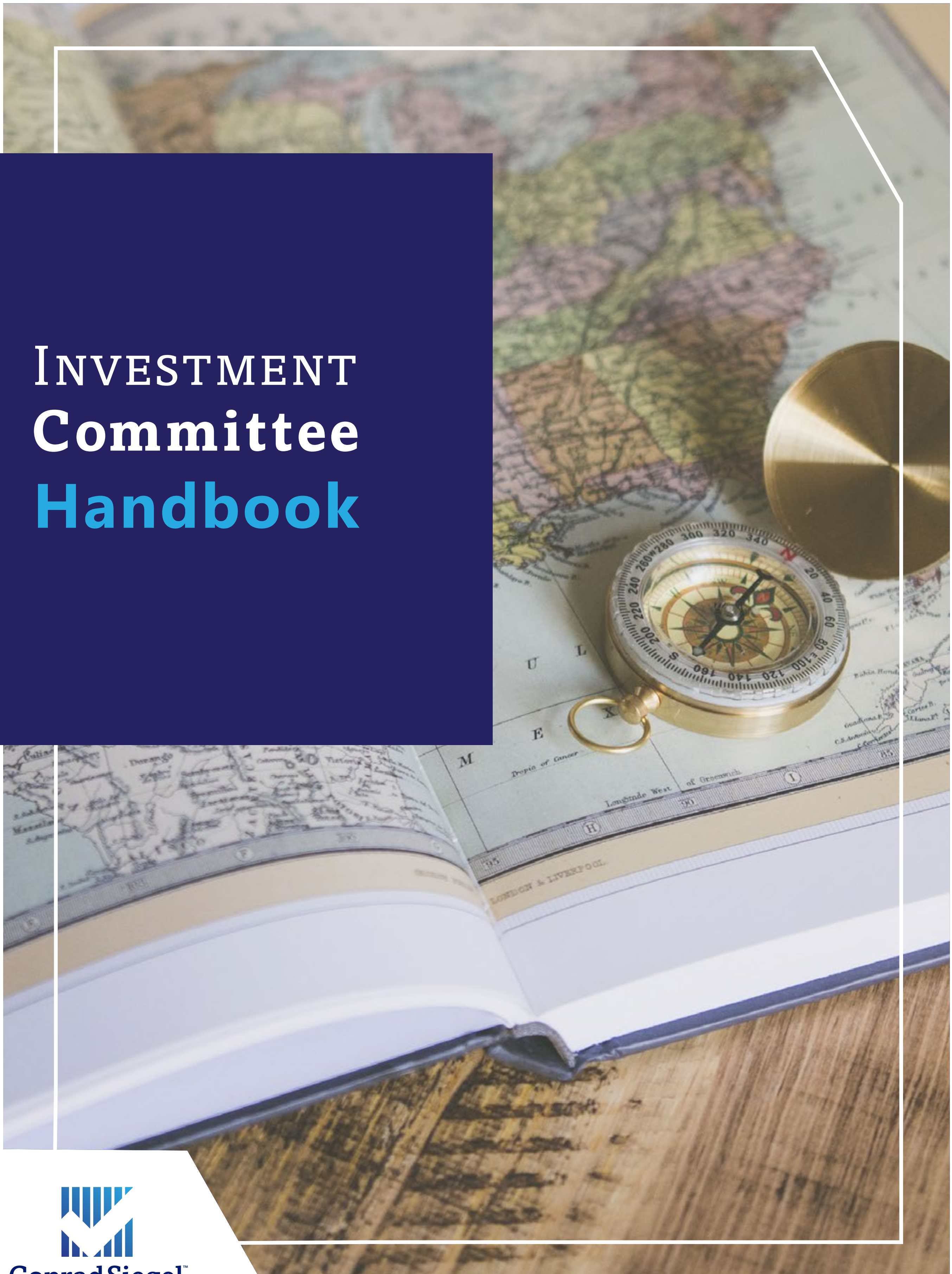
Investment Committee Handbook



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EVERYTHING *you* **Need** to Know

Are you a Plan Fiduciary?

Whether you are a fiduciary is determined by *what you do*, and not necessarily *who you are*.

- Anyone who has **decision-making control over managing a plan** — its assets or its administration — is considered a fiduciary.
- Anyone who **provides investment advice to the plan for a fee** is also a fiduciary.

You might think that if you are not mentioned by name in plan documents that you can escape the fiduciary label and its related responsibilities. This is not true! For example, if there is a committee choosing the plan's investments or ratifying an advisor's recommendations, each person on that committee has fiduciary responsibility.

Most plans have several fiduciaries, some of whom may be "named" and some of whom just have decision-making control over some aspect of the plan. Fiduciaries usually include the plan's trustee, investment advisor, administrative committee, and anyone who selects these individuals. A plan sponsor is always a fiduciary.

Accountants, actuaries, third party administrators (TPAs), and attorneys typically are not fiduciaries, because they lack any discretionary control over the plan.

Everyone working with the plan must know whether or not they are a fiduciary. And if they are, they need to be prepared to meet the expectations of their role, or to recruit someone who can help them meet their responsibilities.

If you alone, or as a member of a group or committee, are selecting and monitoring the plan's investments or approving a provider's recommendations, you are a fiduciary!

Know Your Fiduciary Role

Prudence and Process – the Two P's of Fiduciary Responsibility

Now that you know how to determine whether you're a fiduciary, what do you need to do about it? The Employee Retirement Income Security Act of 1974 (ERISA) has a clear set of responsibilities and duties for fiduciaries. It is important that you take these requirements seriously and understand your own responsibilities as well as those of the other plan fiduciaries.

A fiduciary must always...Be Prudent:

- **Look out only for the interests** of plan participants and their beneficiaries;
- **Diversify** the plan's investments to minimize risk; and
- **Pay only what is reasonable** for plan expenses.

Fiduciaries are not responsible for delivering the absolute best investment performance. They are responsible for following a prudent decision-making process that is reasonable and well-documented, and for making decisions with the best interest of participants in mind.

A prudent process should contain:

- **Hiring advisors** where appropriate;
- **Investment Committees** that meet regularly;
- **An Investment Policy Statement** that provides clarity around how investments will be selected, monitored, and replaced;
- **Investment Committee members** that review materials in advance, attend meetings, ask questions and seek understanding;
- **Investment Committee meetings** that contain well thought out analysis, robust due diligence, lively debate, and decision making;
- **Minutes** that capture attendees, discussions, questions raised, decisions made, and next steps.

YOU DON'T NEED TO GO IT ALONE.

*This does not mean you have to know the ins and outs of the market! But the role's responsibilities include **hiring outside experts** when the plan fiduciaries don't have the knowledge or bandwidth to get the job done.*

Limit Fiduciary Consequences

The basis of the fiduciary relationship – the reason you are a fiduciary – is trust. You are legally entrusted with the plan's proper functioning. The other side of that relationship? If you break that trust, you can be penalized under the law. If you as a fiduciary do not follow the basic rules, you could be *personally liable* to **refund** any losses to the plan that happen as a result.

The U.S. Labor Department may also make you pay **penalty taxes** if you fail to meet your fiduciary duty. Finally, plan participants may bring **civil action** against fiduciaries to recover any money lost by plan fiduciaries who were not fulfilling their obligations.

AM I MY FIDUCIARY'S KEEPER?

It's not just your own actions you need to be concerned about. You could be liable for something a fellow fiduciary does, if you ***participate in, conceal,*** *or even just* ***know about*** *another fiduciary's violation and do not report it, or if you* ***enable them to break the rules*** *by failing to satisfy your own fiduciary responsibilities.*

EXCESSIVE FEES ARE A COMMON COMPLAINT

In light of recent 401(k) plan lawsuits, there is increased scrutiny that employees and their legal representation are placing on plan sponsors. The Supreme Court ruled in Tibble v. Edison that plan sponsors have a "continuing duty…to monitor and remove imprudent trust investments." Lawsuits have been filed against large plans for allowing excessive fees — including health insurer Anthem Inc., which settled for $23.7 million — but have crept down to smaller plans with as little as $188 million in assets as late.

So, how do you protect yourself and limit your personal liability?

Have and Follow the Investment Policy Statement

One document that may be missing from a plan sponsor's files is an Investment Policy Statement (IPS). This document is the roadmap for how you are going to select and monitor investments. By listing specific criteria in the IPS you add clarity to the review process. (see Elements of a Properly Crafted IPS, page 8).

Know your Role and your Plan

Another way to reduce liability is to make sure that you and your fellow fiduciaries are familiar with the plan documents. You must review the documents periodically and make sure that they are being followed. All committee members need to be educated on their roles, responsibilities, and on the need for documentation. Fiduciary training should occur periodically.

Monitor your Service Providers

You are allowed (and even encouraged) to contract outside the plan and the company to make sure certain functions are completed properly. You can hire an ERISA 3(21) investment advisor that makes recommendations which you need to approve before implementation or an ERISA 3(38) investment manager that has discretion over the assets.

- In either arrangement, you do not eliminate your fiduciary responsibility in its entirety. You are responsible for challenging your advisor, seeking understanding of their reports and presentations, and making sure their advice is reasonable.

Review Fees and Expenses

You are responsible for knowing the true and total cost of your retirement plan and ensuring that the fees you are paying are reasonable in light of the services you are receiving (see What You Need to Know About Fees, page 10).

Documentation

Perhaps the best way to show a prudent process is through documentation. That includes a written IPS and documentation showing the review of investments per the criteria outlined in the IPS. It includes documenting fiduciary training sessions and committee meetings. The minutes should highlight the discussion, questions raised, decisions made, and thought process behind those decisions.

Fiduciary Liability Insurance

Plan sponsors are generally aware of a fidelity bond, which is a kind of insurance to protect the plan from losses resulting from dishonest or fraudulent acts by anyone associated with the plan. Fiduciary liability insurance may also be purchased. Before accepting a plan fiduciary position, you should know how your liability will be covered.

ARE YOU *Fulfilling Your* **Fiduciary** Duty?

Establish an Investment Policy Statement

A well-written Investment Policy Statement (IPS) should act as the roadmap for how you are going to select and monitor the investments within the plan.

An IPS forms the basis for demonstrating the very high standard of prudence needed to make investment decisions. Your plan's investment program is judged by the process followed, not by rates of return. If you can show that the fiduciaries' actions were the result of following a prudent, established, documented process, outlined in an IPS, your plan will be much better positioned in the event of an audit or legal action.

While the drafting of an IPS may be best left to an investment advisor, it is still important for each of your plan's fiduciaries to have a working knowledge of the importance of an IPS and the elements of a properly constructed IPS. This knowledge helps you as a fiduciary evaluate the plan and decide whether to make any changes to an existing IPS.

PROCESS PROPERLY

Your plan has an up-to-date investment policy statement (IPS) that describes your process for evaluating the plan's investment menu. Are you fulfilling your fiduciary duty? Trick question! Just because you have the IPS, does not mean you are in the clear. Once you have an IPS in place, it's imperative to follow the document. In fact, having a written IPS and not following it might be more dangerous than not having an IPS at all.

Elements of a Properly Crafted IPS

A well-written Investment Policy Statement is a key building block of a prudent process. Below are some of the most important areas to cover for developing an effective document.

Define the investment and plan objectives

- Be realistic. Achieving the highest possible investment return or beating the market shouldn't be listed as an objective. Include items that are within the committee's control, such as providing a reasonable range of investments.

Define the roles of responsible parties

- Each fiduciary should have a clear understanding of their role. Once roles are defined in writing, review them periodically so responsibilities aren't ignored or forgotten.

Describe the criteria for selecting investments

- Be specific. This helps provide clarity. For example, don't just list that funds should be low cost. You need to explain what low cost means. Instead, state something like funds should have an expense ratio of less than 1%.
- Here's the catch: don't be too specific. If you are too specific, you may need to update the IPS frequently. For example, if you list the funds available to participants, consider listing the asset class instead of the exact fund. This prevents the IPS from having to be updated after every fund change.

> "Be specific. But not *too* specific."

Establish measurement standards and monitoring procedures

- Identify who is doing what and how often.
- Remember that longer term performance is more meaningful.

Identify how to address investments that fail to satisfy the established criteria

- Don't address an underperforming fund by just adding another one for participants to choose from. However, when dealing with annuities you would be required to add another fund.
- Remember it's your responsibility to do what's in the best interest of participants. While you don't want to chase performance at the expense of participants, you also can't ignore poor performance.

What You Need to Know About Fees

You are responsible for knowing the true and total cost of your retirement plan and ensuring that the fees you are paying are reasonable in light of the services you are receiving. Plan expenses can be paid either:

- By plan participants by taking fees from plan assets;
- By the plan sponsor

Fees can be assessed either with a per-person fee or a percentage basis fee. If your plan charges a per-person fee, each participant pays the same amount annually for recordkeeping services, whereas if you charge on a percentage basis, each participant pays the same percentage of their account balance annually. Each method has advantages.

The per-person fee is easy to explain and seems fair since each participant pays the same dollar amount and receives the same services (website access, quarterly statements, access to a call center). However, for new plan entrants this flat fee can seem disproportionately large and be discouraging. On the other hand, a percentage-based fee seems fair because each participant pays a proportionate amount of their assets. While this benefits those with smaller balances, it does mean that those with larger balances pay more in actual dollars. You should discuss the differences and document your decisions.

Annually you should document the categories of plan expenses such as recordkeeping, custodial, investment advisory, and mutual fund expense ratios.

Fees should be benchmarked against plans of similar size based on plan size and participant count. At this point, Request for Proposals (RFP's) are not a requirement and can carry a high cost. A Request of Information (RFI) is less time consuming and can act as documentation for your file on what other providers might charge for similar services.

Why Do Fees Matter?

A 1% difference in expenses isn't a big deal, right? Wrong.
Consider two participants in two different 401(k) plans over a twenty-year period. Each participant has a salary of $50,000 per year and will receive merit increases of 5% annually. Each starts with an account balance of $100,000 and earns an annual return of 8%. They both contribute 5% of their salary every year. One is in a plan that costs 1% of plan assets to run, the other plan costs 2%. The participant in the lower-cost plan will have ***an extra $90,025 after 20 years.***

What You Need to Know About Revenue Sharing

Mutual fund expense ratios are automatically taken by the fund company before returns are posted to investors. The investment returns shown to participants are net of these expenses. These are called hidden or indirect expenses.

Some mutual funds have a revenue sharing component as part of the expense ratio. The revenue the fund "shares" comes back to plan advisors and are intended to cover the cost of participant-level recordkeeping.

Over the last few years, however, paying plan fees through revenue sharing or "ERISA" expense budget accounts have started to go by the wayside because:

- The true provider cost is not as transparent;
- Funds that use revenue sharing often have higher expense ratios (i.e., are more expensive); and
- Participants might not be paying for fees in an equitable manner.

If the plan, in its investment selection process, chooses a fund that offers revenue sharing, it can automatically return that revenue to the participants invested in that fund. Then if your plan charges a recordkeeping fee, it can be equitable, on either a per-person or a percentage basis.

Revenue Sharing Conundrum

Consider an example of a retirement plan with two funds and two participants. One participant invests in a fund that pays no revenue sharing, and the other invests in a fund that pays 0.25%. If revenue sharing is used to pay the plan expenses (which happen to be 0.25%), one participant is actually footing the bill for the whole plan.

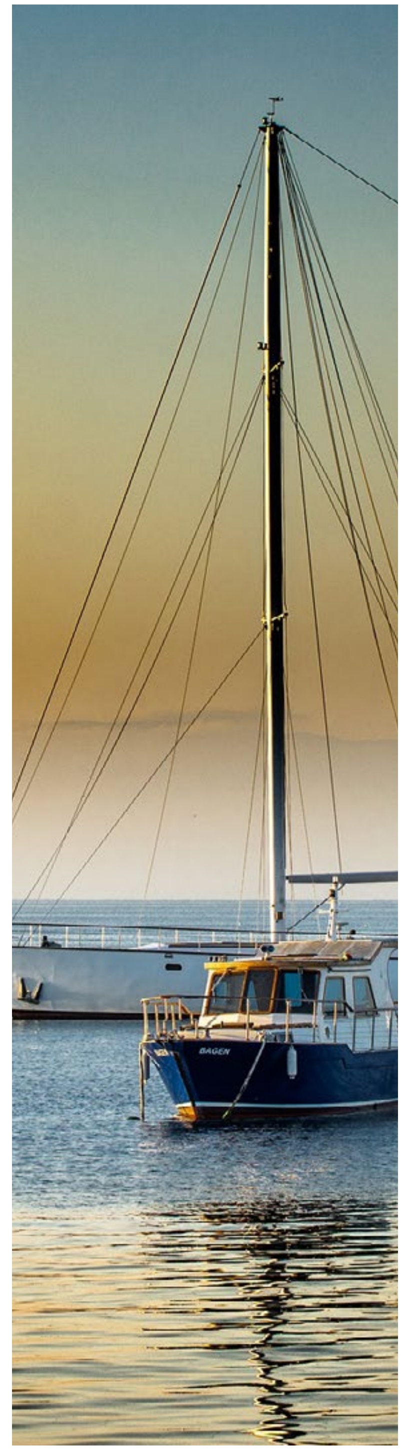
Plan Investments

The Investment Committee needs to discuss the types of participants within the plan. Are there both "do-it-for-me" investors and "do-it-myself" investors? If so, what's the most appropriate lineup for each investor? The group should have conversations around each of the following and determine what's most appropriate for participant demographics:

- What's the difference between index and non-index funds, and what are the pros and cons of each?
- What's the difference between risk based and target date funds?
- If using target date funds, what's the underlying composition of the funds and their glide-path?
- Are proprietary funds a requirement? Are the participants benefiting from this requirement?
- Is the menu size appropriate or is it too large and causing confusion?
- What are CIT's and are they available to the plan?
- What are managed accounts, are they available to the plan, and would participants benefit from this offering or are they cost prohibitive?

While you may be comfortable reviewing the performance and fees of your current investments, the committee should be reviewing these big-picture questions periodically so that they are not overlooked.

> "Are there both "do-it-for-me" investors and "do-it-myself" investors?"



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