enrollment safe over contribution from 10% to 15%

Should 401(k) Plans Add Less Traditional Asset Classes to Their Investment Menus?

- In September, Republican lawmakers introduced a bill that, if enacted into law, will be known as “The Retirement Savings Modernization Act.” This bill would amend ERISA to encourage fiduciaries of defined contribution plans to offer plan participants the opportunity to invest in less traditional asset classes often referred to as “alternative investments.”

- The investment menus of most 401(k) plans are limited to traditional asset classes such as US and international stocks and bonds. Plan fiduciaries have shied away from including private investments and other less traditional asset classes because these are perceived as too opaque and potentially too risky for the average participant to utilize in a prudent fashion.

- In a press release accompanying the bill, Senator Tim Scott of South Carolina explained that defined benefit plans tend to outperform defined contribution plans because these plans invest in a wider range of asset classes that includes alternate investments, hedge funds, and private equity. He suggests that in this regard fiduciaries of defined contribution plans have been too cautious. And while the Senator’s statements are factual in nature, they fail to take into consideration crucial differences that exist between defined benefit and defined contribution plans.

- The press release states “*inflation has eroded and devalued the savings many Americans spent their lives accumulating . . . This bill would modernize retirement plans to ensure they can provide diverse investments with higher returns. American workers and their families deserve to go about their lives with peace of mind knowing their hard-earned money will be secure when they choose to retire…. Our legislation will provide the millions of American savers invested in defined contribution plans with the option to enhance the retirement savings through access to a wide range of alternative investments...”*

- This bill would not change existing fiduciary standards rather it would simply clarify that plan fiduciaries may add alternative investments to defined contribution plans without violating their fiduciary duties under ERISA. It would not create safe harbors for alternative investments and makes clear that decisions to invest in alternative asset classes would have to satisfy existing standards.

- The bill explicitly identifies a wide array of asset classes that would be deemed permissible: commodities, public and private debt, digital assets, hedge funds, infrastructure, insured products and annuities, private equity, real assets, real estate or real estate related securities and venture capital.

- The press release goes on to state that the authors of this bill are relying on studies concluding that exposure to alternative investments may enhance returns. The press release sites a Georgetown University study stating that participants in defined contribution plans could potentially increase returns by as much as 17 percent annually through exposure to alternative asset classes.

- Many industry associations have come out in favor of this bill including the CFA Institute and American Securities Association.

- Some salient facts not addressed in the press release are:

    - In defined benefit plans, unlike defined contribution plans, investment risk is on the plan sponsor which tend to be more sophisticated decisionmakers or who have engaged professional money managers to make investment decisions.

    - Some of the asset classes enumerated in the bill, under current securities laws, are not available to the average retail investor as they are perceived to be too risky.

    - Existing guidance from the Department of Labor cautions plan fiduciaries about crypto currencies and that the Department has stated it does not view private equity as an appropriate investment for most defined contribution plans.

    - Although there are studies, such as the one cited in the press release, concluding that exposure to alternate asset classes may enhance returns, there is much debate around this topic some defined benefit plans (notably large public plans) have experienced significant losses from exposure to these types of investments.

- Plan fiduciaries who desire to give participants the opportunity to gain exposure to alternative investments a brokerage window may be the better approach as opposed to adding these types of investments to the core lineup. Although existing law is not entirely clear on fiduciary responsibility regarding brokerage windows, participants who take advantage of this option tend to be relatively sophisticated high net worth individuals.

What’s keeping 401(k) Plans from Adopting ESG More Quickly?

- ESG investing considers nonfinancial factors such as environmental and social concerns and corporate governance. Assets in ESG strategies have grown significantly in recent years. An important factor driving this trend is increasing concern about climate change.

- In recognition of this trend your advisor now possesses the ability to provide your fiduciaries ESG rating analytics generated by MSCI, one of the leading global investment research organizations.

- A recent Bloomberg Intelligence report indicates that ESG assets may exceed $40 trillion by the end of this year and by 2025 one third of all managed assets worldwide are expected to be in ESG strategies. There are now approximately 550 open-end mutual funds and ETF’s following ESG strategies.

- In numerous surveys plan participants have responded that they are increasingly concerned about sustainability and believe that factors beyond traditional financial parameters should be considered in the investment of their retirement savings. This is especially true for younger participants - Millennial’s and Generation X (people ages 26 to 55).

- Notwithstanding the growing interest in ESG investing, 401(k) plans have been slow to adopt the concept. Only a small percentage of assets in 401(k) plans are currently allocated to ESG strategies.

- Not surprisingly those industries whose values align with ESG investing have been more willing to embrace the concept. Many public plans, along plans sponsored by endowments and foundations, offer at least one ESG option. However, Vanguard’s “How America Saves” study in 2021 revealed that only 13 percent of defined

contribution plans in the private sector offer an ESG option. The same study found that only six percent of participants were utilizing an ESG option when one was available.

- One reason for the reluctance on the part of plan fiduciaries to adopt ESG options is the fluctuations the industry has seen in sub-regulatory guidance from the Department of Labor over the past two-plus decades. ESG has either been slightly in, or out, of favor depending upon the political party sitting in office at the Executive level over the years. The years of back-and-forth guidance is due to the facts that Democratic administrations tend to look favorably on the concept of ESG investing, while Republicans are more skeptical.

- The most recent proposed regulations from the Biden Administration's Department of Labor published early last year give a green light to ESG investing but represent 180 degrees turn from regulations published in 2020 at the end of the Trump administration. All this back-and-forth has created some uncertainty. It is probable that many plan fiduciaries are postponing decisions about ESG investing, at least, until the recent guidance is finalized, which is expected in December of this year. And many fiduciaries may abstain from engaging in ESG talks altogether given the potential for continued political uncertainty impacting how the government views such decision-making into the future.

- A second and more significant hurdle to the growth of ESG assets in 401(k) plans is the lack of target date funds and other asset allocation tools with an ESG approach. In most 401(k) plans, a target date series is the qualified default investment alternative and often holds the majority of plan assets. This has become more true in recent years with the advent of automatic enrollment. Many participants are now automatically enrolled into plans and defaulted into a target date series without taking any action.

- Currently, there is only one ESG target date series with a five-year track record - the Natixis Sustainable Future Funds. But in 2020 BlackRock introduced its life path ESG index series and more such funds will surely follow.

- Some plan fiduciaries may be quick to adopt a target date series with an ESG approach once there are enough of these funds with a track record to allow a meaningful comparison.

- In the meantime, 401(k) plans have more exposure to ESG investing than is apparent at first glance. In a recent Russell Investment survey, 82% of managers, not following a stated ESG strategy, responded they take such factors into consideration in making investment decisions. And thus perhaps fiduciaries studying their existing investment menus for ESG impact investing may be the more prudent course of action over adding explicitly ESG-driven and marketed securities.

For more information, visit [WEBSITE] or call [PHONE].

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