Fiduciary Focus

EDITION 5 - 2023

A Note From the NWCM Team

Welcome to the latest edition of NWCM's Fiduciary Focus! We provide this resource to inform plan sponsors about key fiduciary topics to empower them to better manage the retirement programs in their care.

In this edition, you'll find practical steps to prepare for the **SECURE 2.0 Roth catch-up contribution changes**. You'll also find details on the **recent IRS announcement** of a two-year delay of the rule, and what it means for both plan sponsors and participants.

Given the recent *Rothification* trend, there are many important Roth-related questions that fiduciaries should consider. Our main article in this edition offers a comprehensive overview of what you need to know (and what we're still waiting to find out) about Roth. We conclude with a review of recent retirement plan-related litigation, along with informed commentary on the potential broader implications for fiduciaries.

Fiduciary Tip for Plan Sponsors

SECURE 2.0 was enacted on December 29, 2022. Among its 92 legislative items, the bill included provisions that involve significant changes to both Roth and catch-up contributions. These changes will likely affect how your retirement plan operates.

Beginning in 2026, certain catch-up contributions will be required to be contributed on a Roth basis. Participants who made more than $145,000 (indexed for inflation) in the prior year at the same employer **must make** catch-up contributions on a Roth basis. Because of this, unless a plan provides for catch-up contributions in Roth accounts, then **no one** in the plan can make catch-up contributions.

Initially set for a 2024 rollout, the IRS recently announced that the effective date of this provision would be pushed to 2026, to allow for an “administrative implementation period.” This announcement is a positive development, offering plan sponsors, third-party administrators, recordkeepers, and payroll providers additional time to get ready and execute the Roth catch-up contribution changes. That said, don’t let this news serve as a reason to delay taking action in preparing your plan and participants for this important upcoming change.

As is the case with all the provisions of SECURE 2.0, we encourage you to review applicable provisions and consider these steps:

1. Assemble your implementation team, and be sure to include all relevant stakeholders, including the recordkeeper, third party administrator (if applicable), payroll provider, retirement plan advisor/consultant, legal and/or compliance counsel, and stakeholders from the retirement plan fiduciary committee.
2. Once your SECURE 2.0 working group is established, meet to determine the capabilities of the service providers regarding Roth and catch-up contributions.

3. Once capabilities are confirmed, evaluate which service providers can support the provisions desired by the settlor and the plan fiduciaries.
4. Communicate with participants regarding how you will handle the change in catch-up provisions. Impacted participants now have until 2026 to make pre-tax catch-up contributions (up to the limit). Though it may be a small population, this change may have a big impact on their personal financial situation.
5. Moving forward, plan sponsors should also monitor each year for employees who recently reached/surpassed the limit (which is indexed) to notify them that they will no longer be eligible to make catch-up contributions on a pre-tax basis. Once the limit is indexed each year, plan sponsors may also want to notify participants who were previously ABOVE the limit that they have now fallen below the limit and are again eligible.
6. Stay tuned for updates related to SECURE 2.0, which will be forthcoming from the IRS, DOL and potentially legislators but don’t let the potential for those updates stall your progress. Work with a retirement plan advisor or consultant to assist with your review and monitoring of these forthcoming provisions.

If you want to add Roth into your plan, you will need to communicate with your implementation team described above as soon as possible. Please reach out to your financial advisor if you would like more information. As always, we appreciate the opportunity to be of service.

Introduction to Roth 401(k)

Named after Delaware Senator William Roth, the Roth IRA was introduced in 1998 and was followed by the Roth 401(k) in 2006. Over the past decade, the percentage of defined contribution retirement plans allowing Roth accounts has nearly doubled, rising from 49% in 2011 to 88% in 2021, according to the Plan Sponsor Council of America.[1] The recent enactment of SECURE 2.0, along with its numerous Roth-related changes, is anticipated to further fuel the "Rothification" trend and will likely lead to even more plans offering Roth.

Providing a Roth option can enhance the attractiveness of a retirement plan and cater to participants seeking flexible tax advantages. As the landscape of retirement planning evolves, embracing Roth can potentially make your plan more competitive and better aligned with the needs of your employees. Whether your retirement plan already offers a Roth option or you're considering adding one with the upcoming SECURE 2.0 changes, this article will help break down what you need to know.

What is Roth?

The primary difference between a traditional 401(k) and a Roth 401(k) is when taxes are paid. Traditional contributions use pre-tax money, while Roth 401(k) contributions use after-tax money. Roth 401(k) earnings grow tax-free, allowing tax-free withdrawals in retirement if certain conditions are met. Generally, no taxes will be due on withdrawals of Roth funds if the withdrawal takes place after age 59½ and after at least 5 years have passed since the first Roth contribution.

Younger individuals are often encouraged to make Roth contributions as they are generally assumed to be in a lower income tax bracket now compared to their anticipated higher income tax bracket in the future. Yet, advantages exist for both pre-tax and Roth contributions across all age groups, and some participants choose both options.

Pros/Cons of Roth

Choosing a Roth 401(k) comes with its pros and cons, and it will ultimately depend on each participant's individual financial situation and personal preferences.

The primary advantage of a Roth 401(k) is the potential for tax-free growth, making it attractive for those expecting to be in a higher tax rate in retirement. However, this advantage is traded for the initial short-term benefit of contributing using pre-tax dollars. This trade-off particularly impacts lower-income participants who could benefit from a Roth 401(k), but utilizing after-tax funds might strain their budget and impact their ability to save sufficiently for retirement.

Roth 401(k)s also offer benefits to high-income earners who are restricted from participating in traditional Roth IRAs due to income restrictions. Unlike Roth IRAs, Roth 401(k)s have no income caps, enabling individuals with higher incomes to participate. And while contributions to a Roth 401(k) are subject to annual contribution limits set by the IRS, Roth 401(k) plans offer the advantage of higher contribution limits compared to traditional Roth IRAs.

"Rothification"

The Roth 401(k) option has been available for almost two decades, and as mentioned earlier, is becoming increasingly prevalent in plans. However, only about 28% of participants made Roth contributions in 2021.[2] That said, it seems that Congress is aiming to increase the use of Roth in retirement plans. We've seen an emerging trend of incorporating Roth provisions into retirement bills, a phenomenon termed "Rothification."

The reason congress is motivated to expand Roth in 401(k) plans is due to the immediate taxation of Roth contributions. As a result, an increasing number of legislative proposals have included Roth provisions to offset the overall cost of the bill. When Congress introduces a bill, the Congressional Budget Office (CBO) estimates its potential cost.[3] If the CBO's projection is high, the bill's chances of passing may decrease. To counter this, attempts are often made to add in "pay-fors" to help offset the estimated cost. That is why when it comes to retirement plan legislation, Roth has become a useful budgetary tactic.

This was particularly evident in Secure Act 2.0, which included several provisions expanding the use of Roth in retirement plans.

SECURE 2.0

The Secure 2.0 Act was signed into law on December 29, 2022, as part of the Consolidated Appropriations Act of 2023[4]. Among the many provisions included in SECURE 2.0, there were several provisions relating to Roth. Some of the key Roth-related SECURE 2.0 changes concerning retirement plans included:

- The elimination of required minimum distributions (RMDs) in Roth 401(k) plans.
- The requirement that catch-up contributions be made as Roth for eligible plan participants who earned over $145,000 (indexed) in wages the previous year (beginning in 2026).
- The option to treat employer non-elective or matching contributions as Roth.

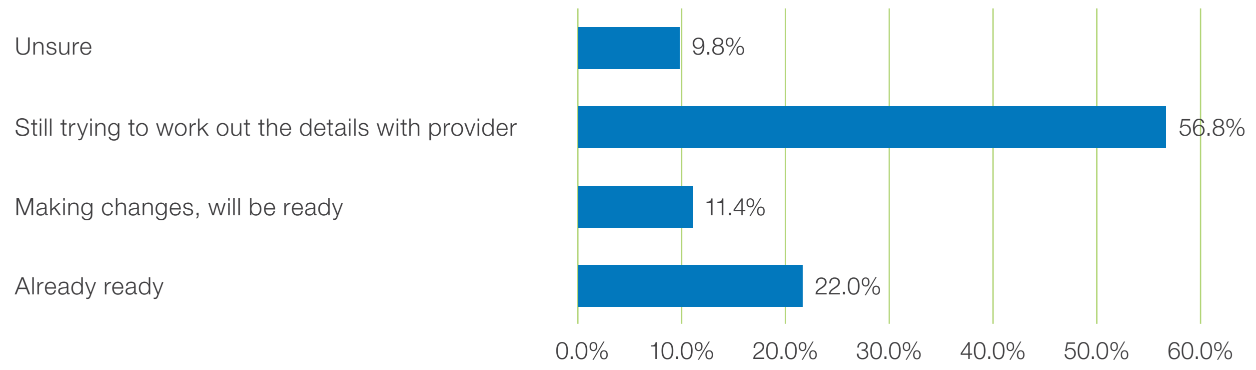
Issues/Controversies

The Roth-related provisions in SECURE 2.0 represent a significant shift and have not been without controversy. While some of the Roth-related provisions are considered optional, the change related to catch-up contributions has been seen by many as effectively mandating the inclusion of Roth.

Nearly all 401(k) plans (98%) currently allow catch-up contributions, according to an analysis of Vanguard analysis.[5] Under the current understanding of SECURE 2.0, all these plans will be mandated to adopt a Roth provision if they want to continue allowing catch-up contributions.

Following the announcement by the IRS of a two-year delay, the Roth catch-up provision is now slated to go into effect in January 2026. This last-minute delay occurred following pressure from various retirement-industry lobbying groups. These groups pushed for a delay due to the administrative complexity involved in implementing the change, which will require extensive coordination among various parties and systems. The delay comes as welcome news, as a recent survey by the Plan Sponsor Council of America revealed that only a third of plan sponsors felt they would be ready for this provision by the initial 2024 effective date.[6]

Plan Sponsors Ready to Implement Catchups as Roth



The American Benefits Council and the American Retirement Association were among the retirement industry trade groups that expressed concerns.[7] The coalition pointed out several administrative challenges with this provision, which are detailed below:

- Not all plans have a Roth option and adding this option is not always simple, as various factors may need to be considered.
- Many governmental plans do not provide for Roth contributions and may require legislative action to do so.
- Some employers may elect to eliminate catch-up contributions altogether instead of dealing with the complexities of adding a Roth option.
- The $145,000 FICA limit for Roth catch-up contributions is not related to any other limit that currently exists for qualified plans.
- Payroll providers will require system updates to identify individuals with FICA wages exceeding $145,000 from the prior year and to differentiate employers based on age.
- There are timing concerns relating to providing communications to participants to allow them to make elections before January 1st, for wages that are not known until after January 1st.

To further complicate matters, a technical error in SECURE 2.0 initially raised concerns that the bill might effectively prevent all catch-up contributions (both Roth and pre-tax) starting in 2024.[8] Fortunately, in the recent guidance announcing the two-year implementation delay for Roth catch-up contributions, the IRS also clarified that catch-up contributions are in fact still allowed after 2023, despite the drafting error in the bill.

In addition to the changes to catch-up contributions, the SECURE 2.0 Act also introduced an optional provision that would allow for plan participants to opt for any fully vested employer contributions to be treated as a Roth contribution. Although this provision was immediately enacted, no guidance from the IRS on this complex provision has been issued.

It is not yet clear how this participant election will be documented in plan records or how it will be reported to service providers and applicable government agencies. Recordkeepers are likely to handle tracking but as of now most recordkeepers are waiting for IRS guidance before making the required system updates.

Other issues that must be clarified by the IRS involve the taxation of these contributions on both the participant and employer side. For now, the implementation of this provision is likely to remain stalled until the IRS provides guidance.

What's Next?

While advisors, plan sponsors, recordkeepers, and payroll providers can all breathe a collective sigh of relief over the delay in implementation for the Roth catch-up provision, it would be a mistake to delay planning any further. The time is now for plan sponsors to review the changes outlined in SECURE 2.0 with their trusted implementation team.

Stay tuned for additional updates related to SECURE 2.0, which will be forthcoming from the IRS, DOL and potentially legislators, but don't let the potential for those updates stall your progress. For specific immediate actions that plan sponsors should take, please refer back to the Fiduciary Tip section of this guide, which outlines steps plan sponsors should be considering now. If you have any questions during this process, NWCM is here to assist with your review and monitoring of these changes.

Litigation Updates

Excessive Fee Cases

Hughes v. Northwestern University

Case Summary: In 2022, the Supreme Court reviewed an ERISA case (Hughes v. Northwestern University) that involved claims of excessive plan fees and imprudent investment options. Several other excessive fee cases were placed on hold pending the Supreme Court's ruling.

Case Outcome: The Supreme Court reversed the lower court's decision, stating that excessive fee claims should be reviewed on a "context-specific" and "case-by-case" basis.

Lower courts are now applying the standard outlined by the Supreme Court. Some recent dismissals (e.g., Smith v. CommonSpirit Health) have been viewed as wins for plan sponsors, with rulings recognizing the challenging tradeoffs fiduciaries face and highlighting that courts should acknowledge the wide range of reasonable judgments that a fiduciary may make.[9]

Despite the recent dismissals, the trend of excessive fee cases does not appear to be slowing and the future of excessive fee litigation remains uncertain.

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A total of 88 excessive fee cases were filed in 2022, the second most ever, surpassed only by the record of 97 cases filed in 2020.[10]

Vellali v. Yale University

Case Summary: After six years of working its way through the courts, an excessive fee related case, Vellali v. Yale University, recently proceeded to trial. Unlike most ERISA cases that are either dismissed or settled before reaching this stage, this case actually proceeded to a full jury trial.
Key allegations in the case include:

- Failure to consistently monitor recordkeeping costs.
- Failure to obtain competitive bids from other providers or periodically renegotiating pricing.
- Failure to prohibit providers from engaging in cross-selling activities with plan participants.

Case Outcome: On June 28, 2023, the jury concluded that the defendants had breached their duty of prudence by allowing unreasonable fees; however, they found that no loss or damages had been proved by the plaintiffs as a result and therefore no damages were awarded. The jury subsequently ruled that the plan had followed a prudent process and had not failed to appropriately monitor the plan investments. Despite the somewhat contradictory ruling, the outcome is considered a victory for the plan fiduciaries.

Action Item: Recent excessive fee case decisions have been seen as wins for plan fiduciaries, but litigation is expected to continue and outcomes in such cases can be unpredictable. These cases highlight the importance of monitoring investments and ensuring reasonable plan fees. It is essential that plan fiduciaries establish a robust process to document their fiduciary decision-making process. NWCM can assist plan fiduciaries in navigating these requirements effectively.

Cybersecurity Cases

Giannini v. Transamerica Retirement Solutions

Case Summary: In a lawsuit filed in late 2021 (Giannini v. Transamerica Retirement Solutions), a plan participant alleged that the plan's Recordkeeper, TransAmerica, failed to safeguard participant data which resulted in a data breach.

Case Update: In August 2022, TransAmerica filed a motion to dismiss the case. The dismissal motion was pending as of the last edition of the Fiduciary Focus. TransAmerica subsequently provided evidence indicating that the breach was the result of a coding error, which had potentially enabled administrators of other plans to access the plaintiff's retirement plan and tax information, but not the broader public. TransAmerica argued that it was therefore implausible that they were responsible for the extent of harm alleged, including the misuse of identifying information for fraudulent purchases. In light of this new information, the plaintiff agreed to voluntarily dismiss the suit on March 03, 2023.

Disberry v. Colgate-Palmolive[11]

Case Summary: Last edition, we introduced the case of Disberry v. Colgate-Palmolive, which involved a former employee whose plan balance was stolen via a cyberattack. A hacker obtained access to the participant's online account by deceiving the recordkeeper's customer support call center, pretending to be the participant, and subsequently receiving a full distribution of the account balance. The plaintiff claimed the recordkeeper failed to sufficiently safeguard the plan assets from the cyberattack.

Case Update: Motions to dismiss have been filed in which the plan argues that the fraud was not the committee's fault. The recordkeeper places blame on "bad actors" for the "unfortunate loss" and denies any fiduciary responsibility. In January 2023, the plaintiff modified the complaint to add a state negligence charge against the Colgate-Palmolive Committee. Subsequently, in March, the court approved a motion that would enable the recordkeeper (Alight) to safeguard proprietary business information. We will continue to monitor this case.

Action Item: Plan fiduciaries should confirm whether their current or prospective providers offer security guarantees that will protect plan participants in the event of a cyberattack. Additionally, plan fiduciaries should keep the recent DOL cybersecurity guidance in mind when selecting and monitoring plan service providers, in order to ensure the security of participant data. As part of their guidance, the DOL published a list of online security tips that can be provided to employees. The action items outlined can help plan participants protect their retirement accounts from fraud and theft.

NWCM has released a Cybersecurity Training Lab for our clients, which is available in ShareFile or upon request. It is highly recommended that you complete the Training Lab and follow the action steps provided to ensure that your organization is following industry best practices.

Litigation Updates

Target Date Funds

Jones et al. v. Dish Network Corp. et al.[12]

Case Summary: In our last edition, we covered various lawsuits related to both actively and passively managed target date funds. One lawsuit (Jones et al. v. Dish Network Corp. et al.) involved claims that a plan sponsor had breached fiduciary duty by choosing and maintaining an actively managed target date series, which the plaintiffs claimed to be "riskier and more costly" compared to other available options. Conversely, we also discussed several "cookie-cutter" lawsuits filed against plans offering passive target-date series, which claimed that the plan fiduciaries had prioritized low fees over performance.

Case Update: The case involving actively managed target date funds was dismissed on March 27, 2023. The judge found that the plaintiffs had failed to establish that the plan fiduciaries had behaved unreasonably in selecting the actively managed target date funds, noting that:

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> **"It is prudent to offer a range of reasonable investment options, including passive and active funds."**

For the cases involving passively managed target date funds, we confirmed in the last edition that the first two of the eleven cases had been dismissed. An additional case was dismissed in February 2023, followed by another dismissal in June 2023. It is expected that the remaining complaints will follow suit and be dismissed as well.

> **Action Item:** It is important to follow a thorough evaluation and documentation process when making investment decisions. Plan fiduciaries do not have a responsibility to select either the best performing investment options or the least expensive options. Fiduciary prudence is assessed based on whether a prudent process was followed in arriving at a decision, not on its results.

Newsletter Sources

[1] https://www.psca.org/news/press-room/wake-covid-19-retirement-savings-surge

[2] https://www.psca.org/news/press-room/wake-covid-19-retirement-savings-surge

[3] https://www.cbo.gov/about/products/ce-faq

[4] https://www.congress.gov/bill/117th-congress/house-bill/2617

[5] https://institutional.vanguard.com/content/dam/inst/vanguard-has/insights-pdfs/22_TL_HAS_FullReport_2022.pdf

[6] https://www.napa-net.org/news-info/daily-news/ready-roth-catch-contribution-changes-plan-sponsors-answer

[7] https://image.uschamber.com/lib/fe3911727164047d731673/m/1/Roth+Treasury+Transition+Letter+Final+7.19.pdf?utm_source=sfmc&utm_medium=email&utm_campaign=attribute%201&utm_term=20230719_EPD_EBCupdate&utm_content=7/19/2023

[8] https://www.napa-net.org/news-info/daily-news/major-secure-20-error-puts-catch-ups-jeopardy-ara%E2%80%99s-graff

[9] The Court noted that actively managed funds "represent a common fixture of retirement plans, and there is nothing wrong with permitting employees to choose them in hopes of realizing above-average returns over the course of the long lifespan of a retirement account."

[10] https://www.jdsupra.com/legalnews/excessive-fee-litigation-a-new-hope-2396224/
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[11] https://www.lawyersandsettlements.com/legal-news/erisa/what-now-retirement-plan-cybertheft-erisa-lawsuit-watch-23704.html

[12] https://www.napa-net.org/news-info/daily-news/dish-beats-back-excessive-401k-fee-suit
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NWCM Fiduciary Focus Contributors

Valerie Haley, QKA®
Retirement Plan Service Associate
valerieh@nwcm.com

Nicholas Axline, QKA®
Retirement Plan Service Associate
nicholasa@nwcm.com

Thomas Resner
Director of Retirement Plan Operations
thomasr@nwcm.com