TRANSITION MANAGEMENT

THE DEFINED CONTRIBUTION PLAN TRANSITION

Successfully Restructuring Assets in the Defined Contribution World

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Transitioning assets for defined contribution (DC) plans has the same basic goals as transitioning for defined benefit (DB) plans. However, just as there are distinctions between the structures of DC and DB plans, there are significant differences as to how their transitions must operate as well. Restructuring events for DC plans are far more complex and require careful planning to succeed.

Among the prime differentiating factors of a DC plan transition are the potential for ongoing investment activity and greater visibility by investors. During the transition, participants will be able to monitor their investments and may continue to move their assets in a variety of ways, including:

- Payroll contributions
- Retiree disbursements
- New loans
- Loan repayment
- Inter-fund transfers
- Full distribution for departing employees

In order to avoid ongoing activity from participants, many DC plans consider a blackout period during the transition event. A blackout period restricts participant activity in the DC plans and prohibits any movement of assets.

While this will serve to simplify the transition and make the planning process easier, a blackout period is undesirable from a participant perspective since no fund changes, contributions or payments whatsoever are permitted. If for example, a market event occurs that investors want to act upon, the plan participants will be unable to respond during the blackout period. For this reason, it typically makes sense to conduct a transition without a blackout period whenever possible.

Following are some considerations when transitioning DC assets to help facilitate a smooth event and manage the process without a blackout period.

HIRE THE TRANSITION MANAGER EARLY

For a typical DB plan asset restructuring, the transition manager is usually engaged prior to the start of the event. A DC transition, however, will require considerably more planning and coordination. Therefore transition managers should be hired well in advance of the event so that they may participate in the planning process and contribute to strategy. In more complex DC plan transitions, it is not unusual to hire the transition manager months in advance of the event.

Due to the complexities of a DC plan transition, a transition manager with experience in managing such events should be selected. The transition manager needs to be familiar with the planning process and be aware of potential issues that may arise during the transition. References from other plan sponsors may prove helpful when identifying transition managers with sufficient expertise in this area.

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In addition, the transition manager selected should be acting directly in a fiduciary capacity as investment advisor. An investment advisor or any other party that exercises discretionary control over a covered plan's assets is deemed a fiduciary under the Employee Retirement Income Securities Act of 1974 (ERISA). An ERISA fiduciary is obligated by law to act solely in the best interests of a plan. Fiduciary oversight from a third party is not sufficient to protect the interests of the plan. The transition manager, who is responsible for strategy and planning, needs to be a fiduciary to the DC plan.

Once hired, the transition manager should also perform a precursory examination of the assets in the legacy portfolios to be sold. This review should identify any securities that may be difficult to sell. Examples include low-liquidity equities, TBA bonds and currency forwards. These securities may need specialized handling, which should be addressed early on in the planning process.

COORDINATE AMONG ALL INVOLVED

Conducting a DC transition without a blackout period generally is in the best interest of plan participants. If a full blackout period is deemed necessary, it should last no more than three days.

To avoid a blackout of activity, the planning process must be started early and should include input from the plan sponsor, consultant, transition manager, fund accountant daily valuation team, custodian and investment managers. Communication between all parties involved in the restructuring will be critical in the days leading up to the event and during the transition itself. This line of communication should be established in the early planning stages.

DEVELOP A TIMELINE

As part of the planning process, a timeline of the event should be completed at least one month prior to the start of the event. The timeline needs to consider and be built around the expectations of the plan participants as communicated by the plan sponsor. Key components of the timeline include:

- The termination of legacy managers, including certification of assets. The certification process usually takes two days. More planning may be required for mutual or commingled funds (more detail to follow).
- Trade execution and settlement, reflecting the specific securities, portfolio liquidity and markets involved.
- The funding process, including reconciliation of assets by the custodian and transfer of assets between accounts.

Once a pre-trade analysis has been completed, the timeline can be updated with any changes in the expected trading timeframe.

The timeline should also include potential cash activity after the conclusion of the transition. Cash may continue to post to the transition account in the form of accrued interest, principal paydowns on mortgage-backed bonds, dividends and tax reclaims from foreign securities. The timeline and transition plan should include this activity.

MAP FUND FLOWS

A map of anticipated fund flows will detail the projected movement of assets. The fund accountant daily valuation team will play a key role in this process. While mapping may not be difficult for moves in which one asset manager is replacing another, more complex transitions will have much more intricate mapping. This is particularly true in DC transitions in which multiple managers are changing, life cycle funds are being introduced or participants are being asked to make new selections.

The ultimate goal of fund flow mapping is to coordinate the timing of necessary asset movements. Since plan participants will continue to make contributions and shift assets, the investment amounts involved will be moving and the mapping must remain flexible. Periodic updates also will be needed to keep figures accurate. During the transition event, participant flows will need to be reflected on a same-day basis and must be incorporated into the trading by the transition manager.

PLAN FOR LIQUIDITY

The transition plan must include a strategy to provide sufficient liquidity to accommodate participant activity. The recordkeeper can provide an expectation of participant flows by looking at the last two or three months of activity. During a transition, though, participant activity historically is higher as a result of the event itself. Since flows will happen on a T+1 basis, but the majority of equities and bonds settle T+3, liquidity must be planned in advance to accommodate activity.

In most restructurings, the simplest solution is to use existing cash balances from the legacy portfolio for liquidity purposes. If the plan has an equitization program in place, this also can be used easily to manage liquidity during the event.

In the absence of sufficient starting cash or an equitization program, additional cash should be raised to provide liquidity. Depending on the time this cash is needed, shortened settlement may be required. This cash liquidity buffer can then be equitized using derivatives or target funds to maintain exposure. While there is an additional cost to shorten settlement and temporarily equitize proceeds, we believe the cost is nominal and these strategies may be necessary to provide liquidity and keep assets invested in the market.

When the target allocation is a mutual fund, any cash available from the legacy portfolio, no matter how small, generally should be invested immediately into the target mutual fund. For example, suppose that the targeted transition date for a DC plan is Wednesday, May 31. All available cash from the legacy portfolio could be used to purchase shares of the mutual fund on Tuesday, May 30 at the close. This cash purchase then can be used for participant withdrawals immediately without waiting for the remainder of the trades to settle.

ADDITIONAL CONSIDERATIONS FOR FUNDS

When commingled or mutual funds are involved in the DC transition, there are additional nuances to consider that do not apply to separately managed accounts. There are several questions in particular that DC plan sponsors should ask that will help address these differences.

What are the funding/redemption options?

The primary question to ask is how the commingled/mutual funds are going to be funded or redeemed. Certain funds may give an option of either cash or in-kind with securities. More commonly, a fund will only permit one option or the other. This decision is at the discretion of the fund, not the plan sponsor.

For defined contribution plans, a mutual fund frequently will mandate that assets be restructured outside of the fund to avoid impacting their fund's performance. This in-kind funding/redemption requirement is more common when the DC plan's assets represent a significant percentage (more than 10 – 15%) of the mutual fund's total assets.

It is also common for a fixed income mutual fund to require an in-kind redemption. For commingled funds, the funding or redemption is most commonly completed with in-kind securities unless the size is small. Since the fund is being managed, presumably, for a number of other investors, the question of redemption/funding options can be asked in advance of the actual transition event since the fund manager still has an incentive to continue managing the assets effectively.

Are there any peculiarities or additional costs for buying and selling funds?

It is crucial to know what restrictions may exist when buying or selling the funds involved.

- Some funds, for example, require the cash to be in the account before the fund can be purchased (pre-funding on T-1).
- Others only require that cash be in the account on settlement date.
- There are also some mutual and commingled funds that can accommodate settlement on a T+3 basis as opposed to the normal T+1 basis.
- Commingled funds can also charge back for associated transaction costs.

A review of the investment management agreement may also identify managers that require advance notice of termination. Knowing these irregularities can help plan sponsors avoid potential pitfalls and lead to adjusting the restructuring strategy.

When redeeming assets, what will the in-kind security list look like?

The terminated fund managers generally have discretion as to how to deliver the assets from their funds. The in-kind asset list may be created either using a pro rata slice or adjusted manually by the portfolio manager.

Terminated fund managers could even use the event to restructure their own portfolio. In these instances, the delivered in-kind security list will contain a number of less desirable positions and typically will be more concentrated.

There are also some rules in the international market that complicate in-kind redemptions. In certain instances,

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an in-kind redemption may trigger a change of beneficial ownership, which in turn may lead to local tax liabilities. This situation can often be avoided if the fund manager delivers a pro rata slice of fund assets.

Moreover there are certain countries where securities cannot be transferred in-kind or where in-kind transfers are prohibitively expensive. A cash redemption may therefore be necessary. Examples of these countries include Greece, South Korea and Malaysia.

CONCLUSION

Defined contribution plans have been receiving more attention as they assume more prominent roles as retirement vehicles and replace or supplement traditional defined benefit plans. Many plan sponsors are also making changes within their DC plans to offer investments better suited to their participants' needs.

As a result, transitions within DC plans have been increasing and must be managed with an understanding of the unique environment that the plan faces, including the potential for ongoing investment activity and high level of visibility by participants. While the underlying goal of a transition is the same regardless of the plan structure, special handling is necessary to provide a high level of success to DC transitions.

FOR MORE INFORMATION

To learn more about managing defined contribution transitions, please contact Northern Trust's Transition Management group at 312-557-5173 or e-mail ntgi_transition_management@ntrs.com.

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