

# Chapter 1

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## WHY YOU NEED A 401(k) INVESTMENT COMMITTEE

Studies show that many of today's 401(k) plans do not offer a fully diversified menu of investment choices. "Nearly two-thirds of 401(k) plans aren't offering enough choices and lack the right types of funds needed to create a diversified portfolio suited to each worker's risk tolerance".<sup>1</sup>

One of the common misconceptions in the 401(k) retirement market is that when the plan participants are responsible for making their own investment decisions (also commonly referred to as *participant directed plan*), then the plan sponsor is free from liability relative to the investment options. This is a complete fallacy. Under the Employee Retirement Income Security Act (ERISA), 401(k) plan sponsors are accountable for providing plan participants with an array of appropriate investment options to allow the participants to properly diversify and avoid the risk of large losses. However, the plan sponsor has a fiduciary obligation to monitor these investment options on an ongoing basis to ensure they continue to be prudent and appropriate for use.

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<sup>1</sup> *Wall Street Journal* (2/15/05). Data were based on a study conducted by finance professors at New York University and Fordham University, which analyzed 417 plans using data from Moody's Investors Services and the University of Chicago Center for Research in Security Prices.

A best practice for company sponsors of 401(k) retirement plans is to form an investment committee to participate in the governance of the plan and to oversee the plan's investment options. Small-plan sponsors typically argue against having investment committees, especially for smaller plans, and suggest that it is too time consuming. "My partners and I review the funds as need-be," says one small-plan sponsor. Sponsors of 401(k) plans need to understand that under ERISA they are fiduciaries and as such are personally liable for their actions. Having such a casual approach to the very important process of monitoring the appropriateness of the investment options being provided to the participants leaves them fully exposed to lawsuits. In today's environment, the best way for plan sponsors to manage their fiduciary liability is to develop, follow and document a prudent investment process.

## **Establishing a Benefits Committee**

Advancements in technology and productivity have given us access to products and services that previously were thought to be unavailable or unaffordable. For one, it wasn't that long ago that automobile safety features like antilock brakes and airbags were available only in high-end luxury cars like Mercedes-Benz or Lexus. Currently they are standard features whether you are driving a car that costs \$70,000 or \$17,000. There are many examples of products and services that originate up market and eventually trickle down to all consumers. Most large pension and 401(k) plan sponsors, as well as nonprofit and government plans, use an investment committee to oversee the investment management process. The reason is simple: protect the plan against potential or unforeseen liability. In light of poor investment performance, lack of understanding of plan fees and revenue sharing arrangements, mutual fund scandals, and the recent wave of new investment products (lifecycle and lifestyle funds, managed accounts), the need for plans of all sizes to form a benefits committee or separate investment committee is

becoming an important factor in the management of 401(k) plans. Regardless of whether your company has a plan with \$1 million or \$100 million in assets, ERISA standards are nondiscriminatory and are applied equally.

Let's take a closer look. ERISA requires that all plans have a plan administrator and named fiduciary who are responsible for the operation and administration of the plans. A common practice for ERISA covered plans is the establishment of a benefits committee to serve as the plan administrator and named fiduciary, because many functions of the benefits committee are fiduciary in nature and must be carried out in the best interests of plan participants and beneficiaries. (AON ). To comply with their obligations, fiduciaries must exercise the care of a prudent person who is familiar with all aspects of the plan and investment issues. Although benefits committees have ultimate responsibility, they often delegate some of their fiduciary duties by forming an investment committees or employing outside service providers.

The investment committee is responsible for managing the investment process for the plan, whereas the benefits committee is charged with much broader responsibilities of administering the plan. The benefits committee's responsibilities are the non-investment related issues such as plan design, administration issues, and employee communications.

In this highly charged environment of corporate governance, regulatory scrutiny, and fiduciary liability exposure, the creation of a separate investment committee (whose responsibility is limited to reviewing the investments in the company's 401 (k) plan), is a sound risk management strategy for plans of all sizes.

# The Role of the Investment Committee

The scope of fiduciary responsibility for investment committees is much wider than generally recognized because the ERISA definition of fiduciary is so broad. Named fiduciaries are those listed in the plan documents as having responsibility for plan management. Persons who are delegated duties by named fiduciaries are also considered to be named fiduciaries and, therefore, assume the responsibilities and liabilities that go along with that obligation.

The investment committee is charged with establishing a prudent process by which retirement plan vendors, investment products offered (whether separate accounts or mutual funds), and related expenses are analyzed and monitored on a regular and consistent basis. However, it is important to keep in mind that committee members oversee the management of the retirement plan, but do not manage it themselves. In general, the investment committee has the following responsibilities:

1. Review and approve the fundamental operations, financial and committee charter.
2. Hold meetings regularly.
3. Develop an investment policy statement.
4. Evaluate the manager's performance and take appropriate actions.
5. Select and remove investment managers.
6. Monitor the activities of prudent experts.
7. Review investment management fees paid by the plan and participants.

8. Review procedures for providing financial and operational information to the board.
9. Document the investment process and decisions made.

In essence the investment committee is charged with developing the plan's long-term investment policy and carrying it out on a consistent basis. The resolve of the committee will be challenged in reaction to short-term market events; therefore, it is critical for investment committees to understand their role and maintain their discipline in fulfilling their fiduciary duties.

## **Defining a Prudent Investment Process for 401(k) Plans**

As mentioned earlier, the duties of an investment committee are fiduciary in nature and, as a result, members of an investment committee are considered investment fiduciaries. As an investment fiduciary, you are required under ERISA to make investment decisions that are:

1. Prudent
2. In the sole interest of the plan participants and beneficiaries
3. Diversified to minimize the risk of large losses
4. In accordance with the plan document

Failure to satisfy these four standards can expose a fiduciary to personal liability (which includes home, personal assets, and business assets) for any resulting plan losses from breach of fiduciary responsibility. In fact, ERISA Section 409(a) states: "Any person who is a fiduciary with respect to a plan, who breaches any responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any profits of such fiduciary which have been made through use of assets of

the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.”

ERISA does provide plan sponsors with relief under Section 404(c) for investment choices made by plan participants. However, it does not relieve a fiduciary/investment committee from liability for the selection and monitoring of the plan investment options. So how does an investment committee meet its ERISA duty? What procedures does it follow?

The first step to ensure compliance with ERISA standards is to establish and follow a well-defined investment process. Statutes, case law and regulatory opinion letters dealing with investment fiduciary responsibility further reinforce this important concept.

Compliance with your fiduciary responsibilities does not require that you have the best performing investment choices available to your participants all the time, with the lowest cost. The investment committee’s primary role is to manage the process. That is, an investment committee’s responsibility is to provide the essential management of the investment process, without which the other components of the investment plan cannot be defined, implemented, or evaluated (Center for Fiduciary Studies [www.cfstudies.com](http://www.cfstudies.com)).

Fortunately, there are resources available to fiduciaries for developing and documenting a formal investment process, by which they can prudently manage their defined contribution plan assets and substantially reduce their fiduciary liability. For example, the Foundation for Fiduciary Studies, which is an independent, non-profit organization, has published the *Prudent Investment Practices for Investment Stewards*.

Developed specifically for investment fiduciaries and those involved in investment-making decisions, the Foundation has identified

three major legislative acts involving fiduciary relationships, including ERISA. The result was the following seven global fiduciary precepts (Ibid) for any fiduciary to follow:

1. Know standards, laws, and trust provisions.
2. Diversify assets to the specific risk/return profile of a client.
3. Prepare an investment policy statement.
4. Use prudent experts (money managers) and document due diligence.
5. Control and account for investment expenses.
6. Monitor the activities of prudent experts.
7. Avoid conflicts of interest and prohibited transactions.

If members of an investment committee are personally accountable by law for their actions, then adopting a consistent, disciplined and documented approach is critical to successfully managing their investment fiduciary responsibilities.

