One of the most important aspects of your retirement plan that requires care and attention is the plan's investment lineup. As a plan sponsor, it is critical for you to understand **who** has fiduciary responsibilities with respect to your plan's investments, **what** those responsibilities are, and **how** they may best be discharged. Of course, the answers to these questions can vary depending on the specifics of your plan, and getting professional advice tailored to your plan from a qualified expert may be useful. This chapter provides some basic guidance concerning the **who, what and how** of fiduciary oversight of plan investments.

Who is a fiduciary with respect to the plan's investments?

Whether a person is a fiduciary of a plan depends upon the *functions* performed for the plan, not the person's *title* or *position*. So while a plan's fiduciaries may ordinarily include discretionary trustees, investment advisers, and named fiduciaries such as investment or administrative committees, others may have a fiduciary role if they have decision-making power for the plan.

When it comes to the plan's investments, most defined contribution plans are set up so that the participants themselves can decide how to invest their plan accounts. Nonetheless, plan fiduciaries do have responsibility for choosing the investment options that will be made available to participants.

Fiduciary roles with respect to plan investment options can vary—some plan sponsors may decide to appoint an investment committee responsible for selection and oversight, hire an investment adviser to provide professional advice, or outsource decision-making authority to an investment manager.

Fiduciary roles with respect to plan investment options can vary. Some plan sponsors decide to appoint an investment committee that is given decision-making authority with respect to the selection and oversight of plan investments. But not everyone who serves as a fiduciary is an expert in investments. For this reason, the plan fiduciary or fiduciary committee may decide to hire an investment adviser to provide professional advice. If the plan fiduciaries retain the decision-making authority, they can and should consider the professional advice, but they are still responsible for investment decisions for the plan. That said, plan fiduciaries may choose to outsource their decision-making authority to an "investment manager" fiduciary as contemplated by ERISA § 3(38). A 3(38) investment manager fiduciary assumes full responsibility for investment decisions for the plan, and must be someone with the requisite qualifications, such as a registered investment adviser (RIA). If you, as a fiduciary, decide to go this route, it is important that your delegation of authority to the 3(38) investment manager fiduciary be in writing and be clear as to what specific duties are being delegated. Even when you hire a 3(38) investment manager to select, monitor, and make changes to plan investments, you as the plan sponsor are still responsible for selecting that professional and for overseeing their performance.

What are the fiduciary's responsibilities with respect to plan investments?

Regardless of the approach for overseeing investments, plan sponsors are still responsible for selecting investment professionals and overseeing their performance. This includes evaluation of a plan's needs and the options available in the marketplace.

The basic responsibilities of an investment fiduciary are selecting and monitoring the investment options that are made available under the plan, and the oversight of any plan investment managers.

Meeting these responsibilities requires a plan fiduciary to engage in an informed and thorough evaluation of the plan's needs and the options available in the marketplace. With respect to the plan's needs, every plan is different, and there is no one-size-fits-all approach. If you are responsible for the plan's investments, you may want to consider, for example, the characteristics of your employee-participants. For example, what is their average age? Do you have a large older population that is nearing retirement? What are their education levels? Are they sophisticated when it comes to finances and investments? With these kinds of considerations in mind, a fiduciary can look at the options available in the marketplace. But keep in mind that there are many available options, and there is no single, correct choice for any or all plans.

In evaluating the available options in light of your plan's needs, you may find it useful to understand some basic concepts about investments, including the *types* of investment vehicles available to retirement plans, *asset classes* and *management strategies* to choose from, and the *costs* associated with the available options.

TYPES OF INVESTMENTS VEHICLES AVAILABLE TO RETIREMENT PLANS

There are several different types of investment vehicles available to retirement plans, depending on the plan's needs and its size.

Mutual funds

Mutual funds are a popular choice for retirement plans. A mutual fund is a pooled investment vehicle managed by a professional asset manager that invests in an array of securities such as stock, bonds, money market instruments and similar assets, depending on the fund manager's strategy. Investors purchase shares of the fund, and the shares are valued on a daily basis, which means that investors are generally free to sell their shares. Mutual funds are registered with and overseen by the Securities and Exchange Commission (SEC), and are subject to certain disclosure requirements. As a result, publicly-available information about a mutual fund's investments, performance and fees is readily accessible, as are tools such as Morningstar.com that can help investors compare a mutual fund to other comparable funds.

Commingled pools

A commingled pool is a type of collective investment vehicle that combines assets from several sources to reduce the cost of managing each account separately, which may result in lower costs to investors compared to other investment vehicles. Examples of commingled pools include insurance company separate accounts or bank-sponsored common or collective trusts. The investment objective or style is set by the insurance company or bank, and access to these investments may be subject to higher investment minimums than mutual funds. Commingled pools are non-registered investment vehicles, which means that they are not subject to the same regulatory oversight as mutual funds, and information about their investments, performance and fees generally is not publicly available. While the commingled pool's manager will provide some disclosures to investors, the disclosures may not be as extensive as mutual funds are required to provide, and it may be more challenging to get information about other commingled pools to make comparisons.

> There are several different types of investment vehicles available to retirement plans in many different varieties, depending on the plan's needs and size.

Separate accounts

A separate account is an investment portfolio managed by a bank or an investment firm on behalf of a single plan sponsor. This structure may allow for more control on the part of the plan sponsor with regard to the separate account's investment strategy, but it also requires the sponsor to enter into a variety of service arrangements to obtain investment management, custodial, accounting, and other services for the separate account. Separate accounts tend to have high minimum investment requirements, but lower investment management fees than other investment vehicles. Separate accounts are non-registered investment vehicles, and information about their investments, performance and fees generally is not publicly available, and present some of the same benchmarking challenges as commingled pools.

Employer stock fund

An employer stock fund lets plan participants invest in the employer's company stock. These funds can be structured in different ways, but typically the fund is primarily invested in shares of the company. It may also hold some cash in order to ensure liquidity (the ability for investors to get out of the fund quickly, where permitted). Given the unique nature of these types of funds, there are special considerations that plan sponsors should keep in mind when their plan offers them. These considerations are discussed further below.

ASSET CLASSES, MANAGEMENT STYLES AND ASSET ALLOCATION VEHICLES

The investment vehicles described above are available in many different varieties, depending on the types of assets that the vehicle invests in, and the management style and allocation strategies used by the fund manager.

Asset classes

An asset class is a category of investments that share particular characteristics. The main asset classes are: equities (stock), fixed-income (bonds), cash equivalents (money market instruments), real estate, and commodities. However, within each of these classes you will find a variety of options.

- Examples of stock funds include U.S. stock funds (e.g., Blue Chip Growth) or international and global stock funds (e.g., Asia Opportunities).
- Examples of bond funds include U.S. bond funds (e.g., Short-Term Bond) or international and global bond funds (e.g., Emerging Market Bond).

Management style

When investing in a particular asset class, a fund manager may utilize either "active" or "passive" management strategies. There are different costs associated with each type of strategy, which will result in different fees for investors.

- In an *actively-managed fund*, the manager actively analyzes and selects investments with the goal of outperforming the market. The fund manager will have a stated investment objective, and will utilize different analyses and trading strategies to attempt to achieve above-market returns. Actively-managed funds will likely have higher research and trading costs than passively-managed funds, resulting in greater overall expenses. The active fund manager's objective is to produce superior returns, even after fees are taken into account.
- In a *passive fund* the manager tries to achieve a return for investors that is comparable to the return of the overall market or a particular index, such as the Standard & Poor's 500 Index. A passively managed fund (or index fund) can usually operate at lower costs than an actively managed fund, resulting in lower overall fees to the investor.

Asset allocation vehicles (including target date funds)

Some investment managers combine the use of different asset classes and management styles to provide one-stop shopping for investors in the form of an *asset allocation vehicle*. An asset allocation vehicle invests in different asset classes over time in order to achieve a diversified investment portfolio geared toward either a target risk profile (such as conservative, moderate or aggressive—sometimes called a "lifestyle" fund) or a target retirement date (such as 2040 or 2060—sometimes called a "target date" or "lifecycle" fund). These vehicles can be structured as mutual funds, commingled pools, or separate accounts, and can utilize active or passive investment strategies (or a combination of both). Typically, these vehicles are structured to have an asset allocation strategy that changes over time, either to maintain a specific level of risk (in the case of lifestyle funds) or to decrease risk as the investor moves closer to retirement age (in the case of target date funds).

FEES ASSOCIATED WITH PLAN INVESTMENT PRODUCTS

The fees associated with plan investments are one component of a plan's overall expenses. Fees for investment management and other related services typically are assessed as a percentage of the assets invested in the fund (e.g., 0.50%). This is called the fund's *expense ratio*. The expense ratio may also be expressed in "basis points" (one basis point is equal to 1/100th of 1%). For example: 0.50% = 50 bps. These asset-based fees are deducted directly from investment returns and apply to all investors.

The *total expense ratio* for an investment option may reflect different component fees, including investment management fees, shareholder servicing fees or other fees. Fund expense ratios typically compensate the fund's management company for a variety of services, such as investment management, diversification, liquidity, communication, educational services, and administrative and recordkeeping services. However, when a fund is offered in a retirement plan, a portion of the fund's total expense ratio may be available to help offset the plan's administrative expenses. In this regard, revenue generated in connection with plan *investments* can be used toward plan *administration*:

For instance, when a fund is offered in a retirement plan, other service providers, such as the plan's recordkeeper, often provide services in connection with the plan's investment in that fund that would otherwise be performed by the fund or its service providers. For example, a fund's transfer agent usually has to keep track of shareholder positions in a fund. In 401(k) plans, the recordkeeper often fulfills that role. As a result of this arrangement, the fund avoids the expense of such services, which it would otherwise incur, and either the fund or its transfer agent may agree to pay a portion of its fees to the plan recordkeeper as compensation. These *administrative fee payments* by the fund or its service providers to the recordkeeper are sometimes referred to as "revenue sharing." Administrative fee payments are part of—and not additional to—the fund's total expense ratio, which highlights the importance of considering the plan's total fees when reviewing for reasonableness.

The amount of administrative fee payments available in connection with a plan's investments may depend on the *share class* of funds the plan uses. When selecting funds, plan fiduciaries should be aware that mutual funds may offer multiple share classes. Each share class represents a different investment option in the mutual fund. For example, a mutual fund may have a "retail" share class that is available to all investors, and an "institutional" share class that has a minimum investment requirement and is available to institutional investors such as large retirement plans. The total expense ratio for each share class may be different, and may result in different administrative fee or revenue sharing payments available to pay the plan's recordkeeper for administrative services. In this regard, the availability of different share classes may allow for flexibility in the plan's fee arrangement.

How does a fiduciary discharge its responsibility with respect to plan investments?

While plan fiduciaries are expected to act prudently in selecting investments for their plan, the good news is that investment decisions will not be judged based on hindsight. For example, choosing an investment that ultimately performs poorly due to unforeseen market conditions should not, in and of itself, result in legal liability. Fiduciaries are not judged by the results that they achieved for their plans, but rather on whether they acted prudently in making investment decisions. In other words, the *inputs* to the fiduciary's decision-making are more important than the *outcomes*. This puts a premium on the *process* that you, as a fiduciary, use to make investment decisions for your plan.

> Fiduciaries are not judged based on hindsight (i.e., they are not judged by the results that they achieved for their plans), but rather on whether they acted prudently in making investment decisions.

A good process will be thorough, consistently-applied and well-documented. Documentation of your decision-making process should make clear what information was considered and what decisions were made.

FOR EXAMPLE, A GOOD FIDUCIARY PROCESS IN OVERSEEING A PLAN'S INVESTMENTS MAY INCLUDE:

Understanding the plan document, which may set forth investment objectives or mandates for the plan.

- In addition to the plan document, investment fiduciaries should understand and consider any *investment policy statement* (IPS) that has been implemented for the plan. Although ERISA does not require it, some plan sponsors elect to establish an IPS that sets forth the plan's specific goals and objectives. The DOL has described an IPS as a written statement that provides the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories or investment management decisions. An IPS may describe the plan's investment structure and enumerate criteria and procedures for selecting, monitoring, and replacing investment options in the plan.
- There is no requirement that a plan sponsor utilize an IPS. However, should the sponsor choose to adopt an IPS, it is important that the IPS be carefully drafted. A "detailed roadmap" approach to drafting an IPS may provide comfort to decision-makers wanting clear direction on their selection and monitoring responsibilities. On the other hand, a less formal "framework" approach may help to avoid overly restrictive policy terms or policies that are too difficult to follow.
- The sponsor may benefit from input from the plan's consultant or any investment fiduciaries in drafting the IPS. If an IPS is adopted, it is important that the IPS is considered and followed by the plan's investment fiduciaries, and that the fiduciaries document their consideration of the IPS in making investment decisions for the plan.

Meeting regularly to discuss and review the plan's investments and keeping notes or minutes of such meetings.

Periodically reviewing the plan's investments, comparing the performance, expenses, and volatility of the plan's investment options to appropriate peer group and index benchmarks.

- For example, if a plan offers mutual fund options, plan fiduciaries can utilize publicly-available information to compare the funds' performance and fees to those of their respective categories as identified by Morningstar. The plan's service providers may also provide information that can assist with comparing the plan's investments to appropriate benchmarks, as may any investment consultant or adviser that the fiduciaries hire.
- When evaluating investment expenses, keep in mind that fiduciary prudence does not require the selection of the cheapest available option. What is important is that the fiduciaries consider available alternatives (including alternative share classes of funds) and the impact on the plan's overall expenses. For example, there may be instances where the selection of a fund share class with a higher total expense ratio is the right choice for your plan in light of the administrative fee payments that will be made to your plan's recordkeeper, which may avoid the need to assess other fees.

> A good decision-making process will be thorough, consistently applied and well-documented (i.e., documentation should make clear what information was considered and what decisions were made), and will utilize experts when needed.

Applying special considerations when it comes to default investment options, target date funds and employer stock funds.

- **Qualified default investment alternatives.** A plan may utilize default investment options for plan participants who are automatically enrolled in the plan and do not make affirmative elections as to how their plan accounts should be invested. Under DOL rules, a plan fiduciary will not be liable for any investment losses that occur as a result of automatically investing a participant's assets in a default investment option that is a qualified default investment alternative (QDIA). QDIAs are investment options that comply with DOL regulations that are designed to protect participants' interests even where they do not make affirmative elections with respect to their retirement savings accounts. Examples of investments options that the DOL has deemed appropriate for use as a QDIA include target date funds, balanced funds and managed accounts. Of course, QDIAs must be prudently selected and monitored just like other plan investment options.

- **Special considerations for target date funds.** Target date funds that share the same target retirement date may have very different investment strategies and risks. While these funds generally move to a more conservative allocation as the target retirement date approaches, some target date funds may not reach their most conservative investment mix until 20 or 30 years after the target date, while others reach their most conservative investment mix at the target date or soon thereafter. Plan fiduciaries should be aware of these and other differences when evaluating available options and consider these differences in relation to their priorities for addressing market risk, inflation risk, and longevity risk.

- **Special considerations for employer stock funds.** If a plan sponsor decides to make its company stock available as an investment option under the plan, proper monitoring of the employer stock fund will include ensuring that the investment fiduciaries and plan participants have information about the company's financial condition so that they can make informed investment decisions. In addition, participants must be given the opportunity to divest (sell) their investments in publicly-traded employer securities and reinvest their money in other diversified investments options in the plan. Where employee contributions to the plan are invested in company stock, the participants must have the right to divest immediately. Where employer contributions are invested in company stock, participants must be allowed to divest if they have three years of service. Some plan sponsors will limit the amount of employer stock a participant may hold in his or her account.

  Because of the potential for conflicts of interest where the company offers its own stock for investment by its employee benefit plans, some plan sponsors may elect to outsource the fiduciary oversight of their employer stock fund to an independent fiduciary in order to minimize risks. In that case, the independent fiduciary is responsible for evaluating the company stock, monitoring its performance, and making recommendations and decisions as to existing and new investments in company stock, or liquidations of plan holdings in company stock. In all events, it is important to remember that an employer stock fund should be monitored just like you would monitor other plan investments.

We know you take your responsibilities with respect to plan investments seriously, and we hope this information is helpful to you as a fiduciary. But keep in mind that being a plan fiduciary does not require you to be a financial expert. What is important is making thoughtful decisions as part of a consistent and documented process, and utilizing experts when needed.

ACTION ITEMS

Find out who is responsible for directing investments in your plan.

Consider setting up a formal investment committee if you don't have one.

Consider developing an investment policy statement documenting all of the plan requirements and processes.

Review company stock options (if any) for compliance, and consider engaging an independent fiduciary to help monitor the appropriateness of company stock as an investment option.

T. Rowe Price would like to recognize Alison Douglass for her contributions to authoring this chapter.

ALISON DOUGLASS

Partner, Goodwin Procter LLP

Alison Douglass is a partner in Goodwin Procter's ERISA Litigation Practice and has been recognized by Chambers USA as an "Up and Coming Practitioner" in her field. Alison has counseled and defended a broad range of clients, including 401(k) plan fiduciaries and service providers, in all phases of ERISA-related litigation, including pre-litigation counseling and a wide variety of trial and appellate matters in courts across the country. She has also represented clients in regulatory investigations and governmental proceedings, including before the U.S. Department of Labor and the Securities and Exchange Commission.