Grant Thornton

Trends and insights:
Focusing on the fiduciary agenda

Retirement plan survey 2011

DrinkerBiddle

PSA Plan Sponsor Advisors
Retirement Plan Consultants

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Glossary of terms

§408(b)(2)
Under the ERISA Section 408(b)(2) regulation, the covered service provider must disclose in writing to the responsible plan fiduciary the direct and indirect compensation it expects to receive for the services being rendered.

Accumulation
When investors attempt to build up the value of their retirement portfolio over time, they are said to be accumulating wealth. The reinvestment of profits over the course of the investment time horizon can greatly boost the pace of accumulation through the benefits of compounding.

De-accumulation
When investors attempt to receive periodic distributions from the value of their retirement portfolio over time, they are said to be de-accumulating the portfolio position. The ideal de-accumulation approach allows the retiree to retain significant upside on portfolio returns while still being able to minimize the risk of outliving assets or reducing retirement income due to poor returns.

Employee Plans Compliance Unit (EPCU)
The EPCU develops compliance projects and performs data analysis to focus on areas of potential noncompliance.

ERISA
The Employee Retirement Income Security Act of 1974. Title I of this Act, which covers vesting, funding and fiduciary standards applicable to employee benefit plans, is enforced by the U.S. Department of Labor (DOL).

Fiduciary
Any person who has discretionary authority over the administration of a plan or the management of plan assets, or who renders investment advice to a plan for a fee.

Limited scope investment advisor
An ERISA Section 3(21)(a) investment advisor is one who acknowledges a fiduciary role without taking discretion; the advisor provides investment advice, but leaves the ultimate decision to the plan sponsor.

Outsourced investment advisor
An ERISA Section 3(38) investment advisor assumes discretion for selecting, monitoring and replacing investment options with authority to buy and sell securities as appropriate. This role is effectively the outsourcing of the role of hiring and firing the managers or choosing and replacing other specific investment options.

Financial Reporting Executive Committee (FinREC)
The committee is formerly known as the Accounting Standards Executive Committee (AcSEC) and is the AICPA's senior technical committee for financial reporting. Its mission is to determine the AICPA's technical policies regarding financial reporting standards and to be the AICPA's spokesbody on those matters, with the ultimate purpose of serving the public interest by improving financial reporting.

403(b) plan
A retirement plan established for employees of public schools, employees of organizations described under IRC Section 501(c)(3), and certain ministers and their employees.

404(c)
A section of Title I of ERISA that allows plan fiduciaries to absolve themselves of liability for the results of investment decisions made by participants who have the ability to direct the investment of their own accounts. 404(c) does not relieve fiduciaries of their responsibility to make suitable investment options available to plan participants.

Risk-based investment
An investment option featuring an asset mix determined by the level of risk that is appropriate for each individual investor.

Treasury inflation-protected securities (TIPS)
Funds that are intended to provide protection against inflation. The principal of a TIPS investment increases with inflation and decreases with deflation, as measured by the Consumer Price Index.

Highlights

Investments

While organizations are making progress, with 77% offering training to their plan's administrative/investment committee, 41% of those did so infrequently and without a set pattern. A best practice is to offer training every year, as well as legal updates as new developments occur. Even more, less than half of all investment committees are providing governance reports to the sponsor's board of directors. Considering ongoing developments, more regular training is recommended not just for administration, but to ensure that boards of directors receive the reporting necessary to make informed decisions regarding risks and opportunities related to benefits strategy and operations. More informed decision-making to mitigate risks and leverage opportunities is a practice all organizations should strive to attain.

Plan sponsors do, however, differ in the type of investment advisor relationship they establish. Over half of respondents work with a limited scope investment advisor (ERISA Section 3(21)(a) investment advisor), where both the advisor and the plan sponsor have co-fiduciary responsibilities on the investments for the plan and share in the liability. Another 14% percent of plan sponsors surveyed engage an outsourced investment advisor (ERISA Section 3(38) investment manager) who selects and adjusts investment options without explicit direction from the plan sponsor. Deciding on a fiduciary structure should include some consideration of your investment committee's investment expertise, your desired involvement in your plans' investment decisions, and your committee's understanding of the risks and fiduciary responsibilities as a plan sponsor. In any case, plan sponsors should be aware of and stay consistently informed about the investments being made on behalf of participants.

Of the asset classes in the plan, emerging market (EM) equities were the clear leader with 77% of plans reporting inclusion or consideration. Real estate investment options followed with 53%, global bonds 48%, TIPS 39% and socially responsible 27%, and commodities rounded out the responses at 20%. In considering these options, plan sponsors must consider the potential diversification benefits and enhanced return offered by adding the correct asset classes within their portfolio architecture.

Employer/employee contributions

During the past several years, a considerable number of plan sponsors eliminated or reduced matching contributions. While the majority of survey responses indicate that plan sponsors will not reinstate or were unsure if they would reinstate previously eliminated or reduced matching contributions in 2011, almost 30% of respondents stated they were planning to restore matching contributions. This may signal to employees that things are getting better and reignite interest by those employees who decreased contributions to their 401(k) in order to increase their take-home pay during the recession.

Still, almost 42% of respondents will not be reinstating their match, so plan sponsors should be aware of employee cut-backs in contributions by participants. Anytime employees as a whole cutback on their contributions, a 401(k) plan is likely to have difficulty passing required discrimination testing and plan sponsors should ensure that service providers doing testing are utilizing all testing options to help the plan pass.

Even with cutbacks by both plan sponsors and participants, only 5% of plan sponsors said that many of their employees have expressed concerns about their retirement readiness. Considering the issues facing participants, including reduced employer contributions, decreased plan balances, economic uncertainty and regulatory/administrative updates such as Roth conversions, participants may not be aware that they need to be concerned.

Enhancing plan participation

Many organizations appear to be slow in adopting strategies that offer the opportunity to enhance plan participation as well as participants' odds of success in preparing for a more secure retirement. While the percentage of plan sponsors providing automatic enrollment increased slightly from 39% in 2009 to 45% in 2010, 55% said that they are still not planning to offer any type of automatic enrollment in 2011.

In addition, 58% of plan sponsors stated that they were not considering a Roth feature in their plan at this time. This is effectively the same response we received in the 2010 survey, but this response is slightly lower than the trend in the marketplace, where the perception has shifted noticeably on Roth from a "nice to have" to a strong consideration.

Although de-accumulation is a concept heard more and more frequently in retirement industry conversations, only 9% of plan sponsors surveyed were currently considering the addition of a retirement income solution to provide an ongoing payment stream option for employees. Of the 9% who indicated interest in retirement income options, the response was split almost equally with 52% in-plan and 48% out-of-plan. There is arguably a benefit to looking at in-plan options, assuming that various hurdles can be overcome.

Some options for enhancing plans are more easily adopted than others, but plan sponsors should evaluate their plans and determine appropriate choices for participant success. Conducting due diligence and working with providers requires personnel and resources, but the time to get started may be now.

Maintaining compliance

Fifty-nine percent of plan sponsors responded that they have conducted one or more tax/legal compliance reviews on their plan in the past three years, which is an increase from 46% in last year's survey. Thirty-seven percent of plan sponsors performed general reviews of the entire plan and 22% limited their review to specific identified issues.

A potentially useful tool for self-audit is the 401(k) Compliance Questionnaire issued to a select number of organizations by the Employee Plans Compliance Unit (EPCU) of the IRS in May 2010. Thirty-four percent of survey respondents indicated that they were aware of the questionnaire, while only 2% asserted that they received and completed the questionnaire. Of the plan sponsors surveyed who were aware of the questionnaire, 20% undertook a voluntary internal compliance review, 5% took the additional step of an external compliance review, and 4% initiated plan design changes out of the questionnaire discussion. Utilizing the questionnaire (posted online) to conduct a self-review might be a good idea to ensure you would be able to provide answers during an audit, confirm efficient access to your data, design answers about your plan specifics and uncover mistakes that could be costly if not corrected early.

Interim final fee disclosure regulations were published on July 16, 2010, and are effective January 1, 2012. The majority of our respondents, 92%, signaled they were comfortable that their vendors/advisors would provide the necessary information on fee disclosure regulatory updates. These new disclosures must be provided a reasonable amount of time before the provider arrangement begins, is extended or renewed. Most plan service providers will be required to disclose. However, investments that do not currently hold any plan assets may be exempted. Although many details are provided in the law, there is no form or official format that has been provided for disclosing fees. As a result, plan sponsors may be spending time this year reviewing, understanding and reconciling the fee disclosures they receive from the various vendors providing services to their plans.

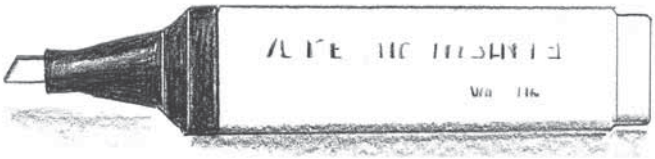
403(b) plans

2009 was the first year that large 403(b) plans (>100 participants) required an audit. Consequently, almost 30% of our respondents who sponsor 403(b) plans found it very difficult to gather pre -2009 annuity contracts and get through the audit process. For plans that have been in existence for many years, gathering the necessary data and getting their arms around opening balances created burdens that a lot of sponsors never expected.

Having worked through the challenges of last year, over 80% of 403(b) sponsors surveyed believe they've established adequate internal controls over ongoing operations. We encourage the remaining sponsors to focus their efforts on ensuring eligible earnings are appropriately calculated and to ensure contributions are remitted as soon as administratively feasible, but no later than the 15th business day of the following month in which the contribution is withheld from pay.

Defined benefit plans

Facing stricter funding requirements and benefit restrictions for underfunded plans after the Pension Protection Act (PPA) passed in 2006, many plan sponsors decided to freeze their existing pension plans and many have designs to freeze in the near future. Fifty seven percent of plan sponsors surveyed had frozen their defined benefit plans to new entrants. Of those who froze plans, 58% had also frozen the accrued benefits to existing participants, while 42% continued to accumulate accrued benefits for the current population. Freezing the defined benefit plan is not the final step; it is an intermediary point in a longer process which contains significant opportunities for plan sponsors to add value and save ongoing costs.

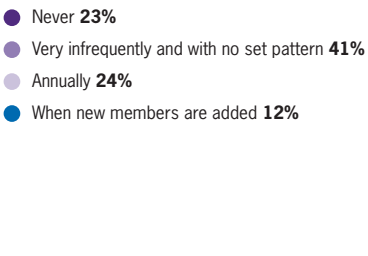


Investments

Effective fiduciary oversight

A resounding 77% of plan sponsors responded that they provide fiduciary training to their plan's administrative/investment committee. However, 41% of respondents noted that they provided such training "only infrequently and with no set pattern." In light of the many new developments annually impacting internal plan fiduciaries, we recommend more frequent (and regular) fiduciary training. The best practice is to provide fiduciary training every year, as well as legal updates as new developments occur.

How often is fiduciary training provided to the administrative/investment committee for your plan (other than by your record keeper)?



Reporting upstream

Only 48% of plan sponsors reported that their plan's administrative/investment committee provided any periodic governance reports to the plan sponsor's board of directors. We believe that periodic reports should be provided, at least on an annual basis (and probably semi-annually for larger plans).

Understanding investment advisor options

The difference between limited scope ERISA Section 3(21)(a) and outsourced ERISA Section 3(38) investment advisors is best summarized as the difference between providing plan sponsors with advice/guidance without decision-making power vs. essentially "managing" the plan's investments with full decision-making power.

More than half of plan sponsors surveyed work with an ERISA Section 3(21)(a) investment advisor, where both the advisor and the plan sponsor have co-fiduciary responsibilities on the investments for the plan and share in the liability. The plan sponsor makes the ultimate decisions in selecting and monitoring the investments.

Fourteen percent of plan sponsors surveyed engage an ERISA Section 3(38) "investment manager." This investment manager can be a traditional money manager or a consultant/advisor who is applying traditional investment consulting services with an additional discretionary authority. Plan sponsors must realize that even if they engage a Section 3(38) manager, the plan sponsor still maintains fiduciary responsibility over selecting and monitoring the investment manager in a prudent manner. The investment manager accepts the authority to manage, acquire and remove investment options. A Section 3(38) arrangement is the highest level of investment liability transfer possible under ERISA. Under a Section 3(38) arrangement, the plan sponsor does not have veto power over the investment process at all.

Only 48% of plan sponsors reported that their plan's administrative/investment committee provided any periodic governance reports to the plan sponsor's board of directors.

Considerations for deciding which type of fiduciary you would like to engage:

- How confident is your investment committee with understanding, interpreting and monitoring investment metrics? How involved do you want to be in selecting and monitoring investments for your plan?
- Make sure your investment advisor agreement clearly states the appropriate type of advisor (Section 3(21)(a) vs. Section 3(38)) that you have engaged. Some advisors do or do not advise on company stock. If you have company stock in your plan, make sure it is understood who is and is not responsible for the company stock.
- Typically, the more fiduciary responsibility you outsource, the higher the price tag.

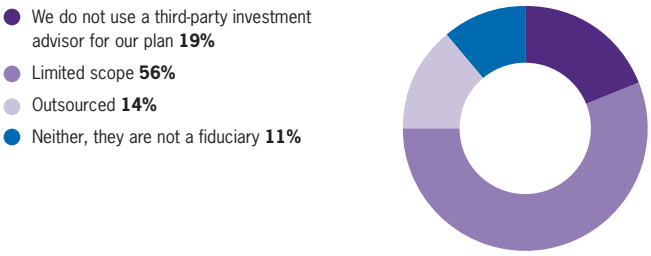
Please note that neither of these designations involves responsibility for the administration of the plan. Plan sponsors need to be aware that they are still responsible for administration and compliance issues associated with the plan, unless their record keeper or third-party administrator has stated in writing that they are taking on the fiduciary responsibility for plan administration.

Popular asset classes

Emerging market equities were the clear leader in responses with 77% of plans reporting inclusion or consideration for 2011. Real estate investment options followed with 53%, global bonds 48%, TIPS 39%, socially responsible 27% and commodities rounded out the responses with 20%. The number one write-in was exchange traded funds (ETF) with 4% of the responses. The common trait of many of these asset classes is the lack of correlation to the equity markets. Asset classes like commodities, real estate, emerging markets and global bonds can be valuable when incorporated into a diverse portfolio, creating a sum greater than the parts. Whenever plan sponsors are adding new investment choices there are three key questions that should be addressed:

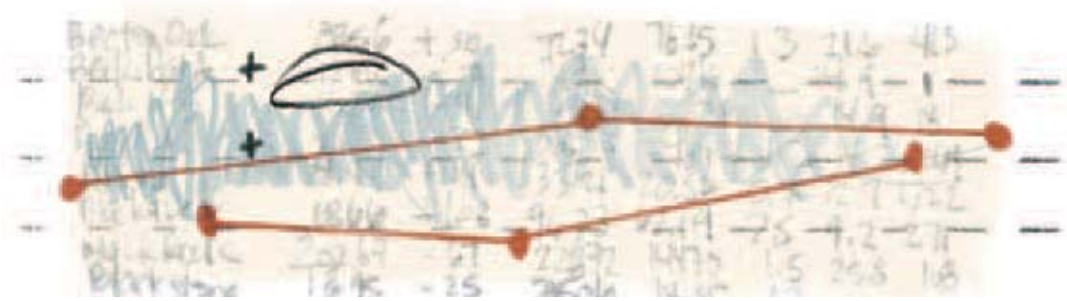
1. Does it provide a diversification benefit?
2. Does it provide an enhanced return profile — essentially, are the expected returns greater within the new asset class than others already available?
3. What does this addition do to the overall portfolio architecture — how many options, what kind of potential overlap, too many "accumulation" strategies vs. balancing accumulation and de-accumulation options, etc.?

If your plan currently engages a third-party investment advisor, what type of fiduciary status does your advisor have?



Emerging market (EM) funds invest primarily in stocks issued by companies domiciled in developing countries experiencing rapid growth and high demand for capital. Historically EM equities earn a higher rate of return than domestic equities to compensate for the additional risks involved. In recent years EM equities have been consistent high performers with an annualized 10-year return of the Morgan Stanley Capital International (MSCI) EM Index of 14.96% vs. -0.02% for the S&P 500 Index. It's important to consider that additional volatility may result from political risks, currency risks and liquidity constraints. Emerging market funds provide investors the ability to partake in the rapid growth of countries like Brazil, India and China.

Real estate investment options typically contain domestic real estate traded through REITs (real estate investment trusts). Real estate is historically uncorrelated with equities, so it can provide a strong diversification benefit. Although REITs are publicly traded and thus fairly liquid, the underlying real estate investments are highly illiquid. Plan sponsors should be sure to review if the underlying real estate investment option invests in REITs or the physical real estate — they are two very different investment strategies and could have significant implications for your participants. With investments in physical real estate, participants may be unable to access their money temporarily and may be placed in a queue with other investors waiting for their investments to be liquidated. While the queues created over the course of the last few years have been cleared (for the most part), many investors were forced to remain in an underperforming fund and so remain skeptical of the asset class. Real estate investments can be far more volatile, but often provide a higher rate of return than broad equities. The 10-year annualized return of the Dow Jones US REIT Index is 11.11% vs. -0.02% for the S&P 500 Index.



Global bonds contain bonds issued by governments or corporations around the world, including the United States. Currently, investors may also benefit from a weakening U.S. dollar, which will increase the returns of the international bonds. As part of a diversified fixed income portfolio, global bonds historically have provided investors with higher yields than domestic bonds. One important cautionary note: In exchange for the additional yield, global bonds may experience increased volatility due to currency fluctuations and geopolitical risks. Over time, investors should keep an eye on the dollar, as performance can lag domestic bonds if the dollar strengthens.

Much of the recent buzz in the institutional investment marketplace has centered on the concept of real return and investment options such as commodities. Commodities are tangible assets, including precious metals, energy resources and agricultural products. Though they can be held in physical form, investment managers typically use derivatives, such as futures contracts, to gain exposure. For a long time now, commodities have been incorporated into hedge fund strategies and sophisticated investment portfolios, but commodity-based mutual funds have only recently matured into retirement plan options. Historically, commodities have been uncorrelated with equities, and as a result, they can help diversify participant portfolios, although the diversification benefit of commodities has eroded a bit in recent years. Commodities have been highly volatile by themselves and are recommended to play a small part in a portfolio. Another consideration with commodities is that in normal environments, commodities will typically underperform equities. Perhaps most interesting — and the cause of much of the buzz — commodities typically provide investors with a strong hedge against inflation.

Service provider disclosures — Schedule C

The completely redesigned and significantly expanded Schedule C was, perhaps, the most intimidating aspect of the 2009 Form 5500 for many plan sponsors. The complex new reporting requirements, coupled with limited guidance from the Department of Labor (DOL) and widely varying levels of assistance from service providers, created a perfect storm for those seeking to accurately complete the schedule.

Plan sponsors hopefully made a good faith effort to report direct and indirect compensation paid to their service providers. However, two developments in particular this past year made it less likely that completed Schedule Cs would provide meaningful fee disclosure:

- the DOL released question #40 in their "FAQs About The 2009 Form 5500 Schedule C," giving service providers the option of not furnishing fee information to plan sponsors because of limitations in their current record keeping and information management systems; and
- the DOL did not release its interim final rule on the reasonableness of service provider contracts until July 2010. This final rule, when effective in July 2011, will require expanded disclosure of fee arrangements to plan sponsors, which should in turn help them more accurately complete Schedule C.

Plan sponsors should be heartened by the fact that despite any shortcomings in their reporting, the DOL is somewhat unlikely to challenge them on it, at least for 2009 returns. Currently, there are no EFAST2 edit checks in place for Schedule C, and given the wide disparity in reporting that was done on 2009 filings, DOL officials have informally stated that Schedule Cs are probably going to be viewed initially as an information gathering tool as opposed to one that will assist with enforcement activities.

How much difficulty did you encounter obtaining the information needed to comply with the expanded Schedule C reporting requirements on the 2009 Form 5500?

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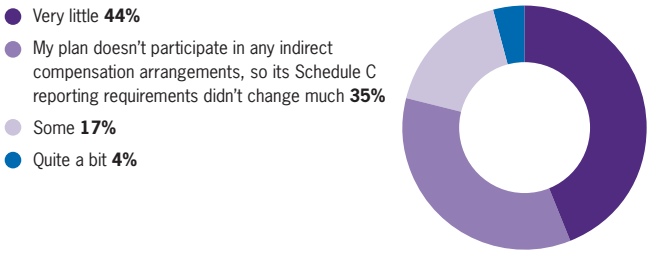
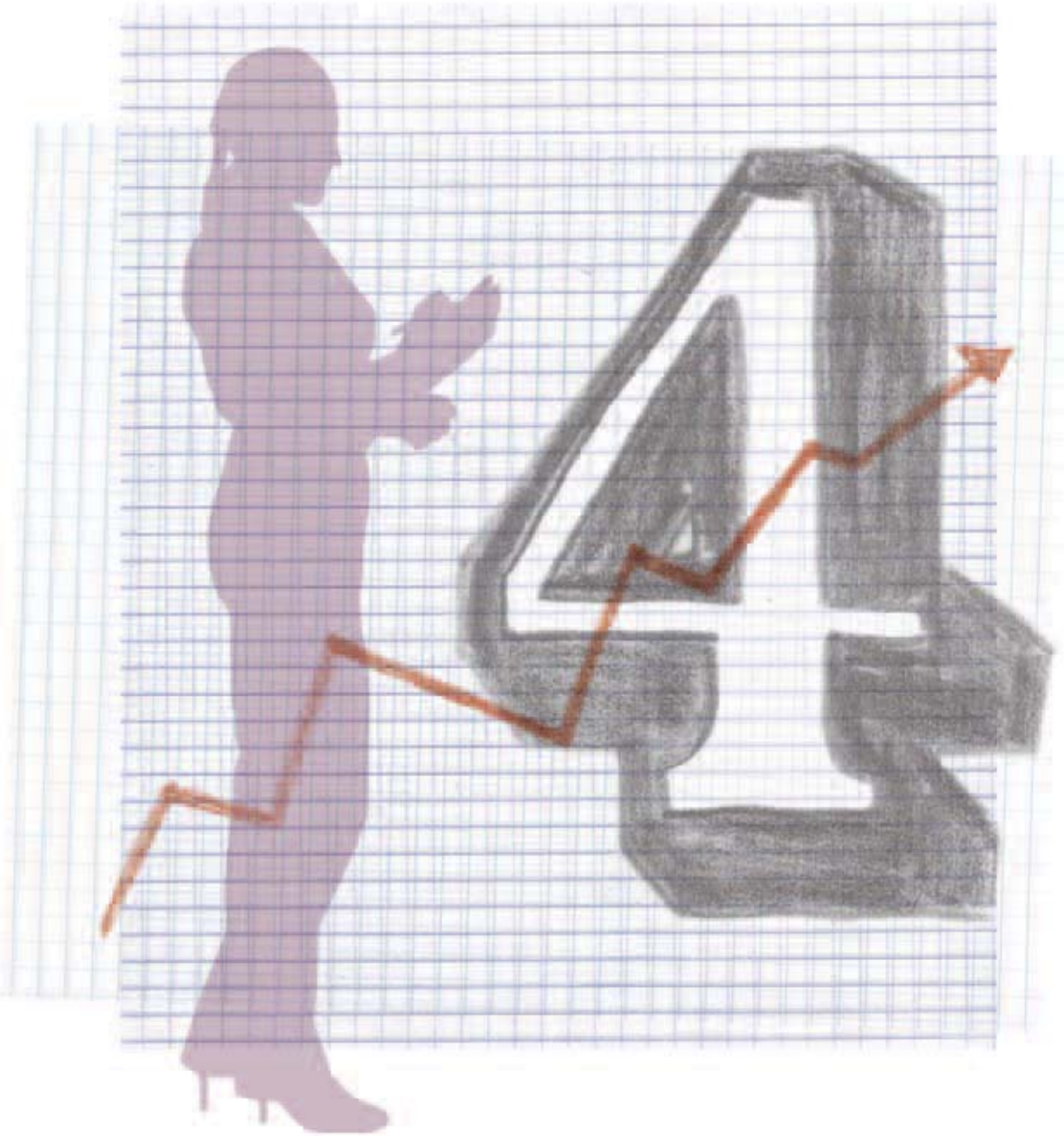




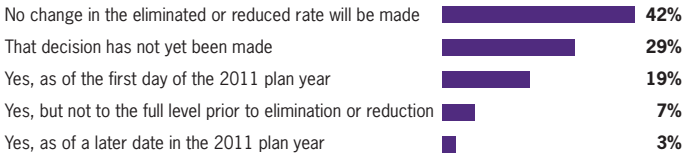
Employer/employee contributions

Employer matching contributions

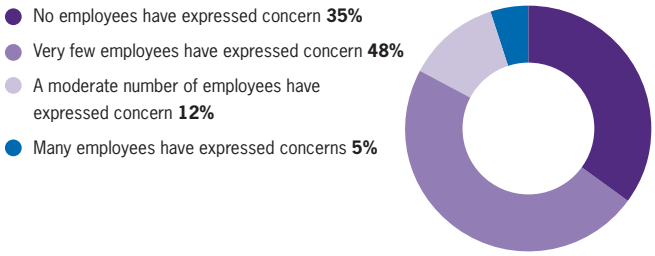
While the majority of responses indicate that plan sponsors will not be reinstating previously eliminated or reduced matching contributions, almost 30% of respondents stated they were planning to restore matching contributions. Nineteen percent of responses indicated the match would be reinstated on the first day of 2011. An additional 10% asserted that only a portion of the match would be restored, or the restoring of the match would occur at some other point in 2011. If you are trying to decide whether or not to reinstate the match, consider the following:

- If you are not in a financial position to reinstate the entire original match securely, consider reinstating at least some of the match. The implicit message to employees is that things are getting better, and this could help reignite interest in employees who have decreased or stopped their contributions to the plan.
- If you can reinstate at least some of the match, consider restructuring the match amount to the same contribution cap as before. For example, if your match was originally 50% up to 6% of pay (equal to 3% of pay) and you can only reinstate half of the match, consider matching 25% up to 6% of pay (equal to 1.5% of pay) instead of 50% up to 3% of pay.

If the employer matching contributions for your plan were fully or partially eliminated or reduced over the past two years, will they be fully reinstated in 2011?



Have employees expressed concerns to your company in 2010 about their retirement readiness based on their current retirement balances and benefit options?



Retirement readiness

Survey responses were in line with the results of many recent behavioral finance studies, with 83% of plan sponsors reporting that either very few or none of their employees had expressed concerns. Only 5% of plan sponsors conveyed that many of their employees have expressed concerns about their retirement readiness.

Studies show many participants surveyed simply do not report to understand what savings balances they will need to retire comfortably. We have experienced a considerable uptick in requests from plan sponsors to assist in communications strategies and retirement readiness programs for their employee populations. The current situation facing participants is that the combination of decreased plan balances, economic uncertainty and regulatory/administrative updates, such as Roth conversions, have significantly increased the number of issues facing participants. However, until they actually face some of these issues, they may not be aware of the critical nature of these challenges.

Economic effects on discrimination testing

Our economic recession has certainly highlighted the need for both businesses and individuals to have ready access to cash. During the past couple of years, many plan participants adopted a defensive posture and elected to forego long-term retirement security in favor of increased take-home pay, accomplishing this by reducing or altogether eliminating their 401(k) plan contributions. While this may not have been their intent, many plan sponsors made this action easier for participants to justify by suspending matching contributions for some or all of the plan year.

Of course, any time that plan participants as a whole cut back on contributing, a 401(k) plan is more likely to have difficulty passing required discrimination testing, e.g., the Actual Deferral Percentage (ADP) test. The purpose of the test is to determine whether all participants are benefiting equitably from the plan. If you have found yourself in this increasingly common position, be sure that the service provider completing testing for your plan is utilizing all available testing options to help the plan pass. For example, ADP testing can be run using what is often called the "otherwise excludable employee" rule, and if your 401(k) plan allows employees to enter the plan prior to the statutory minimum one year of service, it's likely that testing using this rule would improve your results. We have found that many record keepers either aren't aware of the rule or simply don't apply it.

Do you feel that the current economic environment has made it more difficult for your 401(k) plan to pass discrimination testing?

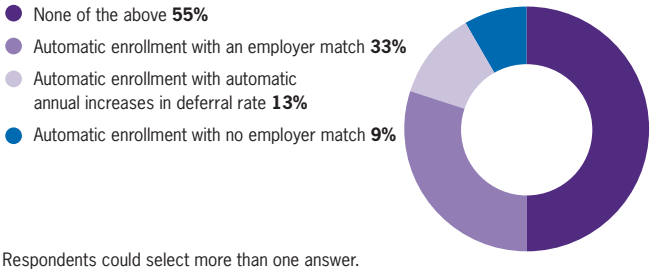
In addition, if you're having testing trouble, it may be time to revisit the safe harbor 401(k) plan concept. Going with a safe harbor design may entail some additional cost, but it's becoming less of a barrier each year as the trend toward more rapid vesting schedules continues. If your plan has relatively few forfeitures, or has forfeitures that are being reallocated to remaining participants, or a profit sharing contribution that could be redesigned in favor of a safe harbor contribution, making the change to a safe harbor design need not be cost prohibitive and can solve many of your testing woes for good. You may also consider automatic features such as automatic enrollment and automatic escalation in contribution rates. It is likely that implementing these plan design features will have a positive impact on plan participation, resulting in improved test results.

Enhancing plan participation

Automatic enrollment

We asked our respondents what form of automatic enrollment (if any) plan sponsors were planning to offer participants in 2011 (to enhance participation and savings levels). Thirty-three percent of respondents reported that they will be offering automatic enrollment with an employer match and 9% reported that they were providing no match with the automatic enrollment feature. Thirteen percent of plan sponsors responded that they were also including an automatic increase in default deferral rates in their automatic enrollment feature. The majority of plan sponsors (55%) noted that they were not planning to provide any form of automatic enrollment feature for 2011.

Which of the following features will your plan offer for 2011?



Respondents could select more than one answer.

Roth contributions

The survey results on Roth accounts came as a bit of a surprise; 58% of plan sponsors stated that they were not considering a Roth feature in their plan at this time. This is effectively the same response we received in the 2010 survey. This response is slightly lower than the trend in the marketplace. The October 2010 survey from Callan states nearly 50% of plans reported an in-plan Roth feature. Perceptions in the marketplace have shifted noticeably on Roth from a "nice to have" to a "strong" consideration. This is consistent with our survey responses, which reveal that 15% of the 42% of plans that include a Roth feature have implemented the feature since the beginning of 2010.

Twenty-eight percent of plan sponsors who indicated that Roth features were being added to their plans in 2010–11 indicated that regulatory updates involving "in-plan Roth rollovers" contributed to the decision. The Small Business Jobs Act of 2010 that was passed on Sept. 27, 2010, allows plan sponsors to offer an in-plan Roth rollover option. This feature allows eligible participants to convert pre-tax money to after-tax Roth money within their defined contribution plan account. The Roth money then grows tax-free. This is different from participants rolling their money over to a Roth IRA.

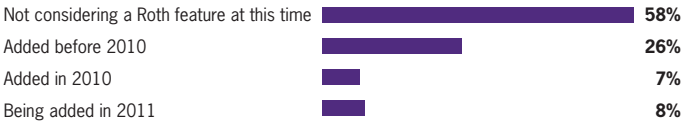
When a participant makes a rollover to a Roth IRA, the money is distributed from the plan and is no longer part of the plan. Eligible participants who can take advantage of the in-plan Roth rollover feature must first be eligible for a rollover distribution under the plan. Typical types of eligible rollover distributions include age 59½ withdrawals, rollover withdrawals and final distributions (terminated/retired participants, spousal beneficiaries, alternate payees). A hardship withdrawal is not an eligible rollover distribution.

- In-plan Roth rollovers are only available to plans that offer Roth deferrals.
- Tax implications for participants:
  - in-plan Roth rollovers are not subject to mandatory 20% withholding when the distribution is made within the plan;
  - in-plan Roth rollers are not subject to the 10% early withdrawal penalty unless the special recapture rule applies (recapture rule/penalty applies if the participant takes a distribution of any portion of the in-plan Roth rollover within a five-year period); and
  - a special two-year income spread over 2011 and 2012 was allowed for in-plan Roth rollovers made during 2010, while for 2011 and beyond, participants recognize the taxable income for the tax year in which the in-plan Roth rollover is made.

For interested plan sponsors:

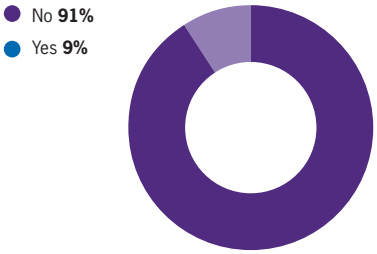
- if you do not have a Roth deferral feature, consider adding it your plan;
- adding Roth deferrals requires a coordinated effort between your payroll and record keeper vendors, as the Roth is a new contribution type that needs to be tracked separately; and
- it is important that you appropriately communicate the Roth deferral and the in-plan Roth rollover feature to your plan participants. Be careful not to provide tax advice to participants.

What is your plan's current stance towards Roth contributions/accounts?



Responses do not total 100% due to rounding.

Are you considering adding income replacement solutions to your retirement plans to provide an option for ongoing payment streams to retirees?



Income replacement solutions

Studies indicate that defined benefit plans typically earn about 1% more per year than defined contribution plans. This knowledge, combined with the spectacular growth of assets in defined contribution plans, has led efforts to create a more defined benefit-like structure within defined contribution plans, including the replication of an income stream at retirement.

Already, efforts have been made to help participants better manage their plans and make the right investment decisions with streamlined investment options and the introduction of target-date and risk-based funds. However, until recently, the focus has been on the asset accumulation phase with little emphasis on income distribution. In addition to encouraging greater participation, offering higher savings rates and offering better risk-adjusted investment options and asset allocation advice, plan sponsors are starting to look at income replacement options as a way for employees to transition more effectively from accumulation to distribution at retirement.

There is currently a debate as to whether these income replacement or lifetime guarantee options should be offered in-plan or out-of-plan, and there are a number of operational and regulatory issues that plan sponsors must consider. Only 9% of plan sponsors surveyed were considering the addition of a retirement income solution to provide an ongoing payment stream option for employees. Of the 9% who indicated interest in retirement income options, the response was split almost equally with 52% in-plan and 48% out-of-plan. There is arguably a benefit to looking at in-plan options, assuming that various hurdles can be overcome.

Earlier consideration would allow a participant the opportunity to address the following risks:

- **Longevity risk** – the risk of out-living one's savings.
- **Interest rate risk** – the risk that inflation will erode long-term purchasing power.
- **Market risk** – the risk that investment performance will reduce the market value of a participant's portfolio at retirement.
- **Risk of ineffective financial management** – the risk that a participant will not manage a lump sum distribution at retirement effectively.

While an in-plan option can offer the participant certain benefits, such as dollar cost averaging, institutional pricing and a way to smooth out market and interest rate risk while transitioning from the accumulation stage to the distribution stage at retirement, significant concerns still remain. For example, if a participant changes jobs, the new employer may not support the current option, which would then have to be rolled over to an IRA. Also, if an annuity is selected, a participant may lose control of the underlying assets.

Defined contribution plans are in the early stages of a major transformation from savings or investment vehicles and supplemental retirement income into the major component of income replacement for all but the poorest of Americans. A successful transition within the architecture of defined contribution plans may be critical to a secure retirement for a majority of Americans. This transformation requires new, and unfortunately complicated, investment solutions and operational changes to record keeping platforms and additional guidance from regulators. Interested plan sponsors should begin the process of evaluating their plans and determining appropriate choices to ensure participant success. Conducting due diligence and working with providers will take time. But the time to get started is now.

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Maintaining compliance

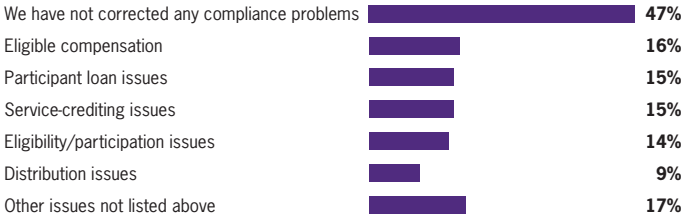
Operational compliance review

Tax and legal compliance have become increasingly difficult for plan sponsors. One way to assess the audit and/or litigation risk is to perform an operational compliance review periodically. Fifty-nine percent of plan sponsors responded that they have conducted one or more tax/legal compliance reviews on their plan in the past three years. Thirty-seven percent of plan sponsors performed general reviews of the entire plan and 22% limited their review to specific identified issues. We are pleased with this serious attention by our respondents to a potentially costly issue.

Common compliance issues

We also inquired which compliance problems have been corrected by plan sponsors in the past three years. This was done to obtain data on the relative proliferation of various problems. The most common corrections involved eligible compensation (16% of respondents), participant loan issues (15% of respondents), service-crediting issues (15% of respondents), improper inclusion or exclusion of participants (14% of respondents) and improper distribution issues (9%). Forty-seven percent of respondents reported that they have not corrected any compliance problems in the past three years. All plans have some level of compliance problems. The 47% of respondents that have not corrected any compliance issues are just not looking for them or, even worse, failing to correcting problems once identified. The latter strategy is especially dangerous.

What compliance problems have you corrected in the past three years?



Respondents were able to select more than one answer.

401(k) compliance

Plan sponsors were given 90 days to complete the survey sent by the IRS's Employee Plans Compliance Unit (EPCU). The questionnaire included several sections, asking for various plan design and demographical information. It was NOT an audit. However, if the questionnaire was completed incorrectly or not completed at all, EPCU is following up. Thirty-four percent of survey respondents indicated that they were aware of the questionnaire, while only 2% asserted that they received and completed the questionnaire.

If you did not receive the questionnaire, you can review it online and use it as a self-audit tool. The self-review might be a good idea to ensure you are able to provide the answers in case of an audit and confirm efficient access to your current data and design answers about your plan. You can locate the compliance questionnaire at: http://www.irs.gov/retirement/article/0,,id=223440,00.html.

The EPCU plans to post findings from the survey on its website by June 30, 2011. The results will help identify areas requiring additional education, outreach, guidance and compliance activities. It's important to find plan mistakes early because corrections can become more costly the longer you wait.

Top 10 errors

1. Plan document failure
2. Failure to follow the terms of the plan document
3. Failure to use the plan's definition of compensation
4. Failure to follow the plan's matching contribution provisions
5. Failure to satisfy the ADP or Actual Contribution Percentage (ACP) nondiscrimination testing
6. Failure to include all eligible employees
7. Failure to limit elective deferrals to the IRC 402(g) limits for the calendar year
8. Failure to timely deposit elective deferrals
9. Failure to follow the plan's loan provisions and violation of IRC 72(p)
10. Failure to follow the plan's terms regarding hardship distributions

Of the plan sponsors surveyed who were aware of the questionnaire, 20% undertook a voluntary internal compliance review, 5% took the additional step of an external compliance review, and 4% initiated plan design changes out of the questionnaire discussion. The EPCU is the IRS's fastest growing market segment. We can expect the number of plan audits to increase dramatically.

Fee disclosure regulation changes

The overwhelming response from plan sponsors, a full 92%, signaled they were comfortable that their vendors/advisors would provide the necessary information on fee disclosure regulatory updates. ERISA Section 408(b)(2) applies to retirement plans, including defined contribution and defined benefit plans, with exceptions for non-ERISA plans. Interim final fee disclosure regulations were published on July 16, 2010, and are effective January 1, 2012. This disclosure regulation is designed to provide fiduciaries with the information they need to satisfy their obligations under ERISA Section 404(a)(1) regarding reasonableness of fees. Service providers not in compliance will be subject to the prohibited transaction rules of ERISA and related excise tax. Service providers must comply if they are a "covered service provider" that can reasonably expect to receive at least $1,000 or more in direct or indirect compensation.

Covered service providers can be separated into three types:

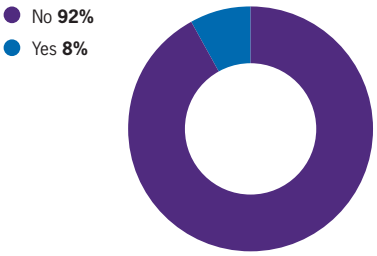
1. Those providing advisor services as a fiduciary as defined by ERISA Section 3(21)(a) as a fiduciary to an investment in which the covered plan has a direct equity investment or services provided directly to the plan per the 1940 Investment Advisers Act or any state law.
2. Those providing record keeping or brokerage services to an individual account plan that permits participants or beneficiaries to direct the investment of their accounts.
3. Those providing other services such as accounting, auditing, actuarial, appraisal, banking, consulting (specifically related to the development or implementation of investment policies or monitoring of service providers or investments), custodial, insurance, investment advisory for the plan or participants, legal, record keeping, securities or other investment brokerage, third-party administration or valuation services.

Fee disclosures are required to be in writing and must cover three issues:

1. **services** – description of the services to be provided to the plan;
2. **status** – indication of whether the covered service provider is a fiduciary and/or adviser under the Investment Advisers Act of 1940 or any applicable state law; and
3. **compensation** – four types of compensation that need to be disclosed:
   a. description of all reasonably expected direct compensation in the aggregate or by service;
   b. description of all reasonably expected indirect compensation including the identification of the services and the payer of the indirect compensation;
   c. description of any compensation that will be paid among related parties if it is set on a transaction basis (e.g., commissions, soft dollars, finder's fees or other fees based on business placed or retained) or is charged against plan assets (e.g., 12b-1 fees) including identification of the services and the payer of such compensation; and
   d. description of any compensation received in connection with the termination of the arrangement.

These new disclosures must be provided a reasonable amount of time before the arrangement is begun, extended or renewed. Investments that do not currently hold any plan assets may be exempted. Although many details are provided in the law, there is no form or official format that has been provided for disclosing fees. As a result, plan sponsors may be spending time this year reviewing, understanding and reconciling the fee disclosures they receive from the various vendors providing services to their plans.

Do you feel comfortable that your vendors/advisors will provide you with all the necessary information on the fee disclosure regulation changes, including ERISA?



EFAST2 update

If you sponsor an employee benefit plan, sooner or later you will encounter EFAST2, the DOL's new all-electronic filing system for Form 5500. Fortunately, Schedule C confusion and challenges aside, the general consensus appears to be that EFAST2 is a welcome and substantial improvement over EFAST1. The DOL's web-based filing portal, IFILE, consistently worked well even while some third-party software packages faced technical issues, and many plan sponsors have been surprised to find their completed Form 5500s with all attachments showing up on the DOL's website within minutes after being filed. EFAST2 certainly appears to be delivering on its promise of providing more timely information to both the government and the public.

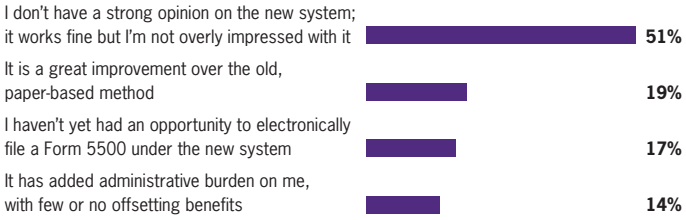
Without a doubt, the new system has challenged some plan sponsors. According to DOL officials, approximately 670,000 returns were filed under EFAST2 through the major deadline of Oct. 15, 2010. Interestingly, about 20% of these were amended returns, many of which were probably needed to fix various errors made during the filing process. The DOL also said that Oct. 14 was its busiest day for receiving filings. While many plan sponsors and service providers still waited until almost the last minute to file, they may have taken to heart the DOL's warnings about flooding EFAST2 with more returns that it could handle in the waning hours of Oct. 15.

The DOL recently said that approximately 10,000 filers will be receiving correspondence early in 2011 regarding the need to correct their return because it was electronically signed only by the plan sponsor, with no plan administrator signature. E-signature issues like this seem to be the most commonly encountered problem for many users of EFAST2. The DOL's many FAQs on EFAST2 can be time consuming to wade through, but they address nearly all common filing questions.

Timeliness of contributions

Remember that the DOL's plan asset regulation requires that all participant contributions (whether pre-tax or after-tax) be remitted to the plan's trust as soon as they can be reasonably segregated from the plan sponsor's assets. While there is an outside time limit of the 15th business day of the month following withholding, that is definitely not a safe harbor. When determining how quickly participant contributions to your plan can be segregated, a key consideration is the complexity of your payroll process. In general, the more complex the payroll process (i.e., multiple locations where payroll is processed, in-house proprietary system vs. payroll outsourced to national vendor, etc.), the more time is deemed to be practicable for remitting contributions.

What is your overall assessment of the new electronic filing process for Form 5500?



Responses do not total 100% due to rounding.

When the DOL's safe harbor regarding the timeliness of participant contributions to small (i.e., unaudited) plans was proposed in February 2008, and then finalized in January 2010, it highlighted the fact that contribution timeliness continues to be a key area of focus for the agency. Without a doubt, remitting participant contributions as quickly as they can be segregated from the plan sponsor's general assets is not always easy for plan sponsors. Based on how many violations we see in this area, and informal comments from the DOL that around 90% of submissions under their Voluntary Fiduciary Correction Program (VFCP) relate to delinquent contributions, you are certainly not alone if you have found yourself grappling with this issue.

While the DOL has chosen not to issue a safe harbor for large plans, in part because it did not receive many comments on a large plan safe harbor after the release of the proposed rule for small plans, DOL officials informally state that they continue to believe that most large plans should be able to segregate participant contributions even more quickly than small ones. If small plans are held to a seven business day standard under the safe harbor, large plans should be doing better than that in the government's eyes. We often see regional DOL offices, whether as part of an investigation or a review of a VFCP submission, hold large plans to a three-to-seven calendar day standard, unless the plan sponsor can present very compelling evidence for why more time is needed.

403(b) plans

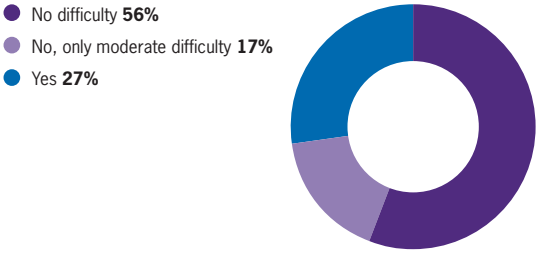
Year 1 reflections

Filing the 2009 Form 5500 was a rude awakening for almost 30% of our respondents who sponsor 403(b) plans and found it very difficult to gather pre-2009 annuity contracts and just get through the audit process. 2009 was the first year that large ERISA-covered 403(b) plans (>100 participants) required an audit. For plans that have been in existence for many years, gathering the necessary data and getting their arms around opening balances created burdens that a lot of plan sponsors never expected. Prior to amended regulations, most 403(b) sponsors did not view the plan as a separate reporting entity. Historically, it was viewed as a collection of individual accounts with which participants could engage in a range of actions with limited involvement by the plan sponsor. Accordingly, various records relating to contracts entered into prior to Jan. 1, 2009, were not maintained. This approach, which was taken by many plan sponsors, coupled with the lack of information made available by third-party service providers, created many audit challenges. The DOL recently reported that these challenges likely resulted in 20% of 5500s filed by plan sponsors being either incomplete or containing disclaimer opinions.

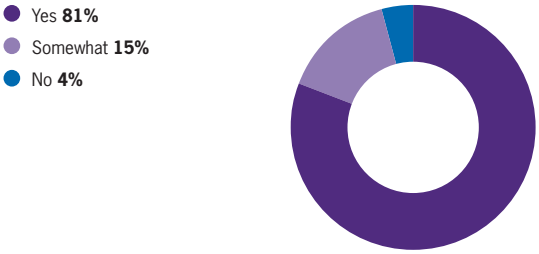
Year 2 focus

With a rough year behind 403(b) sponsors, over 80% of our 403(b) sponsors believe they've established adequate internal controls over ongoing operations. We encourage the remaining plan sponsors to focus their efforts on ensuring that eligible earnings are appropriately calculated when determining employee and employer contributions and ensuring contributions are remitted to the trustee or custodian as soon as administratively feasible, but no later than the 15th business day of the following month in which the contribution is withheld from pay. Plan sponsors need to be aware that the 15th business day is not a safe harbor. Determining and documenting what the company defines as "as soon as administratively feasible" is an important step in fiduciary oversight.

Did you experience significant difficulty getting plan level reporting for pre-2009 annuity contracts?



Do you feel adequate internal controls have been established related to the plan operations of your 403(b) plan?



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Defined benefit plans

Trends and funding

There was a significant movement to freeze defined benefit plans after the Pension Protection Act (PPA) passed in 2006. Facing stricter funding requirements and benefit restrictions for underfunded plans, many plan sponsors decided to freeze their existing pension plans, and many have plans to freeze in the near future.

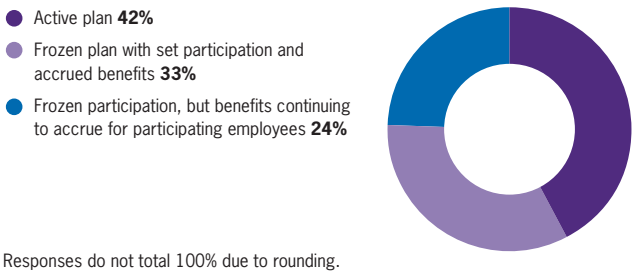
Of our survey responses, 57% had frozen the plan to new entrants. Of those frozen plans, 58% had also frozen the accrued benefits to existing participants, while 42% continued to accumulate accrued benefits for the current population.

Post-freeze, plan sponsors may have a better handle on future funding requirements, but administrative fees, Pension Benefit Guaranty Corporation (PBGC) premiums and investment monitoring are ongoing concerns. Performing a strategic review of the frozen defined benefit plans allows plan sponsors to make key long-range planning decisions and is an important step in the evolution of a pension plan. Depending on the age and service of the frozen population, frozen plans may still face 50 years before the last participant exits the plan. Here are five questions that should be addressed in the strategic planning process:

1. Are we really planning on running the plan to the final participant?
2. Are we planning to terminate in X number of years?
3. Are we planning to terminate with X number of remaining participants?
4. Should we consider a partial plan termination as an interim step in the process of terminating the plan?
5. How should our prospective investment strategy and investment policy statement change to reflect the changing needs of the plan?

Freezing the defined benefit plan is not the final step; it is an intermediate point in a longer process which contains significant opportunities for plan sponsors to add value and save ongoing costs.

If you sponsor a defined benefit plan, have you frozen the plan?



Responses do not total 100% due to rounding.

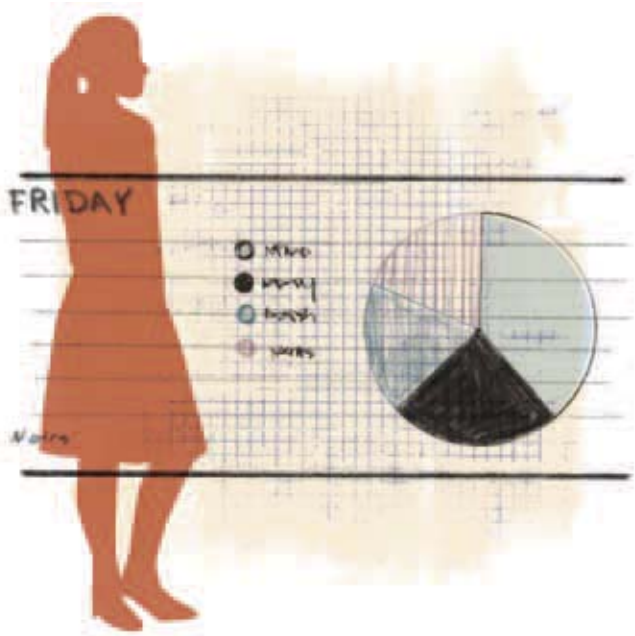
Many plan sponsors are still coming around to the idea of matching funding to the plan liabilities. The surveyed group indicated that 48% with defined benefit plans had conducted an asset liability management (ALM) study. Essentially, an ALM strategy is the practice of managing risks that arise due to mismatches between the assets and liabilities (debts and assets) of the plan. Actuaries forecast the expected liabilities of the plan over the upcoming period of years, and ideally an investment strategy can be implemented to target the ongoing liabilities.

As the PPA funding relief (extended in 2010) eventually runs its course, plans will be faced with the burden of 100% of the unfunded accrued liability, compared to a burden of 96% for companies in 2010. Additionally, the current low interest rate landscape puts pressure on plan sponsors to fund plans adequately. This is all the more reason for plan sponsors to manage closer to the defined benefit plan liabilities where possible.

Post-freeze, plan sponsors may have a better handle on future funding requirements, but administrative fees, Pension Benefit Guaranty Corporation (PBGC) premiums and investment monitoring are ongoing concerns.

The typical investment strategies that work hand-in-hand with ALM studies attempt to match the duration of the investment portfolio with the liabilities. Ideally, this allows the investment performance to track with the liabilities, drastically minimizing large or unexpected swings in funding requirements. In the past, this liability matching or immunization strategy could be expensive to implement and maintain, due to the frequent rebalancing of the portfolio in an attempt to match the duration of the liabilities. The strategy, while enticing, was perceived to be viable for only the largest of plans. Advancements in vendor architecture, investment analytics and overlay management have made liability matching investment strategies a viable option for the middle and large markets.

With the implementation of PPA and the significance of plan funding percentages, contributions to pension plans have become a moving target. As plan sponsors focus on achieving funding levels, and as actuaries evaluate contributions to meet those objectives, questions arise as to the proper accounting at the plan level.



Plan accounting for contributions

Almost 60% of our survey respondents estimate the plans' contribution receivable based on future funding estimates, while almost 20% wait to record their contribution receivable until actual contribution funding is determined. Contributions receivable are amounts due as of the reporting date to the plan from employer(s), participants, etc. Amounts due include those pursuant to formal commitments as well as legal or contractual commitments. The FinREC has recommended that the ERISA minimum required contribution determined by the actuary be recorded as a contribution receivable in the plan's financial statements if not paid by year-end. Sometimes a contribution made after year-end that was not the result of a formal commitment at year-end is later re-characterized for funding and tax purposes by the plan sponsor as a contribution attributable to the plan year being reported on. This re-characterization may constitute a nonrecognized (Type 2) subsequent event (an event occurring after the reporting date that is indicative of conditions, e.g., a formal commitment, that did not exist at the reporting date) and consequently would not be recorded as a contribution receivable.

The accounting policy for contributions to my defined benefit plan is as follows:

- Estimated using expected funding determined by actuary **58%**
- Cash basis **23%**
- Recorded based on actual funding **19%**

Appendix

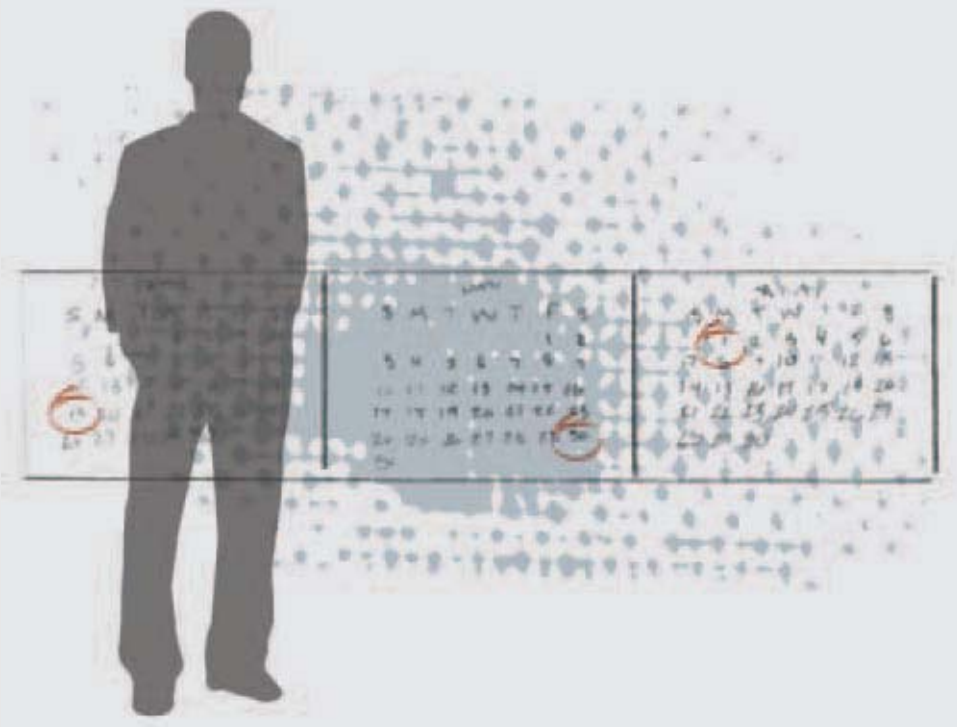
About the survey

Drinker Biddle & Reath, Grant Thornton LLP and Plan Sponsor Advisors conducted this confidential survey to assess the level of understanding of investments, fees and administrative practices pertaining to retirement plans. The survey was conducted online from November 2010 to January 2011 with 429 independent plan sponsors participating. Survey topics included investments, fees, administration and other industry issues. Most participants came from the manufacturing, wholesale and distribution (29%) and not-for-profit (29%) industries with the remainder being in the retail (12%), financial institutions/services (10%), technology (9%), construction, real estate and hospitality (5%), general services (4%) and other (3%) industries. Survey participants primarily held the positions of CFO (53%), human resources/benefits manager (9%) and human resources/benefits vice-president (19%). The remainder held miscellaneous finance positions.

DrinkerBiddle

About Drinker Biddle & Reath LLP

Drinker Biddle & Reath has more than 25 employee benefits professionals. Our lawyers work as a team with lawyers in other practice areas, such as health law, labor, securities, tax and bankruptcy, to advise clients on employee benefits and executive compensation issues. Our practice includes all aspects of qualified and nonqualified retirement plans; health, welfare and fringe benefit plans; specialized employee benefits issues under the Internal Revenue Code and ERISA; executive compensation; ERISA litigation; investment adviser and fiduciary issues; ESOPs and other stock-based compensation plans; global equity plans; and litigation of these issues. For more information, please visit www.drinkerbiddle.com.



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The goal of the Employee Benefits practice of Grant Thornton LLP is to ensure that its clients' benefit plans are 1) compliant, 2) a tool to attract and retain talent, 3) cost-effective and 4) easy to administer.

About Plan Sponsor Advisors

Plan Sponsor Advisors (PSA) is an independent retirement plan consulting firm. The staff of PSA brings a wealth of knowledge and experience to help companies manage their retirement plans and mitigate fiduciary risks. The firm has advised plans with over $55 billion of retirement assets since 2002.

PSA's clients include public and privately held companies of all sizes ranging from family held companies to global corporations, major universities as well as major health care systems and hospitals. The co-founders of the firm, Jennifer Flodin and Donald Stone, are well known thought leaders in the industry.

Further information

If you would like to receive additional hard copies or an electronic copy of Grant Thornton's Seventh Annual Retirement Plan Survey, please visit our website at www.GrantThornton.com/benefitsaudit. Inquires regarding this survey may be directed to:

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