

MEMORANDUM¹

January 6, 2012

TO: New Hampshire Retirement System Board of Trustees
FROM: Groom Law Group, Chartered
RE: LSR 12-2876.1 and SB 249

Introduction

You have asked us to identify legal and fiduciary concerns regarding the language in LSR 12-2876.1, which addresses the establishment, functioning, administration, and management of a public defined contribution ("DC") plan, and SB 249, which provides for the private administration and management of the New Hampshire Retirement System ("NHRS" or the "System"). We have identified concerns relating to the impact of the proposed DC plan on NHRS's funding status and investment objectives, the administration and management of NHRS by an outside service provider, and compliance with the Internal Revenue Code ("Code"). We discuss our concerns below.

With your consent, we have relied solely on the facts and representations as you provided them, and we have assumed these facts and representations are true, correct, and complete, and have made no independent investigation thereof. Variations from the facts and representations you provided could cause the legal conclusions in this memorandum to change. This memorandum is based on the Constitution of New Hampshire and laws

¹ On January 10, 2012, the NHRS Board of Trustees waived the attorney-client privilege with regard to this memorandum.

of New Hampshire at the date hereof and is subject to change with subsequent amendment or interpretation of such laws.

Proposed Legislation

LSR 12-2876.1 limits membership in NHRS to employees who start their employment before November 1, 2012, and establishes a DC plan for public employees who begin employment on or after November 1, 2012. LSR 12-2876.1 sets out employee and employer contribution rates for the DC plan, provides for employer payments to NHRS on behalf of DC plan members in order to fund NHRS's unfunded accrued liability, provides that employers pay the costs for long term disability insurance benefits and life insurance benefits, establishes rules for vesting and the disbursement of funds, and sets out options for the management and administration of the DC plan, as well as the NHRS corpus fund.

SB 249 articulates the legislature's finding that the administrative and management services currently handled by NHRS can be provided more efficiently and less expensively by a private-sector service provider. The legislation instructs New Hampshire's department of administrative services, which is part of the State's executive branch, to contract with a "suitable professional services organization" for the administration and management of the operations of NHRS. SB 249 § 2, I. Under SB 249, the NHRS Board of Trustees ("Board") and the department of administrative services must prepare a description of the duties and procedures governing the administration and management of NHRS. SB 249 § 2, I. Then, the department of administrative services must publish a request for proposals ("RFP") for service providers, review and consider qualifications after receiving proposals, and negotiate a

contract with the "highest qualified firm" for the "administration and management of the operations of the retirement system at compensation which the department of administrative services determines is fair and reasonable to the state." SB 249 § 2, II.

Analysis

We discuss in detail below the legal and fiduciary concerns we have identified in connection with the proposed legislation.

a. Impact of the Proposed DC Plan on NHRS's Funding Status and Investment Objectives.

GRS provided NHRS with a Defined Contribution Retirement Plan Study ("Report"), dated December 27, 2011, in which it describes the potential cost to NHRS of enactment of LSR 12-2876.1, as proposed. The Report provides that, for NHRS as a whole, the present value of the contribution shortfall under the proposed legislation is estimated to be \$237 million.² See Report, at A-1, B-3, C-2.

Additionally, in its presentation at NHRS's November Board meeting, GRS opined that the System might have "different investment objectives requiring a lower rate of return assumption" once active employees retire and the System is populated exclusively by retirees. See GRS's New Hampshire Retirement System June 30, 2011 Valuation, November 8, 2011, at 45. On this point, we recommend that the Board consider 1) whether an increasingly retiree-lopsided System might require a change in investment objectives and a lower rate of return assumption *before* the System becomes retiree-only, and 2) when, in terms of the ratio of active employees to retirees, such

² This raises the question whether the proposed level of funding is "determined by sound actuarial valuation and practice, independent of the executive office," as required under the New Hampshire Constitution Article 36-a ("Article 36-a"). Further, under the proposed legislation, it is unclear whether the service provider selected by the department of administrative services might be responsible for hiring an actuary, a duty currently performed by the Board pursuant to RSA 100-A:14 and 15. The service provider's choice of actuary under LSR 12-2876.1 also could implicate the requirements of Article 36-a.

changes might be necessary. GRS's experience with this dynamic in other public systems might provide some insight here.

b. Administration and Management of NHRS by an Outside Service Provider.

RSA 100-A:14 and 15 provide that the Board administers NHRS, and the Board and the Independent Investment Committee manage NHRS's assets. Proposed RSA 100-E:13, II (b) and (c) of LSR 12-2876.1, however, would permit the department of administrative services to allow "qualified entities engaged in retirement and pension plan management" to compete for these duties by submitting RFPs to the department of administrative services. SB 249 requires the department of administrative services to contract with a "suitable professional services organization" for the administration and management of NHRS's operations.³ SB 249 § 2, I.

Outsourcing administrative and management duties is unusual for a public employee plan and raises some concerns. First, the proposed legislation grants the department of administrative services – an agency under the executive branch – the authority to select the outside service provider that will handle duties that the Board currently performs. Allowing an executive branch agency to decide who administers and manages the trust corpus and under what conditions they are administered and managed could be viewed as shifting control over the System's assets to the executive branch. Executive branch authority over the NHRS's assets could, in turn, create a greater potential than under the current system for the diversion of assets from NHRS for use by the State, which the New Hampshire Supreme Court in *Board of Trustees of the New Hampshire Judicial Retirement Plan v. Secretary of State*, 161 N.H. 49, 55-56 (2010)

³ It is unclear whether the "administration and management of the operations of the retirement system" to be performed by a service provider pursuant to SB 249 includes investment management duties.

("Sudan") found violates Article 36-a. A determination that the State could save money on the administration and management of the DC plan by using the same service provider to administer and manage the System, for example, could constitute a diversion of assets from the System for use by the State in violation of Article 36-a. *Id.*

Additionally, the New Hampshire Supreme Court in *New Hampshire Retirement System v. Sununu*, 126 N.H. 104, 109 (1985) recognized NHRS's independence from the executive branch based, in part, on the System's status as a trust. *See* New Hampshire Constitution Article 36-a (NHRS's assets are to be "invested or disbursed as in trust"). Under the common law of trusts, the Court reasoned, the Board "owes the System's members and beneficiaries a fiduciary obligation to manage the System for the benefit of its members and beneficiaries." The executive branch, "[i]n contrast to the duty owed by the [B]oard narrowly to the trust beneficiaries," has "a responsibility to a far broader constituency." *Id.* The Court concluded that involvement by the executive branch in approving the System's personal service contracts would therefore "carry with it the potential for affecting the [B]oard's duty to the trust beneficiaries in a way the legislature did not intend." We believe the same concerns apply to the executive branch's involvement in selecting a service provider to administer and manage NHRS. Notably, the *Sununu* court also recognized the "long-standing administrative interpretation of the System's independence and of the powers and obligations of the board of trustees under RSA chapter 100-A." *Id.* at 110.

Furthermore, pursuant to the New Hampshire Supreme Court's decisions in *Sununu* and *Sudan*, *supra*, the department of administrative services would become a

fiduciary in soliciting and collecting RFP responses concerning the administration and management of the System, and in selecting the service provider.

In addition, neither LSR 12-2876.1 nor SB 249 appears to contemplate the necessity of or any process for fiduciary monitoring of the service provider's performance of NHRS-related administrative and management duties. Moreover, to the extent authority is delegated by the department of administrative services to a service provider, much or all of the delegated authority may require the service provider to accept fiduciary obligations if plan participants are to be adequately protected. Legislative amendments are needed to establish these points regarding the monitoring and performance of the service provider.

Many of our concerns with the private administration and management of the System in fact extend to the DC plan in general. The lack of any provision in LSR 12-2876.1 for monitoring the administration and management of the DC plan is one example. Unless further statutory language governing the DC plan is proffered, the adoption of a formal plan document would likely be necessary to account for omissions in the statutory language such as LSR 12-2876.1's failure to contemplate the need for monitoring of the service provider's performance.

c. Compliance with the Internal Revenue Code.

Optional Membership

Except for certain grandfathered plans, a governmental plan is not generally permitted to adopt a 401(k) feature (i.e., a cash or deferred election with respect to contributions, accruals or other benefits). Treas. Reg. section 1.401(k)-1(e)(4)(i). However, a one-time irrevocable election by an employee to participate or not

to participate in the plan is not a cash or deferred election, so long as such election is made when the employee first becomes eligible to participate in a plan of the employer. Treas. Reg. section 1.401(k)-1(a)(3)(v). Accordingly, the portion of LSR 12-2876.1, proposed RSA 100-E:3, that makes membership in the DC Plan "optional in the case of elected officials, unclassified state employees appointed for fixed terms, or full-time employees of the general court" raises concerns. A "one-time irrevocable election" must be made upon an employee's becoming eligible under any plan of the employer. Therefore, an employee who is currently, or was previously, a member of the retirement system would not be eligible to make a one-time irrevocable election to be covered under the proposed defined contribution plan.

Additionally, due to the technicalities of Treas. Reg. § 1.401(k)-1, a subtle distinction in the language of a statute could affect whether the requirements of the regulation are satisfied. For example, if legislation were drafted to allow an employee to refuse state employee benefits *no later than the time an employee first becomes eligible under a plan or arrangement of the employer*, then the election would likely be permissible under the regulation. However, where, as here, the legislation is drafted to allow an employee to refuse state employee benefits without identifying the time frame for such election, the language would not satisfy the regulatory exception under Treas. Reg. § 1.401(k)-1(a)(3)(v). If the System, as a governmental plan, were to implement the legislation as proposed, the plan may risk the loss of its qualified status.

Normal Retirement Age

IRS regulations provide that the normal retirement age under a tax-qualified plan must be "reasonably representative of the typical retirement age for the industry in which

the covered workforce is employed." A normal retirement age of age 62 or later is presumed to satisfy the reasonably representative requirement; a normal retirement age between age 55 and age 62 must satisfy the reasonably representative requirement on a facts and circumstances basis; and a normal retirement age of 50 or later for public safety employees is presumed to satisfy the reasonably representative requirement. Treas. Reg. section 1.401(a)-1(b)(2). These rules are scheduled to be effective for governmental plans for plan years beginning on or after January 1, 2013.⁴

The retirement ages (age 60 for Group I and age 50 for Group II) provided in the language of LSR 12-2876.1 creating RSA 100-E:12 might be problematic. For Group I, the proposed language is outside the language of the safe harbor, which covers members age 62 years and older. The proposed language for Group II would meet the safe harbor of age 50 for public safety employees. Although there is some concern as to whether the proposed normal retirement age for Group I will meet IRS requirements, this issue could be resolved by upcoming IRS guidance on permissible normal retirement ages for governmental plans. This potential issue may need to be addressed at a later date.

Voluntary Contributions

The scope of the language in LSR 12-2876.1 creating RSA 100-E:4 regarding additional voluntary member contributions is unclear. We suggest seeking clarification on whether the language is intended to cover members of the defined benefit plan, or only members of the proposed defined contribution plan.

⁴ The effective date for governmental plans was delayed by the IRS. See IRS Notice 2007-69 (Aug. 10, 2007) (providing initial transition relief); IRS Notice 2008-98 (Oct. 10, 2008) (providing transition relief until plan years beginning on or after January 1, 2011); IRS Notice 2009-46 (Oct. 28, 2009) (providing transition relief until plan years beginning on or after January 1, 2013).

Pick-Up Contributions

A contribution to a qualified plan established by a State government will not be treated as picked up by the employer under Code section 414(h)(2) unless formal action is taken to specify that the contributions, although designated as employee contributions, are being paid by the employer. A person duly authorized to take such action with respect to the employer must take such action (e.g., in meeting minutes, a resolution, or an ordinance). IRS Rev. Rul. 2006-43 (Aug. 28, 2006).

The language of proposed RSA 100-E:1 of LSR 12-2876.1 provides for contributions to be picked up under Code section 414(h). However, to comply with IRS requirements, employers must take formal action to authorize the pick-up of the member contributions. If the State does not have the authority to make such an election on behalf of participating employers, further action must be taken by the employers to satisfy the IRS requirements.

d. General.

Under RSA 100-E:9, IV, as provided in LSR 12-2876.1, the conversion to a "life annuity contract" is ambiguous and unclear. As drafted, we believe this term could be interpreted either as a stream of payments (1) from NHRS or (2) from an insurance company annuity. Given that the former scenario involves administration on the part of NHRS, we recommend that the System seek legislative clarification of this provision.

*

*

*

We look forward to discussing these concerns with you at next week's Board meeting.