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Managing an NQDC Plan Investment Menu

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In an article for the latest edition of our *DC Observer,* I discussed non-qualified deferred compensation (NQDC) plans, the investment menu structure, and hedging strategies. Unlike a qualified defined contribution plan, in which plan assets are segregated from the employer's general assets in a trust or custodial account, the compensation deferred into an NQDC plan remains commingled with the employer's general assets and the returns are notional. This arrangement is significant because the plan sponsor bears the responsibility for funding the notional returns generated by the investment menu.

(Estimated reading time: 3 min 56 sec)

NQDC plans are simply a contractual agreement between an employer and an employee in which the participants agree to defer a portion of their compensation. In turn, the employer agrees to pay the participants the compensation deferred, adjusted for a notional rate of return, at some future defined date or because of a predefined distributable event. Unlike a qualified defined contribution plan, in which plan assets are segregated from the employer's general assets in a trust or custodial account, the compensation deferred into an NQDC plan remains commingled with the employer's general assets. Plan sponsors can choose to hedge the liabilities generated by these arrangements by "informally" funding the NQDC plan (i.e., the money may be set aside but is not preserved or protected in a trust).

One of the most important elements of an NQDC plan involves its investment menu. Because NQDC plans are not formally funded, the returns generated by participants' investment elections become an aggregate liability for the plan sponsor on the company's balance sheet. As a result, the selection of the investment menu is one of the key drivers of complexity in managing liabilities.

Three common investment menu approaches:

DC Mirror Menus: Often, plan sponsors may be tempted just to "mirror" the investment line-up from their DC plan in their NQDC plan. It can simplify administration of the plan.

But there are potential pitfalls with this approach:

- Not all of the investment vehicles or share classes offered in a qualified DC plan may be available to an NQDC plan, leading to different expenses and returns and complicating the effort to closely match the assets and liabilities on an ongoing basis.
- Since an NQDC plan is not necessarily limited to planning for retirement, the investment options in the DC plan that have been selected for a long-term time

horizon may not fit the needs and objectives of the NQDC plan and its participants.

“Executive” Menus: The general concept is to offer an expanded menu of investment options for the participants—typically executives—in the NQDC plan. This usually takes the form of using some or all of the core investment funds in the DC plan and adding specialty investment options that may not be appropriate in a DC plan. In some cases, plan sponsors choose to offer a completely different investment menu from the DC plan to increase the diversification opportunity for the executives.

A potential benefit of the executive menu is that different asset allocation tools—particularly risk-based model portfolios—can be offered that are more useful to the participants in managing their in-service distributions.

The same asset-liability pitfalls related to the mirror menu apply here but may be exacerbated by the additional options. And participants in NQDC plans, who are supposedly more sophisticated investors, may make the same mistakes as DC plan participants when it comes to using the specialty options (i.e., return-chasing, market-timing, etc.).

Insurance-Based Menu: For tax purposes, some plan sponsors that informally fund the NQDC plan will use corporate-owned life insurance (COLI) as a funding vehicle. COLI allows the employer to receive the death proceeds from an insurance policy income tax-free, assuming proper notices are provided, and the growth in the policy’s cash value is not subject to income tax. Wanting the liabilities and assets to match, they will limit participants to a menu of funds included in the insurance-eligible funds offered within the particular COLI products.

While optimal for asset-liability management, the insurance-based menu approach has some challenges:

- The universe of investment options tends to be narrower and may exhibit more retail-like pricing. This is particularly true for registered COLI products but not as much with private-placement COLI products.
- Using insurance-eligible funds may complicate the flow of data for administration, reporting, participant communication, account values, liability management, etc., as the insurance carrier may be the only reliable source of information on the investment options. Further, fund-related data can also vary by the carrier of a specific product and may require a separate administrator from the DC plan.

You can find more information about NQDC plans and the strategic and tactical issues involved in using them in the latest *DC Observer* here .

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