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## **Lessons from across the pond**

DC plans in the US and the UK



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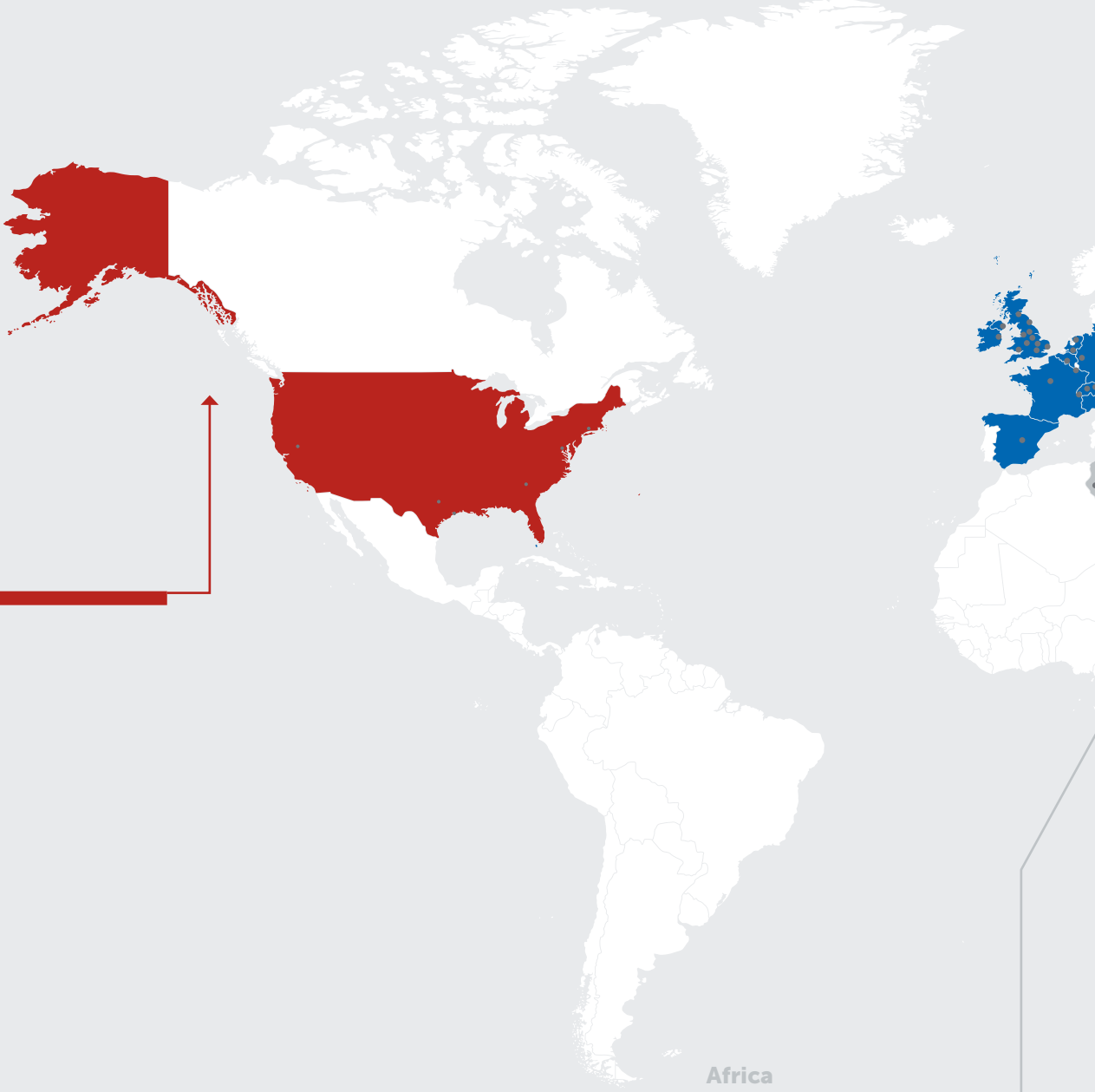
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## 1. The big picture

As in many areas, when it comes to saving for retirement the US and UK share a number of things in common:

- both have an aging population
- both face the challenge of people, in general, under-saving for their retirement
- both have seen a shift in recent decades away from defined benefit (DB) plans as the primary form of workplace pension provision to the widespread use of defined contribution (DC) plans, with this trend starting first in the US and then coming across the pond
- more recently, the UK has followed the US in giving individuals greater freedom over what they can do with their retirement savings, the impact of which in the UK is still unfolding

Although both countries have a history of DB plans, these are now predominantly legacy arrangements with most closed to new participants and, in many cases, future accrual also.

As a result, DC plans are now the primary form of retirement arrangement on both sides of the Atlantic. Consequently, they will play a crucial role in helping both nations ensure that their citizens enjoy a decent standard of living in retirement and in meeting the financial challenges posed by aging populations. DC plans are also a key part of the compensation package for many employees and they are likely to become an increasingly important succession planning tool for US and UK employers alike. Therefore, it is important that employers and policymakers optimize the outcomes from DC plans.

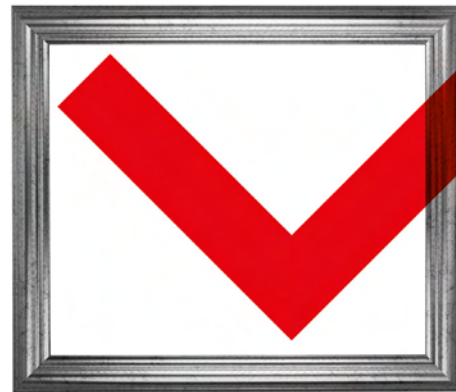
A number of lessons are drawn out in this paper, allowing employers and policymakers to learn from the approaches taken by their US/UK counterparts to make DC plans work more effectively. For example:

- mandatory auto-enrollment and re-enrollment in the UK has been a huge success in boosting participation rates in workplace pension plans to around 90% for many employers – making auto-enrollment more widespread in the US could help to address concerns about adequacy of savings, particularly in sectors such as construction, retail and hospitality.<sup>1</sup> US employers should also consider the merits of automatic re-enrollment in increasing participation rates
- auto-escalation has proved to be a successful tool to get US plan participants to save more in workplace retirement plans – this is something that could be adopted by UK employers to help push up contribution rates to workplace pension plans, which on average have fallen from 9.7% in 2012 (prior to the introduction of auto-enrollment) to 4.2% in 2016<sup>2</sup>
- litigation on the issue of excessive investment fees has forced US plan fiduciaries to focus on negotiating lower fees, and government regulation has demanded greater disclosure of fees– this is something that policymakers and regulators in the UK could draw upon as they seek to introduce greater transparency around pensions investment fees in the UK

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<sup>1</sup> *Retirement Savings Trends: How Employers Can Extend Coverage and Simplify the Retirement Readiness Process*, ADP Retirement Services (2015), available at [https://www.adp.com/tools-and-resources/adp-research-institute/research-and-trends/~/\\_/media/RI/pdf/Retirement%20Savings%20Trends.ashx](https://www.adp.com/tools-and-resources/adp-research-institute/research-and-trends/~/_/media/RI/pdf/Retirement%20Savings%20Trends.ashx) (last visited Nov. 25, 2017).

<sup>2</sup> These figures are the average total contributions (i.e. employer and member contributions) as reported in the *Occupational pension schemes survey: UK, 2016*, ONS.



- concern over excessive fees in the UK has seen the introduction of a statutory cap on charges under default investment funds and also the introduction of additional governance requirements which require an annual 'value for money' assessment to be carried out by trustees and independent governance committees – the US continues to explore ways to manage investment of a statutory limit on fees in the US could achieve a more independent and consistent approach to this issue
- early access by way of plan loans is commonplace under US DC plans – introducing this flexibility in the UK may help to attract and retain the new generation of savers for whom retirement saving competes with other financial demands such as repaying student debt and getting on the housing ladder
- employers in the US have explored numerous ways to improve participant engagement and education. The PensionWise guidance service in the UK offers the US a model of an additional way to engage participants and to offer them retirement guidance and information from an unbiased source

There is also scope for greater collaboration around emerging issues, such as the threat posed by data breaches and cyber attacks. Cyber and data security is a major concern in both the US and the UK. Emerging issues such as provider responsibilities, multi-factor passwords, breach notification, and audit standards are common on both sides of the Atlantic. This is an area in which collaboration between the jurisdictions and the establishment of common processes, standards, and requirements could be valuable to participants, providers and employers alike.

Given the size of the retirement savings challenge faced on both sides of the Atlantic, collaboration and the sharing of best practice is essential. We hope that this paper can serve as a catalyst for further conversations and greater cooperation with our friends across the pond.



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## 2. Overview of the US and UK retirement systems

### US

#### *The three pillars*

- The US has a three pillar retirement system made up of:
  - (i) the state (i.e. social security)
  - (ii) employer-sponsored retirement plans (including DB and DC plans)
  - (iii) private individual retirement savings (e.g. taxable accounts and tax-favored individual retirement accounts (IRAs))
- Until the 1980s, DB pension plans (generally referred to as “pension” plans) were the most prominent form of employer-sponsored retirement plans in the US. Similar to the UK, the most common DB plan structure determines the participant’s retirement benefit using a calculation based upon their final salary and their years of participation in the plan.
- However, the US retirement plan system has moved towards DC retirement plans in the past 30 years. Under a DC plan an individual will have a participant account, to which they and their employer may contribute (with the employer contribution typically in the form of a set percentage or a matching contribution up to a specified level).
- Shortly after being introduced, the DC style of retirement savings became a popular alternative for employers to employer-sponsored DB plans, in large part due to the inherent shift in responsibility (and corresponding liability) from employers to the employees.
- The US has also seen a move to “cash balance plans,” which represent a hybrid between a DC and DB plan. Less common in the US than a DC plan, a cash balance plan is a type of DB plan under which a percentage of an individual’s compensation is set aside in a notional account. In a typical cash balance plan, a participant’s account may be credited annually with a “pay credit” (such as 5% of compensation) and an “interest credit” (e.g. a fixed or variable rate that is linked to an index such as the one-year treasury bill rate). Unlike a true DC plan, a cash balance plan’s solvency is backed by the Pension Benefit Guaranty Corporation.

#### *DC plans*

- The most common forms of DC plans in the US are:
  - (i) 401(k) plans, which allow for employee contributions as well as employer contributions
  - (ii) 403(b) and 457(b) plans, which are similar to 401(k) plans but are available only to tax exempt and governmental employers
  - (iii) employee stock ownership plans (ESOPs), generally involving external borrowing to acquire employer stock, which is then allocated to participant accounts as the loan is paid down
- 401(k) plans are governed by fiduciaries (as defined by the Employee Retirement Income Security Act of 1974 (ERISA)) as employer-sponsored retirement plans.
- In contrast, IRAs are generally not employer-sponsored plans. They are typically individual contractual products, although there are instances where fiduciary duties may arise (e.g. offering investment advice to an IRA holder may impose fiduciary status).

#### *Tax*

- Generally, the US pension system operates on an exempt-exempt-taxed (EET) basis. For instance, with a standard 401(k) plan, participants are not subject to taxation for contributions to the plan or the related investment returns. Instead, they only pay tax on amounts withdrawn. However, this is not universal. For example, a “Roth” 401(k) plan contribution is taxed on a taxed-exempt-exempt (TEE) basis.
- In order to benefit from favorable tax treatment, a plan must be a “qualified plan”. To be a qualified plan, the plan must meet the requirements of the United States Internal Revenue Code (the Code).
- It is common for large employers to operate non-qualified plans for senior executives, often referred to as “top-hat plans”. Such plans do not receive all of the tax benefits that a tax-qualified plan receives.

#### *Normal Retirement Age*

- Historically, retirees could begin receiving social security benefits at age 65. However, that age is set to increase gradually to age 67, based upon an individual’s year of birth, starting in the year 2000.

## 2. Overview of the US and UK pension systems<sup>3</sup>

### UK

#### *The three pillars*

- The UK also has a three-pillar pension system made up of:
  - (i) the state pension
  - (ii) workplace pensions
  - (iii) private pensions
- Traditionally, UK employers that provided a workplace pension plan operated DB pension plans for their staff. The most common type of DB plan in the UK is a final salary pension plan under which an individual receives a pension which is a percentage of their final salary at retirement based on how many years they have contributed to the plan. Career average plans, under which an individual's pension is calculated by reference to their average salary during their career with the relevant employer (as opposed to their final salary) are also used.
- However, as in the US, over the past two decades employers have been closing their DB plans and switching to DC plans for future service due to the costs and risks associated with DB plans.

#### *DC plans*

- The most common forms of DC plans in the UK are:
  - (i) occupational DC plans, which are set up as trusts by an individual employer or a group of connected employers
  - (ii) master trusts, which are set up as trusts and allow non-connected employers to participate
  - (iii) group personal pension plans, which are contract-based arrangements between the individual members and an insurer but set up by an employer
  - (iv) personal pension plans, which are contract-based arrangements set up by an individual directly with an insurer
- Employers and individuals can contribute to all of the plans listed above. However, it is uncommon for an employer to contribute to an individual's personal pension plan.

#### *Tax*

- Like the US, the UK operates an EET tax system for pension savings (although there has been some tentative consideration in recent years of switching to a TEE system – see below). Under this system, broadly speaking, contributions into a 'registered pension scheme' are exempt from tax, the accumulation of the fund is mainly exempt from tax and the majority of the proceeds are taxable at an individual's marginal tax rate upon receipt. Up to 25% of an individual's pension savings can be taken tax free.
- Individuals receive tax relief on their pension contributions at their highest marginal rate. These tax advantages are controlled by the Annual Allowance and Lifetime Allowance, which limit the amount of tax advantaged retirement savings or benefits that an individual can build up in any one year and during their lifetime.
- In order to benefit from favorable tax treatment a plan must be a 'registered pension scheme'. To be a registered pension scheme the plan must meet the requirements set out in the Finance Act 2004.
- Some employers operate unregistered plans to top-up the benefits provided to senior executives.

#### *State pension age*

- State pension age for men is currently age 65. State pension age for women is currently increasing from age 60 to age 65. State pension age for men and women is set to rise to age 66 by 2020, age 67 by 2028 and age 68 by 2046.
- The Government is now required by law to commission an independent review of the suitability of the UK's state pension age every 5 years and has recently concluded that the increase to age 68 should be accelerated.

<sup>3</sup> While the US generally reserves the term "pension" for defined benefit style retirement plans, the UK utilizes the term broadly, encompassing retirement savings plans as a whole.



### 3. Enrollment

#### US

##### Joining a plan

- US employers are not required to automatically enroll workers into a retirement plan. However, a 401(k) plan can be set up with an automatic enrollment feature.
- Automatic enrollment is not mandatory but has been widely adopted by US employers on a voluntary basis. Almost 60% of employer-provided DC plans utilize automatic enrollment features.<sup>4</sup>
- The widespread use of auto-enrollment in the US is, in part, driven by the need for 401(k) plans to pass non-discrimination tests in order to maintain their tax-qualified status. These requirements incentivize employers to encourage employee participation, including through the use of automatic enrollment and by providing matching contributions.
- Several US states, including Oregon, have moved towards a requirement that employers without a retirement plan (usually very small employers) must automatically enroll their employees in individual retirement arrangements, facilitated by payroll deduction. There is a question of whether ERISA preempts (or overrides) these mandates in individual states, and it remains to be seen whether the US courts will allow these arrangements to move forward. States generally cannot require automatic enrollment with respect to employer-sponsored retirement plans due to the preemptive effect of ERISA.
- As of March 2016, almost 70% of employees had access to an employer-sponsored retirement plan.<sup>5</sup> Of those individuals, over half – approximately 54% – participated in such a plan.

#### UK

##### Automatic enrollment

- Almost all employers in the UK are now required to automatically enroll eligible workers into a pension plan, which meets certain minimum quality requirements. This requirement has been phased in since October 2012 and it already applies to most employers. It will apply to all employers (including those with just one employee) as of February 1st, 2018.
- Individuals can opt out once they have been automatically enrolled. However, on average, only around 10% of individuals who have been automatically enrolled have opted out to date. This is significantly lower than most commentators predicted before automatic enrollment was introduced.
- Automatic enrollment has been successful in getting millions more people to save for their retirement. Since this policy was first introduced in October 2012, 8.8 million people have been automatically enrolled by their employers<sup>6</sup> and around 8 million of these have remained within their plan.
- Prior to the introduction of automatic enrollment, less than half the workers in the UK participated in their employer's pension plan. This had risen to 68% by 2016.<sup>7</sup>

##### Automatic re-enrollment

- Employers are required to automatically re-enroll workers who have opted-out and who continue to meet the eligibility criteria at the relevant time back into a qualifying pension plan.
- 530,000 workers have been automatically re-enrolled to date.

<sup>4</sup> See e.g., Barbara A. Butrica et al., *Final Report Submitted to the US Department of Labor, Employee Benefit Security Administration: Pension Plan Structures before and after the Pension Protection Act of 2006*, The Urban Institute (Sept. 2015), available at <https://www.dol.gov/sites/default/files/ebsa/researchers/analysis/retirement/pensionplanstructuresbeforeandaftertheppaof2006.pdf> (last visited Nov. 25, 2017); *Automatic Enrollment, Employer Match Rates, and Employee Compensation in 401(k) Plans*, Monthly Labor Review (May 2015), available at <https://www.bls.gov/opub/mlr/2015/article/automatic-enrollment-employer-match-rates-and-employee-compensation-in-401k-plans.htm> (last visited Nov. 25, 2017).

<sup>5</sup> John J. Topoleski, *Worker Participation in Employer-Sponsored Pensions: A Fact Sheet*, Congressional Research Service (Feb. 27, 2017), available at <https://fas.org/sgp/crs/misc/R43439.pdf> (last visited Nov. 25, 2017).

<sup>6</sup> Automatic enrolment declaration of compliance report, TPR, October 2017.

<sup>7</sup> ONS Statistical Bulletin: Annual Survey of Hours and Earnings pension tables, UK: 2016 provisional and 2015 revised results.



### *Choosing a plan*

- Employers are responsible for choosing the plan that they will use for automatic enrollment purposes.

Under the automatic enrollment laws an employer is required to select a 'qualifying scheme' for its workers. To be a qualifying scheme, a plan must meet certain minimum legal requirements. This includes a requirement for it to:

- be tax registered
- ensure that the minimum level of contributions are paid or a minimum level of benefits are provided
- ensure charges imposed on members' funds invested in the plan's default investment fund are no more than 0.75% per annum

Once a plan has been selected there is no strict legal duty to review the suitability of the plan over time provided it continues to meet these requirements. However, the introduction of auto-enrollment has put greater scrutiny on the governance of pension plans and the steps that need to be taken to ensure that members get good outcomes and value for money. Employees are reliant upon their employer to select a suitable plan and to ensure that it remains so. Consequently, employers taking this minimum compliance approach run the risk of potential claims or future regulatory action should something go wrong.<sup>8</sup>

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<sup>8</sup> For more on this and the steps employers can take to protect themselves from potential liability in the future see 'Automatic enrolment and the law – How far do employers' duties extend?' by Eversheds Sutherland and Royal London.

## Lessons learned

The introduction of automatic enrollment in the UK has resulted in millions more people saving for their retirement. While there is concern that opt-out rates may increase as the minimum contribution rates rise, automatic enrollment is likely to go a long way towards solving the participation problem in the UK. It is also changing people's attitudes to pensions by making it a social norm to save in a pension plan. Many countries are watching the impact of automatic enrollment in the UK to see whether it could offer a solution to low participation rates for them.

In contrast, the US has not mandated automatic enrollment. However, allowing automatic enrollment as an optional approach in combination with non-discrimination requirements that condition tax advantages on broad-based employee participation has resulted in a fairly high level of participation. Employers in the US have not moved to a re-enrollment approach, but as this strategy becomes better known in the US, it may be of interest to employers continuing to look to boost participation.

Although the introduction of auto-enrollment in the UK is solving the participation problem it is not yet solving the adequacy problem, with average contribution rates having fallen since auto-enrollment was introduced, as a result of millions of people being auto-enrolled at the very low introductory minimum contribution rates. The auto-enrollment minimum contribution rates in the UK are set to increase over the next two years, but many are calling for more to be done, with the US example of auto-escalation being seen by some as one of the best ways to boost overall contributions.



## 4. Contributions

### US

#### Minimum contributions

- There are no mandatory minimum DC plan contribution rates for employers or individual savers in the US.
- However, US employers that operate a 401(k) plan can choose between multiple designs, including:
  - (i) a traditional 401(k) plan
  - (ii) a safe-harbor 401(k) plan
  - (iii) a SIMPLE 401(k) plan (small employers only)
- Where an employer operates a traditional 401(k) plan, it is required to carry out annual tests to ensure that contributions made under the plan meet specific non-discrimination requirements. These tests are to verify that deferred wages and employer matching contributions do not discriminate in favor of highly paid employees.
- In order to avoid the need to carry out these annual non-discrimination tests, many US employers choose a safe-harbor 401(k) plan.<sup>9</sup>
- Under a safe-harbor 401(k) plan, employer contributions must be fully vested when made. Further, employers must meet one of several possible contribution requirements, such as being required to pay in a minimum contribution of 3% of each participant's annual compensation.

#### Average contributions

- As of 2017, the average participant contribution rate dropped from 6.9% to 6.2%, according to an annual industry report.<sup>10</sup> The report states that this fall in contribution rates is likely to be the result of an increase in plans with automatic enrollment features, which increase participation but also tend to decrease the average rate of contribution due to the lower default contribution rates.

#### Auto-escalation

- The majority of US employers implementing automatic enrollment plans also provide for automatic annual increases to the participant's contribution rates. This "auto-escalation" typically involves an individual agreeing to increase their annual deferral contribution by, say, 1% per year up to an agreed maximum contribution rate. This increase is then timed to coincide with salary increases each year.
- Some employers have designed their plans so that auto-escalation is the default position when a participant is auto-enrolled in the plan. This structure generally provides an opportunity for the participant to opt out, while other plan designs require participants to make an affirmative election to participate in the auto-escalation feature.

#### Tax advantages

- Under qualified employer-sponsored DC plans, individuals are generally not taxed on amounts contributed to the plan until the year of withdrawal (with exception for plans with Roth or post-tax contribution features).
- In order to encourage employer-sponsored plans, US employers are entitled to a current deduction for contributions to qualified plans despite the amount not being included in the participant's income until a future date.

#### Contribution and savings limits

- For the 2018 tax year, contributions to DC plans are limited to a maximum annual level of \$55,000. Of that overall limitation, employee contributions are capped at \$18,500, with an additional \$6,000 allowance for "catch-up" contributions with respect to individuals who will be age 50 or older at any point during the plan year.
- Because DC plans such as 401(k) plans often use a percentage of the employee's compensation as a metric (e.g. for the formula determining employer contributions), the Code imposes a limitation upon the amount of compensation that can be taken into account for DC plan purposes. For 2018, the annual compensation limit is \$275,000, an increase of \$5,000 over the 2017 limit.
- IRAs are also subject to annual contribution limits. The contribution limit and allowance for additional catch-up contributions for 2018 are \$5,500 and \$1,000 respectively.

<sup>9</sup> See Butrica et al., *supra* note 4, at 5.

<sup>10</sup> See *How America Saves 2017: Vanguard 2016 Defined Contribution Plan Data*, Vanguard (June 2017), available at <https://pressroom.vanguard.com/nonindexed/How-America-Saves-2017.pdf> (last visited Nov. 25, 2017).



## 4. Contributions

### UK

#### *Minimum contributions*

- Under the automatic enrollment laws, a minimum contribution of 2% of “qualifying earnings”<sup>11</sup> must be paid into a pension plan in respect of all eligible workers. This is made up of the employer’s contribution, the individual’s contribution and tax relief.
- Employers with workers in the UK are required to contribute a minimum of 1% of qualifying earnings to a pension plan on behalf of all eligible workers who are in the plan.
- The individual must make up any difference between their employer’s contribution and the total minimum contribution required under the automatic enrollment laws.
- The total minimum contribution required under the automatic enrollment laws is set to rise to:
  - (i) 5% of qualifying earnings from April 2018 (with a minimum of 2% being paid in by the employer)
  - (ii) 8% of qualifying earnings from April 2019 (with a minimum of 3% being paid in by the employer)

#### *Average contributions*

- Following the introduction of automatic enrollment in the UK, the average total contribution rate to workplace DC plans has fallen to 4% of pensionable earnings in 2015<sup>12</sup> down from 9.7% in 2012<sup>13</sup>. This is because, although more people are saving, most are only saving at the minimum rates.
- Therefore, although automatic enrollment is solving the participation problem in the UK it is not yet solving the adequacy problem.
- This trend should be reversed as the minimum automatic enrollment contribution rates increase. However, there have been repeated calls for the automatic enrollment minimum contribution rates to be increased above 8% of qualifying earnings in order to address the issue of widespread under saving in the UK.

#### *Auto-escalation*

- While automatic escalation is permitted in the UK it is not yet commonplace. In fact, only a very small number of employers currently make use of this to boost member contributions.

#### *Tax advantages*

- Individuals receive tax relief on their pension contributions at their highest marginal rate. These tax advantages are controlled by the Lifetime Allowance and Annual Allowance. These allowances apply to benefits and savings across all registered pension schemes.
- Employer contributions are generally eligible for relief against corporation tax. Employers’ pension contributions are also not subject to National Insurance contributions.
- In recent years the Government has reduced the pensions tax allowances that apply to individuals on numerous occasions. There have also been calls for the Government to introduce a flat rate of tax relief for all savers or to switch to a TEE tax system for pensions savings. Neither of these potential reforms can be ruled out.

#### *Contribution and savings limits*

- Under the tax rules, an individual has an Annual Allowance. Broadly speaking, if the contributions paid by, or on behalf of, an individual into registered DC plans (plus the increase in the value of any benefit entitlements under registered DB plans) in a given tax year exceed the individual’s Annual Allowance, the individual will be required to pay tax at their marginal tax rate on the excess.
- The standard Annual Allowance has been as high as £255,000 in recent years but it stands at just £40,000 for the 2017/18 tax year, and this may be reduced to £4,000 in various circumstances.

<sup>11</sup> “Qualifying earnings” means earnings between £5,876 and £45,000 per year for the 2017/18 tax year.

<sup>12</sup> Occupational Pension Schemes Survey 2015, ONS.

<sup>13</sup> Occupational Pension Schemes Survey 2015, ONS.

- In April 2016, the Government introduced a taper to the Annual Allowance for higher earners. This means that the Annual Allowance is reduced for individuals with relevant earnings over £150,000. For an individual earning £210,000 or over the Annual Allowance is only £10,000. Earnings for these purposes are widely defined and include income from sources other than an individual's employment (such as dividend payments and rental income).
- An individual's pension savings are also subject to a Lifetime Allowance, which is the maximum amount of pension savings and benefits that can benefit from favorable tax treatment. The Lifetime Allowance stands at £1m for the 2017/18 tax year, increasing to £1.03m the following tax year.
- If the value of an individual's pension savings/ benefits exceeds the Lifetime Allowance, there is an additional tax of 25% if the benefits are taken as a pension or 55% if they are taken as a lump sum.
- The Lifetime Allowance stood at £1.8m in the 2011/2012 tax year. However, it has been reduced 3 times since then by successive Governments. Individuals have been able to apply for transitional protection each time the allowance has been reduced.



## Lessons learned

Auto-escalation in the US has proven to be an effective way of getting individuals to save more for their retirement. For example, in 2017, the US plan record keeper, Fidelity, reported that in the plans it keeps records for (over 20,000), 27% of plan participants increased their contributions, and 50% of those increases were driven by auto-escalation.<sup>14</sup>

Auto-escalation is not widely used by UK employers at present, but it is an option that UK employers could consider implementing to boost the amount that individuals are saving for their retirement in order to address the fact that most people in the UK are still not saving enough. Without steps such as this being taken it is likely that many individuals in the UK will be unable to retire when they want or need to. This could create difficulties for employers, particularly in relation to succession planning, in the future.

Despite its already widespread popularity, further use of auto-escalation by more US employers would likely continue to help address the issue of under saving in the US.

The closure of DB plans means that an increasing number of people will be dependent upon their DC savings to see them through retirement. If action is not taken to address the issue of under saving in the US and the UK, employers are likely to face increasing challenges around succession planning and managing individuals who want or need to retire but who cannot afford to do so.

<sup>14</sup> See Bloomberg News, *Auto Features are Helping to Fuel 401(k) Growth*, InvestmentNews (May 12, 2017) available at <http://www.investmentnews.com/article/20170512/FREE/170519964/auto-features-are-helping-to-fuel-401-k-growth> (last visited Nov. 25, 2017).

## 5. Investments

### US

#### *Fund choice*

- Under a US DC plan, the plan sponsor would normally appoint an investment committee made up of company employees to select and monitor the investment options under the plan. The investment committee sometimes has sufficient investment expertise to make its own determinations. However, in most cases, the investment committee will engage an expert advisor to assist in the selection of investment options. The participant can then choose from the available options.
- Plans with automatic enrollment also include a default investment fund, which is used if the participant does not make a choice. Target date funds are typically used for the default fund, but other options, such as a balanced fund, are also used.
- Under US law, the selection and ongoing monitoring of the menu of investment options constitute fiduciary acts. Those making these choices are plan fiduciaries for the purposes of ERISA and may face liability for the investments they make available. For example, there has been a great deal of litigation in the US in which plan participants have sued plan fiduciaries for selecting an investment menu or investment options with excessive fees. In fact, over the past decade US employers have agreed to pay over \$350m to settle claims about failures in relation to employee retirement plans, with most of these relating to excessive fees.
- In the case of a plan in which participants choose how their account is invested (such as the vast majority of 401(k) plans), the plan fiduciaries are generally not responsible for the results of participant investment choices. For example, if a participant selects investments that are too aggressive for their circumstances, that is the participant's responsibility. This important safe harbor significantly limits litigation over participant investment results, and it is referred to as "section 404(c)" protection based on the applicable section of ERISA.
- Some plans will enable individuals to invest outside the plan's investment menu through a "brokerage window," which is a brokerage account within the plan that allows for an expanded menu of hundreds of mutual funds and sometimes other investment options.

#### *Costs and charges*

- Due to growing concerns with plan and service provider fees, US DC plans are subject to a complex and ever-evolving set of fiduciary responsibilities with respect to investment fees. Regulatory requirements include extensive fee disclosures and fiduciary requirements that prohibit paying more than reasonable compensation. Also, there has been a great deal of litigation regarding excessive fees, resulting in pressure on plan fiduciaries to ensure that fees are reasonable.

#### *ETI and ESG*

- Fiduciaries responsible for selecting a plan's investments may consider economically targeted investments (ETIs) and environmental, social and governance (ESG) factors. The current guidance, issued in 2015, provides that these factors may be considered to the extent they can be shown to result in better returns or lower risk with respect to a particular investment option. They can also be taken into account as "tiebreakers" between otherwise equally economically favorable investment options.<sup>15</sup>
- Most US plan fiduciaries do not focus on ETI and ESG factors. There is not a specific requirement to do so, the guidance from the government has varied widely with the political philosophy of different administrations, and there is a perception that straying from traditional factors like fund performance could lead to greater risk of litigation.

<sup>15</sup> See Interpretive Bulletin 2015-01, 80 F.R. 65135-65137 (Oct. 26, 2015).



**Lessons from across the pond**

DC plans in the US and the UK





## 5. Investments

### UK

#### *Fund choice*

- An automatic enrollment plan is required to have a default investment fund into which an individual's savings will be invested if the individual does not make a choice.
- The vast majority of savers in workplace DC plans in the UK are invested in the plan's default investment fund. Consequently, the design and performance of this fund is very important. Most default funds tend to be either lifestyle funds or target date funds.
- Most DC plans will also offer a range of other investment options in which an individual can choose to invest. It is now common for this to include an ethical investment option and a Sharia law compliant fund.
- The trustees of the plan or the provider would normally be responsible for selecting the investment options made available to savers and for monitoring their performance and ongoing suitability. An employer may sometimes also play a role in this. Trustees are required to engage an external adviser to advise on investment decisions.

#### *Costs and charges*

- The Government is concerned that individuals get value for money from their pension savings and so in recent years it has introduced:
  - (i) a cap of 0.75% on the annual charge (excluding transaction costs) that can be applied to an individual's savings held in the default fund under a pension plan that is used as an automatic enrollment plan
  - (ii) a requirement for trustees and, in the context of workplace personal pension plans, Independent Governance Committees (IGCs) to assess and report annually on the extent to which the costs and charges under the plan(s) which they oversee represent good value for money for members
- Pension providers that operate DC workplace plans were required to establish an IGC by April 2015. IGCs were introduced to provide an additional layer of fiduciary oversight in the operation of these plans, with a particular focus on ensuring that individuals receive value for money.

- The Government is currently working with the pensions industry to develop new rules regarding the disclosure and transparency of pensions costs and charges and, in particular, transaction costs (the often hidden costs associated with buying, selling, borrowing and lending investments).
- New rules are also being introduced which will mean that as of January 3rd, 2018 fund managers and, where relevant, pension providers will be required to provide information on transaction costs and administration charges to trustees and IGCs in a standard format upon request.

#### *ESG factors*

- Following an extensive review, the Law Commission in the UK has concluded<sup>16</sup> that under UK law, trustees are required to take account of ESG factors in their investment decisions where these are, or could be, "financially material". They may also take them into account where they are satisfied that a particular approach would be supported by an overwhelming majority of the members.
- In addition, the new European Directive on the governance of workplace pension plans (IORP II), which is due to come into force in January 2019, will increase the need for trustees to consider ESG risks in their plan and record their policies for assessing these.
- Research has identified the potential impact of ESG risk on the performance of default funds under DC plans in the UK<sup>17</sup>. This suggests that ESG risk has an intergenerational dimension with the impact of such risks anticipated to increase over time. Therefore, trustees and providers ought to be considering the potential impact of ESG factors on member outcomes, particularly those of younger members.
- The vast majority of workplace DC plans will offer an ethical investment option as part of the range of available investment funds.

<sup>16</sup> "Is it always about the money?" Pension trustees' duties when setting an investment strategy: Guidance from the Law Society.

<sup>17</sup> See PLSA Discussion paper: ESG Risk in Default funds: Analysis of the UK's DC pension market, Feb 2017.

## Lessons learned

The UK has taken a very different approach from the US to ensuring that fees are reasonable. The UK has used a combination of legal limits on permissible fees and expanded governance requirements, while the US effort to control fees has been driven by disclosure requirements and the threat of litigation. Each jurisdiction has had some success, but each could also learn from the other. The UK's governance regime may be something that US policymakers consider at some point, while the US disclosure regime might offer a useful model for the UK.

The recent trend in the US of participants suing plan fiduciaries over the investment charges paid out from pension plans has not yet come across to the UK. However, trustees, providers and employers in the UK should be alive to this risk, particularly as the fees deducted from members' pension funds come under growing scrutiny.



## 6. Governance

### US

#### *Governance model*

- With respect to the management of retirement plans, US law primarily relies on a standards-based regulatory structure, with the role and duties of “fiduciaries” of the plan at the heart of this.
- Fiduciaries are subject to the rigorous and complex fiduciary duty requirements under ERISA – recognized as “the highest known to law.”<sup>18</sup>
- The primary or “named” fiduciary under a US retirement plan is the person named as such in the plan documents. If nobody is named it will be the plan sponsor by default. However, any individual acting in a capacity that fits the definition of a fiduciary under ERISA will be deemed to be a fiduciary to the extent of their involvement with the applicable pension plan.
- ERISA provides that any persons or entities who exercise discretionary control or authority over plan management or plan assets, anyone with discretionary authority or responsibility for the administration of a plan, or anyone who provides investment advice to a plan for compensation or has any authority or responsibility to do so are subject to fiduciary responsibilities. Plan fiduciaries include, for example, plan administrators and members of a plan’s investment committee.
- An employer may be the fiduciary in respect of its DC plan. However, the employer would often delegate this responsibility to one or more individuals or committees, with the selection of the delegate being a fiduciary act in and of itself. In some cases, the plan document may identify an individual holding a particular position (e.g. the Chief HR Officer) as a plan fiduciary or it may appoint a committee to perform this role.
- The types of committees usually established are:
  - (i) an investment committee (made up of company employees) - to select and oversee plan investments, which will sometimes hire its own independent expert advisors
  - (ii) an administration committee (made up of company employees) – to oversee the operation of the plan (other than the investments)
- A DC plan also has a trustee. However, the role of the trustee is normally limited to what is recognized as a “directed trustee,” acting in a role with no discretion to manage or control the assets of the plan and acting solely at the direction of the investment fiduciary.
- Under ERISA, participants can sue for certain damages and other remedies in the event that a fiduciary breaches its obligations. For example, if a fiduciary chooses to offer an investment option that is plainly imprudent based on excessive fees or past performance, the participants can generally sue the fiduciary to make up losses they incur. Where a fiduciary committee of employees is involved, the committee will usually be fully indemnified by the employer, such that ultimately the employer bears the burden of a fiduciary breach.

#### *Participant protection*

- While there is a form of insurance with respect to the financial solvency of DB pension plans in the Pension Benefit Guaranty Corporation (a federal agency funded largely by employer premiums), the financial risk under DC plans lies entirely with the participants. If the employer or other fiduciary has breached its fiduciary obligations, the participants can sue for certain damages, but otherwise participants do not have special protections from investment losses, even in extraordinary circumstances.



<sup>18</sup> See *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982).



## 6. Governance

### UK

#### *Governance model*

- Workplace DC plans in the UK fall into two main categories:
  - (i) trust-based plans
  - (ii) contract-based plans
- Trust-based plans are set up as trusts and they are run by trustees. Trustees owe a range of fiduciary duties to the savers within their plan. Trust-based plans are supervised by the Pensions Regulator and trustees are required to have regard to Codes of Practice and other guidance produced by the Regulator.
- In the case of an occupational pension plan the trustees are typically appointed by the employer as plan sponsor. However, at least one-third of the trustees (known as 'member nominated trustees') are required to be selected by a process involving the members of the plan. It is also becoming increasingly common for at least one professional independent trustee to be appointed to a plan's trustee board to add additional independence, expertise and experience.
- Contract-based plans (such as group personal pension plans) are a contractual arrangement between a pension provider and each individual saver under the plan. The provider will owe a range of contractual duties towards each saver. The provider is also required to comply with rules and duties laid down by the Financial Conduct Authority relating to the operation of the plan and how it conducts its business. This includes a duty to treat customers fairly.
- There are a raft of statutory requirements that apply to the governance and operation of trust-based and contract-based pension plans, which trustees and providers must comply with.
- Since April 2015, providers of contract-based DC workplace pension plans have been required to establish and operate an Independent Governance Committee (IGC) which provides an additional layer of fiduciary oversight in the operation of these plans, with a particular focus on ensuring that savers receive value for money.

- An IGC is under a duty to act solely in the interests of relevant policyholders<sup>19</sup>. It must have a minimum of five members with a majority, including the Chair, being independent of the provider.
- Employers are responsible for selecting the plan which they make available to their workers. However, once selected, the primary responsibility for how the plan is run sits with the trustees or the provider of the plan.
- Some employers that use a contract-based plan have set up their own internal governance committee to monitor the performance of their plan and its ongoing suitability.
- As a result of the introduction of automatic enrollment in October 2012, around 100 "master trusts" have been established to cater for the auto-enrollment market. A master trust is a trust-based plan, run by trustees, which allows unconnected employers to participate in it.
- The Government has recently passed legislation which will introduce a new authorization and supervision regime for master trusts as a result of concerns that some of the smaller master trusts may be unsustainable. This new regime is expected to come fully into force by October 2018.
- As part of this, master trusts will need to be authorized by the Pensions Regulator and have in place sustainable business plans and continuity arrangements. Employers that are using a small DC master trust may want to review the suitability of their plan in light of this.

#### *Participant protection*

- The Financial Services Compensation Scheme (FSCS) exists to provide compensation to consumers and, in some cases, institutional investors in the event that an authorized investment firm fails. The rules of the FSCS are complex and subject to certain limits.

<sup>19</sup> FCA Handbook, COBS 19.5.5.



- The Government has passed legislation which will introduce a new authorization and supervision regime for master trusts. It is expected that this will come fully into force by October 2018. This new regime is designed, amongst other things, to ensure that members' funds are protected in the event that the master trust fails.
- Under this new regime a master trust will be required to have robust continuity arrangements in place which could be applied should the master trust become unsustainable. A master trust will also be required to have sufficient funds in place to cover the cost of transferring members into a new plan, continuing to run the plan in the meantime and, ultimately, winding-up the plan. It is possible that the idea of having a reserve which can be called upon in the event of a plan failure could be applied to other workplace pension plans in the future.
- Plans may also take out insurance or benefit from contractual protection in the event that the plan or a relevant investment fails.



## Lessons learned

In the US, plan governance continues to be an area that generates litigation and takes up a great deal of employer time and attention.

One aspect of governance that has been particularly challenging is the question of whether company executives can successfully wear "two hats" as both plan fiduciaries and officers of the company. In the UK, it is now rare to have a company director sitting as a trustee of the company's retirement plan due to the conflicts that can arise. The introduction of the member-nominated trustee requirements and the more widespread appointment of independent trustees has also seen a greater degree of independent representation on trustee boards. US employers with retirement plans in the UK are sometimes surprised by this.

Although there would clearly be challenges in implementing some of the UK's governance approaches in the US, policymakers and thought leaders in the US may consider the pros and cons of the UK approach of including whether there would be advantages to following the UK's lead and including a fiduciary committee member who is designated as a representative of the plan participants or a member who is a third party professional fiduciary. There is a trend in the US towards using outside investment advisors to make recommendations to fiduciary committees, and these alternative UK approaches to how a fiduciary committee operates could help spur a larger discussion of plan governance in the US.



## 7. Communication and engagement

### US

#### *Providing information*

- Under US law, plan administrators and plan sponsors of qualified private employer-provided pension plans are subject to a series of reporting and disclosure requirements under multiple federal laws. With respect to participant communications, this includes:
  - (i) summary plan descriptions (SPDs), which provide a robust summary of the plan, written in a manner calculated to be understood by the average plan participant. Generally, these must be updated and distributed upon initial enrollment as well as every 5 to 10 years, depending on whether any amendments have been made to the plan
  - (ii) reports and statements regarding the plan's financial activities and individual participants' benefits under the plan
  - (iii) various notices regarding certain aspects of the plan's design, such as a description of the right to direct investments under the plan or a disclosure regarding the fees charged under the plan
- Many 401(k) recordkeepers in the US have websites with extensive features for tracking investment performance, savings levels, and projections of future retirement income. These recordkeepers are also rolling out financial advice programs that help savers determine their risk tolerance and select an appropriate asset allocation for their plan account.
- Although not legally required to do so, some employers are showing participants their retirement savings in an annuity form (even though the plan does not pay in that form) as a way to communicate about adequacy.
- Bipartisan bills have been introduced in Congress as recently as 2017 that would attempt to mandate that employers provide that information.

#### *Guidance and advice*

#### *Engagement*

- While private employers offering qualified DC plans are not responsible for any minimum level of employee savings, they are incentivized to encourage employee engagement based on various other regulatory considerations (e.g. non-discrimination testing, where lower levels of participation can pose difficulties passing the annual testing thresholds).
- One of the main vehicles US employers are using to drive employee engagement with retirement savings is the automatic enrollment feature discussed in section 3.
- Additionally, employers have started implementing holistic financial wellness programs designed to provide advice to employees about saving for retirement, college, or other financial needs. These arrangements include programs such as financial education, savings challenges, and planning for the payment of medical expenses in retirement.
- Many individuals do not seek professional guidance from investment advisors. While there are certain non-profit organizations that work with low to middle income individuals to encourage saving, the US employees most in need of such advice are often the least likely to seek it.
- In fact, while there are exceptions for impartial educational programs with respect to retirement savings as a whole, US employers sponsoring qualified DC plans are often hesitant to do so, as the provision of investment advice could create additional liability and potential breaches of their fiduciary duties.
- As noted above, employer-sponsored financial wellness programs and recordkeeper-based website features are filling some of the need for guidance.





## 7. Communication and engagement

### UK

#### Providing information

- Employers and pension plans in the UK are required to provide individuals with a raft of information regarding their pension under the automatic enrollment laws and the disclosure laws. This includes:
  - (i) informing individuals about automatic enrollment and their rights to opt-out or join a plan
  - (ii) providing individuals with an annual benefits statement
  - (iii) sending a retirement wake-up pack prior to an individual's expected retirement date, which must include information about how an individual can take their savings

#### Engagement

- Many employers and providers go beyond the legal minimum and look for innovative ways to help their workers appreciate the benefits of saving for their retirement and to engage workers with their pensions.
- The UK pensions industry is currently developing an online pensions dashboard, which is due to be launched in 2019. The intention is that the dashboard will enable individuals to search for and view their state pension entitlement and all of their workplace and private pension savings in one place.

#### Guidance and advice

- When the Government announced that from April 2015 it was planning to give savers greater freedom over what they could do with their pension savings, concerns were raised about people's ability to make good choices and to understand the implications of their decisions. As a result, the UK Government set up a free guidance service, called PensionWise, which can be used by anyone over age 50 with DC savings. Guidance can be accessed online, over the telephone or via a face-to-face appointment.

- It is uncommon for individuals in the UK to seek financial advice in relation to their retirement savings. Indeed only 18% of adults in the UK currently use a professional financial adviser<sup>20</sup>. The Government and industry are taking steps to try to increase the number of people seeking advice in respect of pensions and retirement planning.
- For example, the UK Government has recently introduced legislation which will allow savers to access up to £1,500 in three instalments from their retirement plan savings to help pay for advice.
- Providers and financial advisers are also developing robo-advice services with the aim of making advice cheaper and more accessible in the hope that this will increase the number of people who take advice.

#### Pensions dashboard

- The pensions industry is currently working with the Government to develop an online pensions dashboard, which would enable individuals to view their state pension entitlement and all of their workplace pension savings accounts in one place. The current aim is for this to be launched in 2019.



<sup>20</sup> B&CE report 'Public attitudes to financial advice' published February 2016.

## Lessons learned

Since its launch in April 2015, PensionWise has had over 4.65m visits to its website and it has conducted over 127,000 guidance sessions over the phone or face-to-face. Although the level of take-up to date has not been as high as the Government would like, the feedback from those who have received guidance from PensionWise has generally been very positive. PensionWise has made guidance much more accessible and it is also helping to raise the standards of pensions guidance and advice services in the UK more generally.

Financial wellness is a hot topic in the US, and the focus on overall financial health, rather than just retirement in a vacuum, is an approach that appears to strike a chord with employees. A recent report indicates that 84% of mid-sized and large businesses offer financial wellness programs.<sup>21</sup> The concept of financial wellness is starting to be discussed in the UK but there is an ongoing debate about the extent to which employers have a role in promoting this. However, it is increasingly widely recognized in the UK that an individual's retirement savings and preparedness for retirement need to be viewed holistically, with retirement savings being seen as part of that provision alongside other forms of savings, wealth and investments.



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<sup>21</sup> See Bloomberg News, *supra* note 14.

## 8. Distributions

### US

#### Accessing savings

- Generally, an individual in the US may access their DC plan savings once they have left service with their employer, though distributions before age 59 and a half are generally subject to an additional 10% tax on early distributions. Some plans also permit in-service withdrawals while the participant is still employed, although employee contributions to DC plans cannot be accessed until age 59 and a half if the employee is still working for the employer.

#### Early access

- Individuals can access their savings early:
  - (i) in the form of a loan (where such loans are provided for by the plan)
  - (ii) if they are suffering from financial hardship (subject to a number of requirements)
  - (iii) if they have a severance from employment
  - (iv) if they die or become disabled
  - (v) if the plan is terminated
- Generally, when provided for in the plan document, an individual can take out a loan of up to 50% of their vested account balance, subject to a \$50,000 maximum.
- With a general purpose loan, the individual does not need to explain what they are planning to use the money for. However, they are required to repay the loan (principal and interest) through substantially level payments within five years (60 months) and pay interest on the loan at a “reasonable rate of interest”. The interest payments are treated as investment return which is retained within the individual’s plan account.
- A primary residence loan, used in order to acquire a dwelling that will constitute the participant’s principal residence, is not subject to the standard 5-year repayment requirement. Instead, such loans may be repaid in substantially level payments over “any reasonable repayment period” – generally, 15 or 30 years.

- Most plans will allow individuals to take a loan from their savings. However, they typically restrict the number of loans that can be taken and how often they can be requested.
- An individual can access the savings that they built up in their former employer’s DC plan where there has been a “severance from employment” as defined under the Code. The individual will have to pay tax on the amount distributed plus a 10% additional tax if they are under age 59 and a half.
- Alternatively, an individual who changes jobs can roll over some or all of their savings into their new employer’s plan or into an individual retirement account (IRA) without incurring a tax charge.

#### Options at retirement

- As in the UK, at retirement, savers in the US can:
  - (i) take their savings as a cash lump sum
  - (ii) where offered by the plan, use their savings to purchase an annuity
  - (iii) where offered by the plan, make use of instalment payments directly from the trust
- Many 401(k) plans only permit individuals to take their savings as a lump sum. However, an individual can use this to buy an annuity on the open market.
- It is common for individuals to roll the savings from their employer’s 401(k) plan into an IRA, as IRAs generally offer more investment and decumulation options.
- Individuals are required to start taking distributions from their DC plan savings after they reach age 70 and a half.
- Participant freedom to take loans, hardship withdrawals and lump sum distributions upon termination of employment has led to concerns that such “leakage” from the retirement system threatens the adequacy of savings. For example, a 2014 Employee Benefits Research Institute study found that under one set of assumptions, the presence of these features lowers the likelihood of retirement savings success from approximately 55% to 45%.<sup>22</sup>

<sup>22</sup> Jack VanDerhei, Statement for the Record – Testimony before the ERISA Advisory Council, U.S. Dep’t of Labor, Hearing on Lifetime Participation in Plans: *The Impact of Leakages on 401(k) Accumulations at Retirement Age*, ebri.org (June 17, 2014) available at <https://www.ebri.org/pdf/publications/testimony/T-180.pdf> (last visited Nov. 25, 2017).



Lessons from across the pond  
DC plans in the US and the UK



## 8. Distributions

### UK

#### Accessing savings

- Generally speaking, an individual in the UK can access their pension savings without penalty from age 55 (rising to 57 by 2028) or earlier if they are suffering from ill-health which prevents them from working.

#### Early access

- Early access other than where an individual is suffering from ill-health is not permitted. If an individual accesses their savings early they will suffer a penal tax charge. The pension plan may also suffer a penal tax charge. Unlike in the US, there are currently no provisions allowing individuals to borrow from their retirement savings.

#### Options at retirement

- Since April 2015, individuals have had much greater freedom over what they can do with their pension savings from age 55.
- The tax rules prior to April 2015 meant that most savers would take up to 25% of their savings as tax free cash and then use the rest to buy an annuity.
- Individuals who took more than 25% of their savings as cash prior to April 2015 would have had to pay a 55% tax charge on the excess over 25%. As a result, very few people did this. In addition, income drawdown was only available to individuals with large amounts of pension savings.
- However, significant changes were made to the tax rules in April 2015 which mean that:
  - (i) there are now no restrictions on who can make use of income drawdown in retirement
  - (ii) individuals can still take 25% of their savings as tax free cash and any excess that is taken as cash will now only be charged at the individual's marginal tax rate in the relevant tax year

- Individuals can still buy an annuity if they want to but they are no longer forced down this route by the tax rules.
- As a result of these changes:
  - (i) there has been a significant fall in the number of annuities being purchased
  - (ii) many more savers are making use of income drawdown
- Income received from an annuity or via income drawdown will be taxed at the individual's marginal tax rate.
- When the tax rules were changed, concerns were expressed about the risk of people running out of money before they die. It is too early to tell if this will become a widespread problem in the UK.
- Concern was also expressed about people's ability to make good choices and to understand the risks associated with and the implications of their decisions.
- As a result of these concerns, there is a lot of focus on the support and information that is given to individuals as they approach age 55 and begin to make decisions about what to do with their pension savings. Providers are also looking at the potential for introducing default decumulation options for individuals who, for whatever reason, do not make a choice.
- There is now no requirement in the UK for when an individual must access their pension savings.



## Lessons learned

A distinguishing feature of DC plans in the US compared with DC plans in the UK is the ability for savers to access their savings early by way of loans, hardship payments and when they move jobs. During 2016, 1.5% of DC plan participants in the US made a hardship withdrawal and 17% had loans outstanding at the end of last year<sup>23</sup>.

Although concerns could legitimately be raised about the impact that early access could have on income levels in retirement, this flexibility is likely to appeal to many savers. It is one of the reasons why DC plans have been so successful in the US and, if it was introduced into UK DC plans, it could actually encourage people to save more in their pension, secure in the knowledge that they can access their savings (or a portion of them at least) should they need to.

The appeal of early access has been recognized in the design of Lifetime Individual Savings Accounts (ISAs) in the UK. However, rather than creating a new product to compete with pensions, is it time for the UK Government to introduce greater flexibility into the design of DC plans in order to appeal to a new generation of savers for whom retirement saving competes with other financial demands such as repaying student debt and getting on the housing ladder?



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<sup>23</sup> See Bloomberg News, *supra* note 14.



## 9. Current issues / challenges

### US

Key current legal and regulatory issues relating to DC plans in the US include:

- **Tax reform** – While it ultimately resulted in relatively minor impact to retirement plans, the recently passed tax reform involved a number of measures that impact retirement savings in various ways. Accordingly, retirement plan sponsors and their counsel will need to be cognizant of these changes and how to best incorporate them into their plans moving forward.
- **Fee litigation** – Over the past decade, there has been an emergence and sustained growth with respect to litigation involving claims that plan sponsors have breached their fiduciary duties by not monitoring fees charged by plan service providers (such as recordkeepers or investment managers). Such claims are likely to continue to be brought against plan sponsors.
- **Employer stock** – As with fee litigation, there has been extensive litigation in the last 20 years over the prudence of fiduciaries allowing employer stock as an investment option in a DC plan, particularly when there is a major drop in the stock value. In response, many employers have hired independent fiduciaries or frozen or eliminated the employer stock fund, a trend which seems likely to continue.
- **End of the IRS determination letter program** – Prior to 2017, employer-sponsored DC plans were allowed to apply for a new “determination letter” from the IRS stating that the plan was qualified under the Internal Revenue Code. The IRS has recently ended the program for most situations, and it is unclear how this gap will be filled.  
This is a particular issue for mergers and acquisitions, where companies usually rely on having an IRS determination letter as proof of any plans related to the transaction being qualified or in compliance with the tax code.
- **Cybersecurity** – The recent hack involving Equifax has highlighted the vulnerabilities of financial companies. While there is currently no direct rule that applies to US retirement plans, the United States Department of Labor’s ERISA Advisory Council considered and provided recommendations to the Department of Labor on the topic of cybersecurity for ERISA plans in 2016. Also, plan fiduciaries must consider the extent to which they are obligated to consider these issues as part of the duties to the plan and participants.



**Lessons from across the pond**  
DC plans in the US and the UK



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151	924	
1449	2110	
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110		

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## 9. Current issues / challenges

### UK

Key current legal and regulatory issues relating to DC pensions plans in the UK include:

- **Tax reform** – In recent years, the UK Treasury has flirted with the idea of moving from an EET system to a TEE system for retirement savings (as per the approach that is used for Roth 401(k) plans in the US). The UK Government has so far stopped short of overhauling the entire system of tax relief for pension savings. However, in April 2017 it launched Lifetime ISAs which provide an alternative way of saving for retirement and which operate on a TEE basis. When this policy was announced it was seen as a step towards wholesale TEE treatment and an attempt to bring forward tax revenue on retirement savings. However, following the Brexit referendum and the subsequent change of Chancellor, the appetite for wholesale change appears to have receded, but it has not gone away completely and could be rekindled. The prospect of wholesale change would also become more likely if the US were ever to go down this route.
- **Brexit** – Trustees, pension providers and employers need to be alert to the potential impact of Brexit on pension plans, their sponsors and the wider economy. In particular, they should be monitoring the suitability of plan investments and the impact on the sponsor's financial strength.
- **Data protection** – Pension plans and employers will need to comply with the new requirements that will be introduced when the European General Data Protection Regulation comes into force in May 2018. These requirements include additional protections that need to be included in contracts with third parties who process or store plan data, new rights for plan members and new internal policies and processes that need to be put in place. The penalties for non-compliance are also increasing dramatically from the current maximum fine of £500,000 to new maximum penalties of up to €20 million or 4% of global annual turnover – whichever is greater.
- **Cybersecurity** – Trustees and pension providers are required by law to ensure the security of plan data. Recent high-profile examples of cybersecurity breaches have highlighted the risks in this area. The Pensions Regulator has urged trustees and providers to put in place a robust plan for addressing the threat of cybersecurity and cybercrime.
- **Pension scams** – Incidents of pension scams in the UK have been increasing in recent years. Historically, scammers tended to target individuals under age 55 with the promise of giving them early access to their pension savings. However, following the introduction of greater freedom on how savers access their pensions in April 2015, scammers are now increasingly targeting individuals above age 55 with the promise of attractive investment returns on their savings.  
  
The UK Government has proposed introducing a ban on cold-calling regarding pensions in an attempt to reduce the number of scams. However, it is unclear when this ban will become law.
- **Intergenerational fairness** – Policymakers in the UK are increasingly focused on issues of intergenerational fairness. In addition, the new IORP Directive states in the preamble that, *"as a general principle, workplace pension plans should, where relevant, take into account the objective of ensuring the intergenerational balance..., by aiming to have an equitable spread of risks and benefits between generations in occupational retirement provision"*. While this principle will not be binding, it indicates the direction of travel for policymakers in the UK and Europe.
- **Transparency of costs and charges** – The UK Government is working with the pensions industry to develop new rules relating to the disclosure of investment costs and charges, including transaction costs, within pension plans.

## Lessons learned

The introduction of automatic enrollment in the UK followed a comprehensive review of the UK pensions system by the Turner Commission, which published its final report in November 2005. The Commission took a long-term view of the UK pensions system and its aims and objectives. Adair Turner, who Chaired the Commission, also succeeded in building a wide-ranging consensus among policymakers and stakeholders around the Commission's recommendations, which included the proposal to introduce automatic enrollment.

This in-depth review and the building of a widespread consensus has contributed to the successful implementation of automatic enrollment which has been overseen by successive Governments of different political persuasions. It is a great example of effective policy making, particularly in an area such as pensions, where the consequences will be felt for generations to come.



## 10. Our team

Our pensions team advises clients on pensions and retirement benefit issues globally, including in the US, the UK and Europe, Asia and the Middle East. If you would like to speak with a member of the team, please contact:

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