A Guide to Best Practices for 401(k) Plan Investment Committees

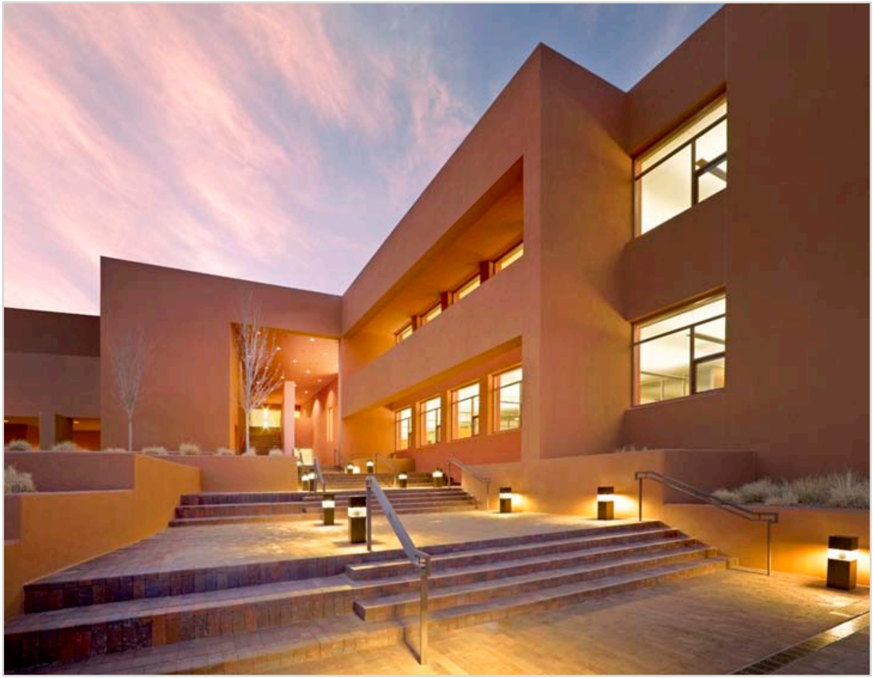
Q2 2012

TP26-a

Thornburg Investment Management®

Firm Profile

- Established in 1982 by Garrett Thornburg
- Privately held
- $78 billion in assets under management as of June 30, 2012
  - 7 Equity Funds
  - 3 Income Bond Funds
  - 3 National Municipal Bond Funds
  - 3 Single-State Municipal Bond Funds
- $52 billion mutual fund assets
- $26 billion institutional & separate account assets



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Thornburg Investment Management®

Today's Agenda

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection

- Role of an investment committee
- Forming an investment committee
- Structuring committee meetings
- Maximizing protection

Article – Plan Sponsor Magazine (October 2011)

PLANSPONSOR

“Wrong” Ways

10 things you’re (probably still) doing wrong as an ERISA fiduciary

One of the most popular (and now regular) sessions at the PLANSPONSOR National Conference is one we introduced several years back titled “10 Things You’re (Probably) Doing Wrong as an ERISA Fiduciary.” Not because those at the conference were lax or slipshod in their endeavors—quite the contrary. Those who seek to know what they might be doing wrong are not generally the ones that need the “help.” However, because the standards imposed on plan fiduciaries by the Employee Retirement Income Security Act (ERISA) are—rightfully—demanding, the potential to misstep without meaning to is ever-present.

In putting together the list that follows, I have drawn on a familiar yet different source: the Employee Benefits attorneys that participated in our annual Employee Benefits Attorneys Guide (see *PLANSPONSOR*, August 2011).

I hope you find this list informative—and that you draw insight and comfort from its contents as well as a reminder of the awesome responsibilities you have as a plan fiduciary.

Reprinted from PLANSPONSOR October 2011

Source: PlanSponsor October 2011

10 Things You're Probably Doing Wrong

Or Not Doing Right as a Plan Fiduciary

1. Not knowing who the plan fiduciaries are
2. Not following the plan's definition of compensation for purposes of determining contributions or benefits and nondiscrimination testing
3. Not making sure that fees are reasonable
4. Failing to read the plan document
5. Not depositing contributions on a timely basis
6. Not monitoring funds on a regular basis
7. Not minding the forest as well as the trees
8. Not paying attention to what your vendors are doing
9. Not fixing things that should be fixed
10. Not seeking the help of experts

Source: PlanSponsor October 2011, Nevin E. Adams, JD

Duty of Procedural Prudence

Common Mistakes by Plan Sponsors

- Failure to control and account for plan expenses
- Failure to define goals and objectives
- Failure to understand sources and levels of risk
- Failure to prepare or maintain an IPS; document the process used to manage investment decisions
- Failure to document the process followed to select and monitor investment options
- Failure to take advantage of safe harbor procedures, especially those defined by 2006 PPA

What Role Does an Investment Committee Play in a Retirement Plan?

Three Facets to Fiduciary Responsibility - Defined

The three facets to fiduciary responsibility:

- Regulatory
  - Operate the plan in the best interests of participants
- Governance
  - Operate the plan so that it is consistent with the goals and objectives of the organization
- Stewardship
  - Operate the plan with an understanding that a well-run plan helps to build participant (employee) trust and loyalty

Source: Strategic Ethos, Don Trone

Decision-Making Committee For Investments Only

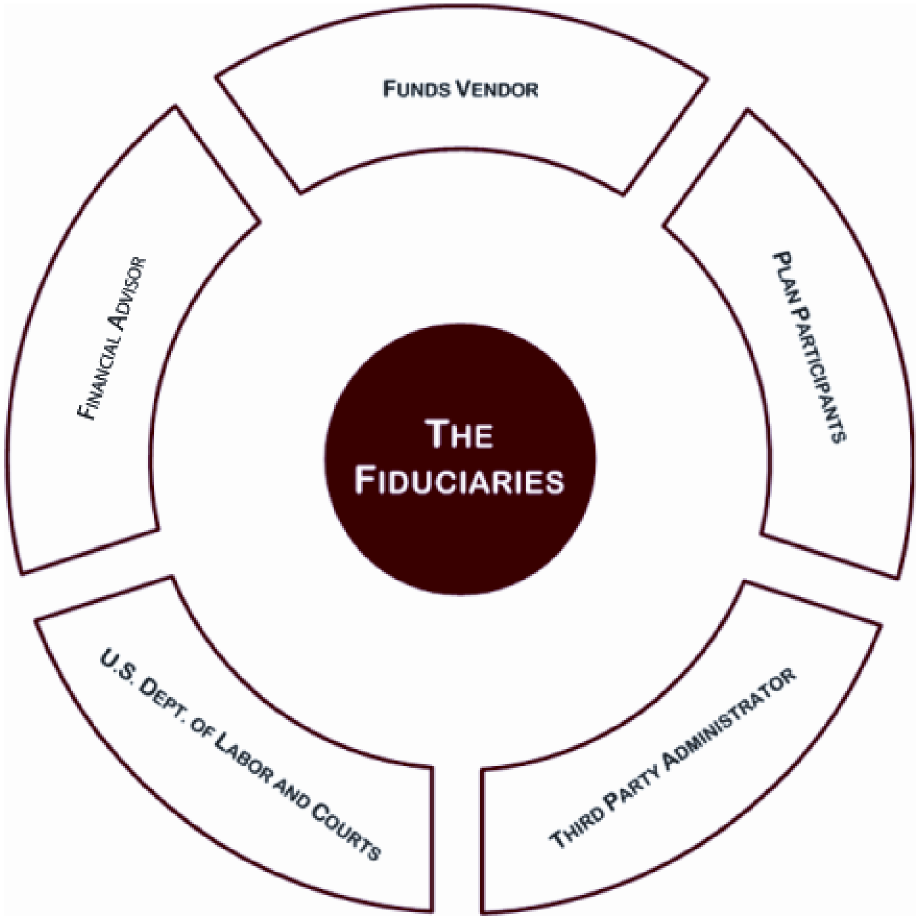
- Initiate and implement investment decisions
  - Group responsible for establishing and following processes for investment decisions
- ERISA has defined four standards of decision-making:
  - Prudent
  - In the sole interest of the plan participants and beneficiaries
  - Diversified to minimize the risk of large losses
  - In accordance with the plan document

Risk of Failure to Satisfy Standards

- Failure to satisfy standards is a breach of fiduciary responsibility
- Exposes fiduciary to personal liability for any resulting plan losses
- Can include loss of
  - Home
  - Personal assets
  - Business assets

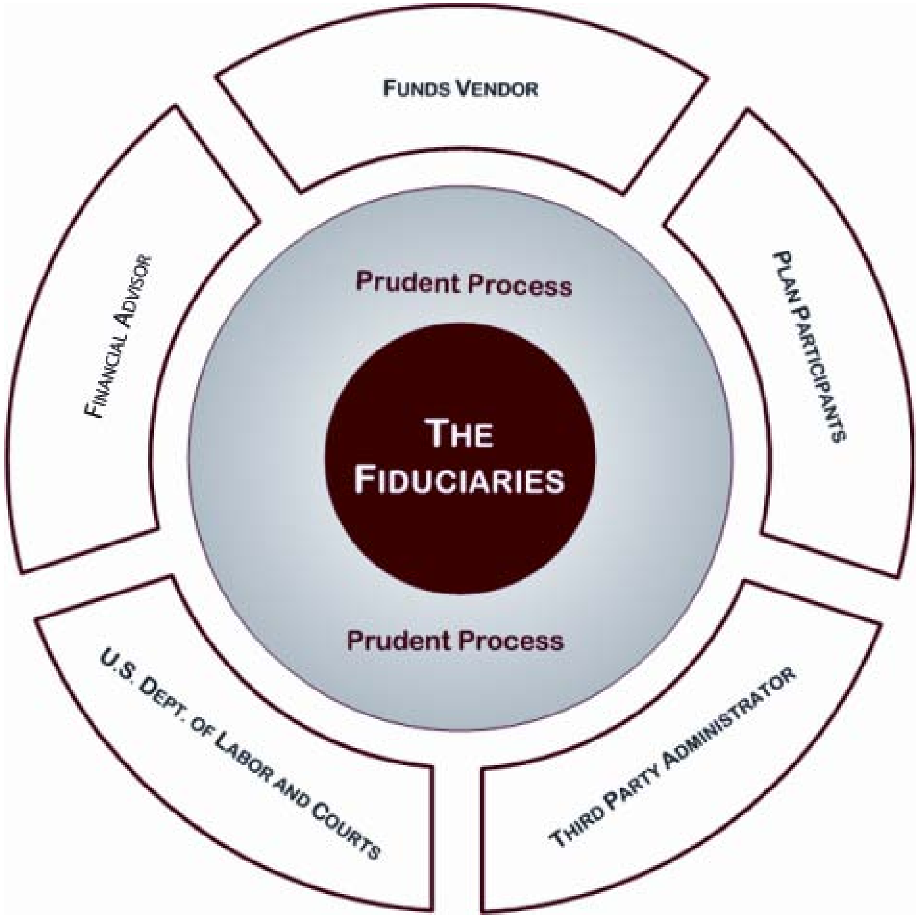
The Prudence Gap

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection



Closing the Prudence Gap

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection



The prudent process is the shield!

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Follow a "Prudent Process"

- Analyze
- Decide
- Document
- Monitor

Objectives of the Committee

Intro	**Role of an Investment Committee**	Forming a Committee	Structuring Meetings	Maximizing Protection

- Establish a formal, prudent process to make investment decisions
  - Create and execute Investment Policy Statement
  - Establish plan policies and procedures for investment fiduciaries
- Analyze, monitor and document on a regular basis
  - Providers
  - Products offered
  - Related expenses
- Best method to fix poorly constructed 401(k) menus

The financial advisor can help...

Gather the information necessary to monitor the investment menu

Importance of the IPS

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection

- Responsible for developing and monitoring the Investment Policy Statement
  - Helps clarify investment-related goals and objectives
  - May help to define accountability and responsibilities
  - Provides a framework for evaluating investment performance
  - Aids in clear communication of plan investment policy to participants
  - Ensures continuity in decision-making as committee members and plan fiduciaries change
  - Protects the sponsor from making capricious or arbitrary decisions
  - Helps the sponsor manage pressure for change generated by participants, vendors or the media

The financial advisor can help...

Draft and monitor the IPS

Investment Policy Statement

The IPS is the cornerstone of ERISA conformity

- Most important function performed by fiduciary
- Provides working framework for trustees and advisors for evaluating investment performance
- Establishes investment options and guidelines for making investment decisions
- Aids in plan audit by the Department of Labor

Uniform Fiduciary Conduct

The fiduciary is required to:

1. Define goals and objectives.
2. Diversify portfolio assets with regard to a specific risk/return profile.
3. Prepare a written investment policy and document the process used to manage investment decisions.
4. Use prudent experts (professional money managers and service providers) to implement the investment policy.
5. Monitor the activities of hired prudent experts.

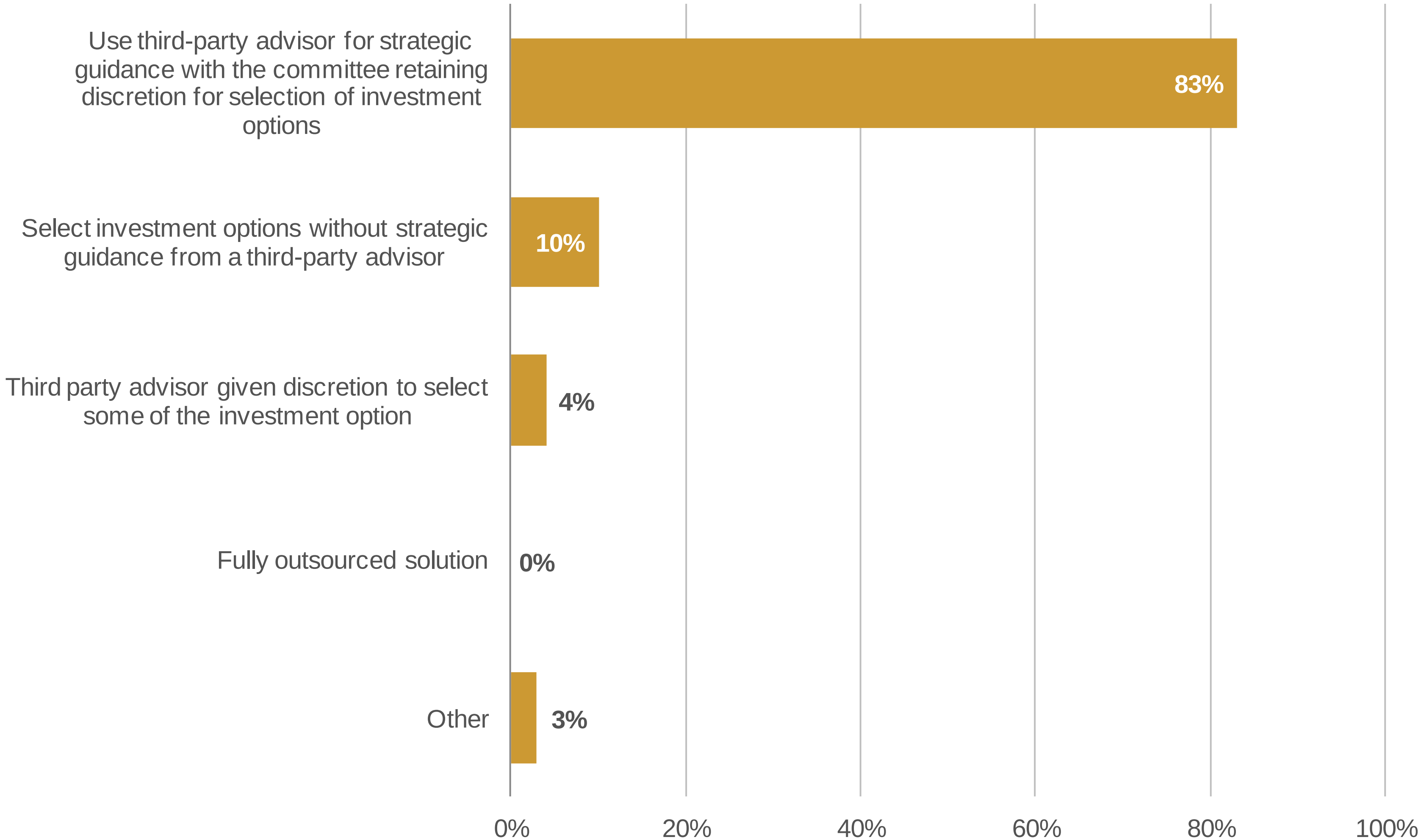
Source: Strategic Ethos, Don Trone

Manager Search and Selection

8 P's

1. People
2. Process
3. Philosophy
4. Plans
5. Product
6. Progress
7. Price
8. Performance

Management of the DC Plan Investment Selection & Monitoring Process



Source: Towers Watson U.S. Retirement Plan Governance Survey December 2011

Allocation to Other Fiduciaries

- If plan permits, fiduciaries may allocate responsibilities – not liable for acts or omissions of other fiduciaries
- Appointment of “investment manager” – not liable for acts or omissions of investment manager
- Duty to monitor other fiduciaries
- 3(21) Investment Advice Fiduciary or 3(38) Investment Manager

Understand Who You Are Hiring

ERISA 3(38) Investment Manager Discretionary Fiduciary

- Plan sponsor appoints an investment manager that will have responsibility for investment matters.
- Acts in a discretionary capacity
- Effectively transfers fiduciary liability of managing the plan's QDIA to a third party
- 3(38) manager must:
  - Be a Registered Investment Advisor (RIA) under the Act of 1940, bank or insurance company
  - Acknowledge fiduciary status in writing
  - Must be formally appointed by the Plan

3(21) (a)(2) Investment Advice Fiduciary Non-Discretionary Fiduciary

- Fiduciary status does not have to be in writing
  - can be based on actions alone
- Generally provides guidance to Plan on investment selection and removal.
- Does not have discretion or final authority on all investment matters
- Renders investment advice to plan and/or participants for a fee or other compensation

Selecting a 3(38) Investment Manager

- Are they an RIA, bank or insurance company
- Acknowledge their fiduciary status in writing
- Fiduciary insurance coverage
- Professional designations
- Reasonableness of fee
- Written description of the investment process
- Establish investment guidelines
- Frequency of investment performance
- Ask for ADV Part 2

Forming an Investment Committee

How to Form an Investment Committee

- Write a charter
  - Purpose – Investment fiduciary to the plan
  - Roles and Responsibilities – Establish objectives and make recommendations with IPS
  - Status and Membership
  - Meetings – How often, action taken for irregular attendance

How to Form an Investment Committee

- Select a team of fiduciaries – get acknowledgement in writing
- Permanent and rotating members
- Educate committee members – enlist advisor and service providers of continuing education
- Document and distribute – agenda, attendees, minutes of meetings

Choosing Committee Members

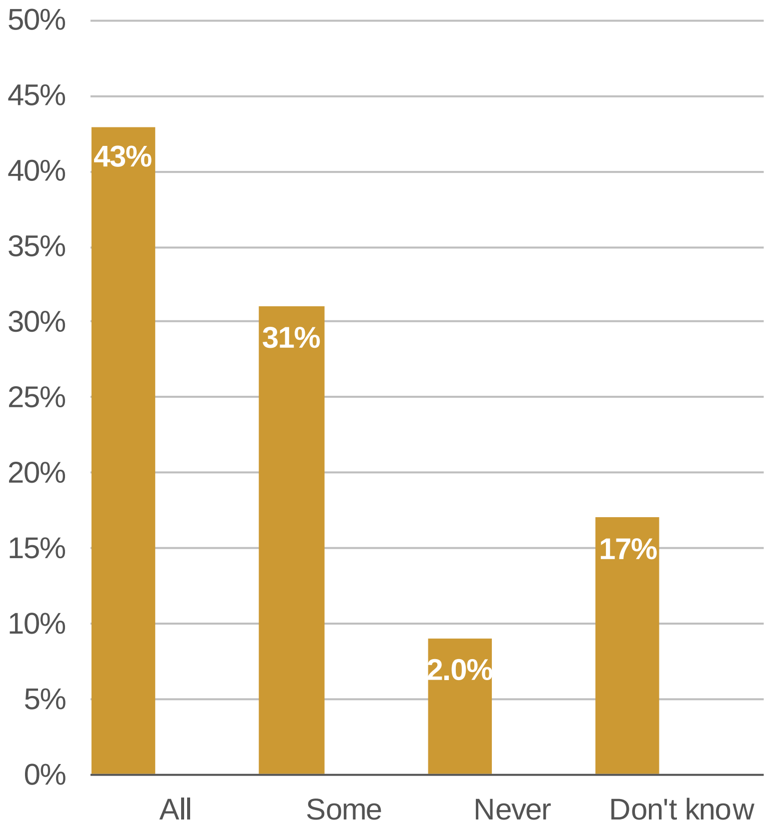
- Who?
  - Related experience: benefits, accounting, legal or finance
  - Senior members of HR, Finance and Operations
  - Ideally headed by someone with strong investment skills such as the CEO or the CFO
- How many?
  - Odd number of voting members — usually 3, 5 or 7 individuals
  - Not too large: Large committees become unwieldy

The financial advisor can help...

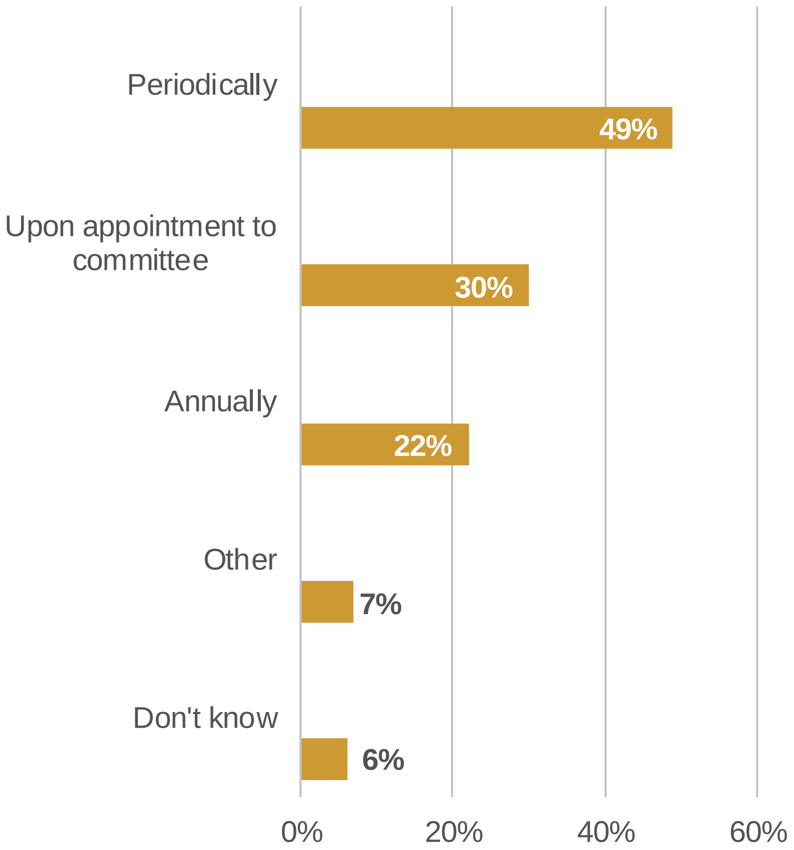
Attend all meetings in non-voting capacity

Retirement Plan Governance – Fiduciary Training and Frequency

Frequency of committee member training



Committee members receiving fiduciary training



Source: Towers Watson U.S. Retirement Plan Governance Survey December 2011

Installing Members

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection

- Orientation program on fiduciary duties, plan document, plan procedures and service providers to educate the newest members
- Review plan documents
  - Understand the plan's investment strategy
  - Willing to perform the duties of a fiduciary to the best of abilities
- Acknowledge in writing: accept the position and duties
- Ignorance, poor communication or inexperience will not be adequate legal defenses
  - Delegation to prudent experts and proper oversight only defenses
  - Government protects participant, not fiduciary or plan sponsor

The financial advisor can help...

Educate new members on investment menu

How to Structure Committee Meetings

What To Do

Meet

Monitor

Document

Structuring Committee Meetings

Intro	Role of an Investment Committee	Forming a Committee	**Structuring Meetings**	Maximizing Protection

- Frequency
  - Meet two to four times per year
- Data gathering by person responsible for leading the committee
  - All relevant investment material
  - Reports from plan advisor
  - Issues to be addressed
- Advance distribution of information
  - Data and agenda distributed before meeting
- Meeting duration
  - Sufficient length to review issues, express views, and reach resolution

The financial advisor can help...

Gather information and address any pressing issues

Agenda: Monitoring Investment Performance

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection

- Compare actual performance results to data or benchmarks in IPS
- Monitored performance includes:
  - Recent and rolling performance of each investment option compared to peer group and industry index
  - Risk-adjusted performance, such as Alpha and/or Sharpe ratio

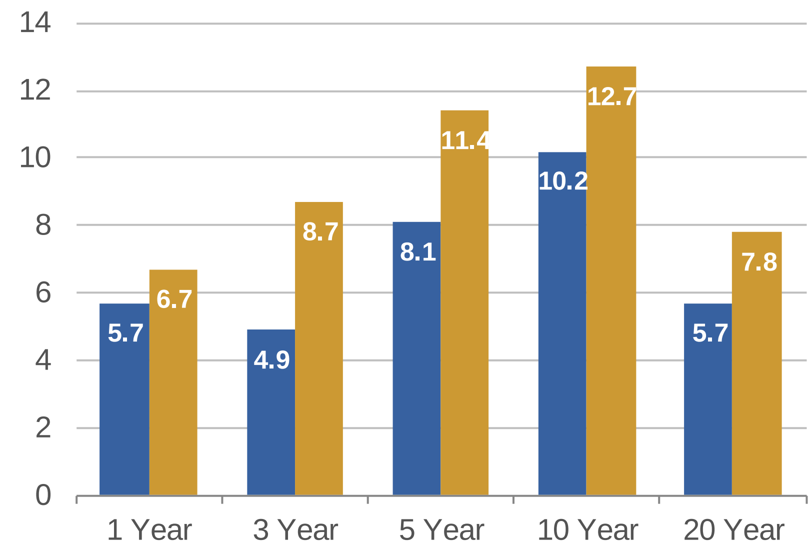


Illustration of a generic performance chart. Not representative of any actual investment.

Agenda: Monitoring Investment Performance

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection

- Common pitfalls in monitoring investment options
  - Duplication in an asset class
  - No representation in major asset classes
  - Poor fund performance compared to peers
  - Chasing last year's performance

The financial advisor can help...

- Monitor and maintain investment menu
- Educate participants about any changes

Agenda: Review of Investment Management

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection

- Monitor all:
  - Changes to portfolio management team, if any
  - Dramatic shifts in assets under management
  - Changes in investment style, indicating style drift
  - Changes in consistency with the stated investment objective
  - Material changes in management fees or associated costs
  - Regulatory concerns – investment manager cited for regulatory issues

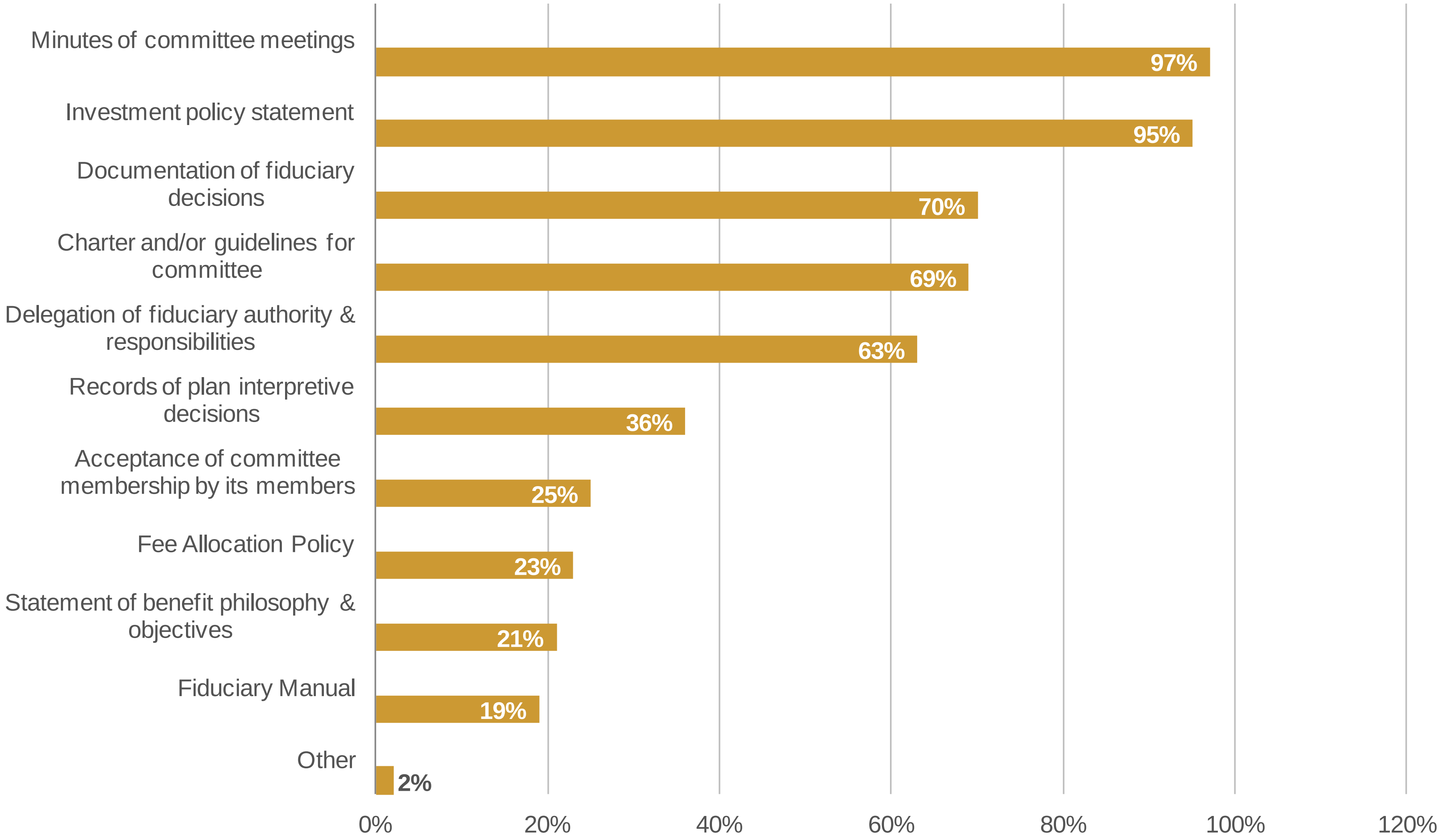
The financial advisor can help...

Address any market conditions that might impact the investment offering

What to Include in Meeting Minutes

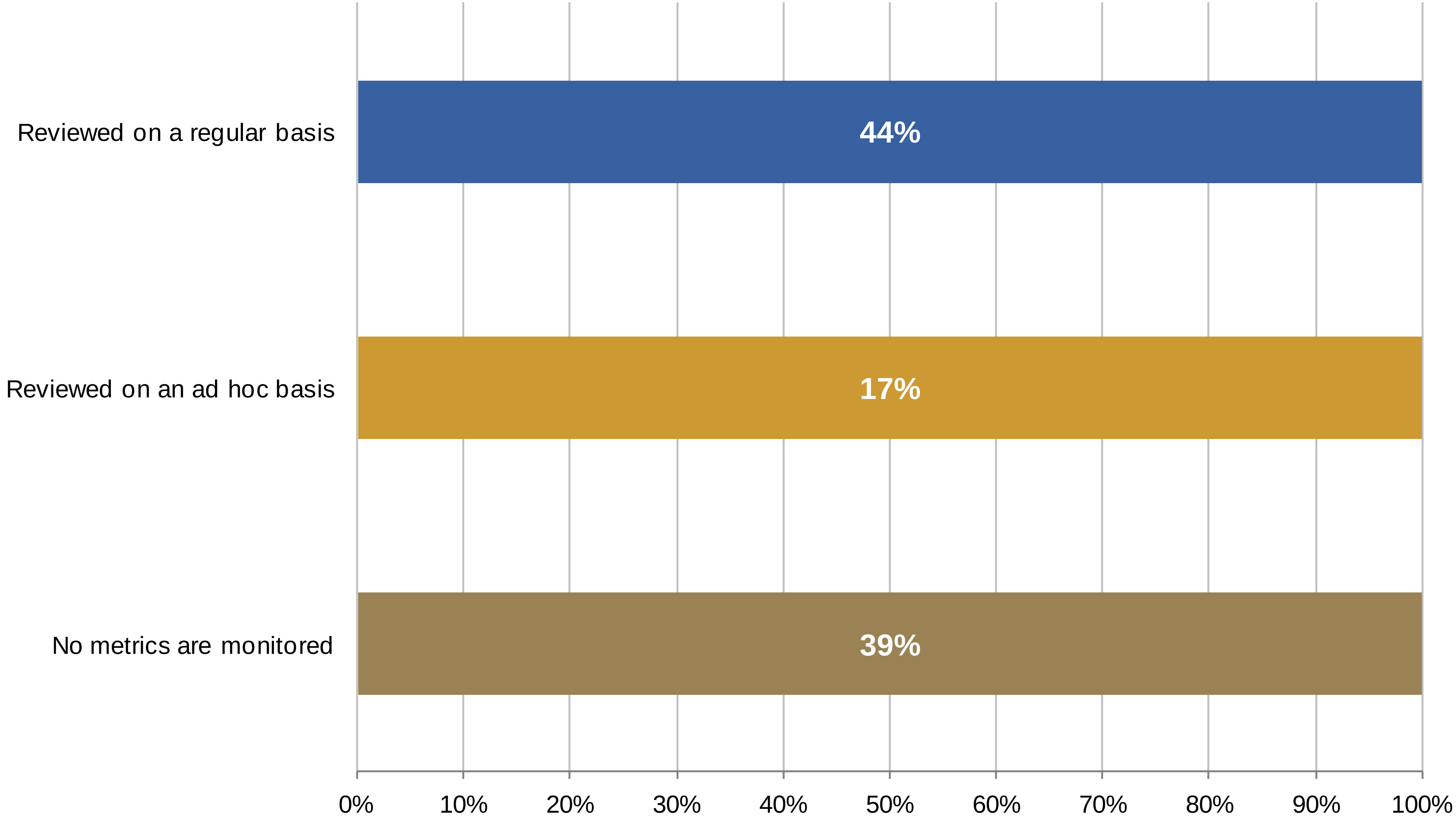
- Who, when, where
  - Date, time and place where meeting was held
  - Members who attended and those who did not
    - Include financial advisor, plan service providers and outside counsel and other non-member guests
- Matters discussed
  - Copy of the agenda
  - Presentations or recommendations given by advisors or plan providers
- Decisions made
  - Include actions not taken or tabled for future meetings
  - Record each member's vote

Documenting Your Plan Metrics



Source: Towers Watson U.S. Retirement Plan Governance Survey December 2011

Documenting Your Plan Metrics



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Creating a Fiduciary Audit File

- Why create a Fiduciary Audit File?
- Fiduciary Audit File covers more than investments
- Investment committee contributes investment-related documentation to the Audit File
  - Demonstrate that investment decisions are procedurally prudent
  - Show that process was properly established and followed
  - Document all significant decisions relevant to the plan

The financial advisor can help...

Identify and organize necessary documentation

Documenting Deliberations

- Commitment to ongoing documentation
  - Clear process for recording activity and decisions
  - Assures continuity and accountability
  - Most important action to demonstrate prudent process
- Keeping accurate account of decisions
  - Fundamental to ongoing plan operations

Maximizing Protection

Minimizing Risk With Fiduciary Liability Insurance

Intro	Role of an Investment Committee	Forming a Committee	Structuring Meetings	Maximizing Protection

- Protects against liability from breach of fiduciary responsibilities, including selection and monitoring of investments
  - ERISA does not require fiduciary liability insurance, but it is strongly recommended
- Designed to protect organization, plan, and individuals
  - Directors, officers, plan administrators, and employees in capacity as fiduciaries
  - Covers damages, judgments, settlements, defense costs, civil penalties
- Up to 5% imposed under ERISA §502(i) and up to 20% under §502(I), and certain settlements, fines, and penalties
  - Legal liability arising from claims
- For alleged failure to prudently act within Pension Reform Act of 1974

Who Pays for Insurance?

- Type of plan, provisions and policy influence cost
  - Plans with company stock have high premiums
  - Typical stand-alone 401(k) very reasonable
  - Who selects legal counsel — insurance company or employer
- Policy premiums can be paid:
  - With plan assets, by employer, or by individual fiduciary
  - Who pays will determine if insurer has recourse
- Recommended: the company, not the plan, purchases insurance
  - If insurance is purchased by the plan with plan assets, then the insurer will have recourse against the fiduciary to recover any paid losses — good for the plan but not for the individual fiduciary
  - Fiduciaries can buy “non-recourse” riders to protect against liability

Additional Types of Related Coverage

- Directors and officers (D&O) insurance usually excludes coverage for ERISA claims
  - Common to have both
- Employee benefit liability (EBL) insurance, like a fidelity bond, does not protect against fiduciary liability
  - Covers errors in administration of benefit plan
- Coordinating coverage is important to managing fiduciary risk

Coordinate coverage to manage fiduciary risk

FIDUCIARY LIABILITY INSURANCE

DIRECTORS & OFFICERS (D&O) INSURANCE

EMPLOYEE BENEFIT LIABILITY INSURANCE

Other Means to Minimize Personal Liability

- Plan sponsor can indemnify fiduciary
  - Sponsor agrees to pay any losses or claims suffered by fiduciary
- Written indemnification agreement
  - Addresses issues that may arise if claim is made
- Indemnification is only as valuable as sponsor's willingness and ability to pay

Challenges and Expectations

- 408(b)(2) and 404(a)(5) fee disclosure
- Benchmark cost for reasonableness
- New emphasis on plan governance
- Retirement income options for participants
- Evaluating Target date funds

Impact of 408(b)(2) on Committees

- Written fee policy
- Method for allocating plan fees or excessive revenue
- Update Investment Policy Statement
- Provider disclosure document complies with law

Selecting and Monitoring Target Date Funds (TDF)

Same fiduciary responsibility as other plan investments

- Will it be used as a QDIA or as a menu option?
- What are the fees associated with TDF?
- What asset classes are used to achieve diversification?
- What is the glide path and how does it work over time?
- Does it go “to” or “through” the retirement age?
  Connect glide path to participant behavior
- Active or passive management or blend of both?
- Proprietary asset manager or non-proprietary or both?
- What is its benchmark for evaluating performance?
  Know the performance of TDF and each of its component investments

Lifetime Income Disclosure

Under the proposal, defined contribution plans subject to ERISA would be required to include "annuity equivalents" on benefit statements provided to employees. An annuity equivalent would be the monthly annuity payment that would be made if the employee's total account balance were used to buy a life annuity that commenced payments at the plan's normal retirement age (generally 65).

Description of S. 2832 from Office of Senator Jeff Bingaman
Source: Reish Reichter Attorneys at Law

In-Plan Guaranteed Income Option

Offers a guarantee of retirement income for life by allowing participants to contribute some or all of their 401(k) contributions into an annuity-like account.

They offer:

- Downside protection
- Upside potential
- Income for life

In-Plan Guaranteed Income Products

Key Considerations

- Insurer risk
- Portability
- Fees
- Educating participants

Risk Management Techniques

- Define roles and responsibilities – delegate if necessary
- Establish or review fiduciary governance process
- Investment review process
- Fee and service reviews
- Ongoing fiduciary education
- Regulatory updates
- New services and resources
- Update fidelity bond and fiduciary insurance policy

Summary

- Review Investment Policy Statement
- Fiduciary Acknowledgement Letter
- Document meetings (minutes, agenda)
- Meet regularly – at least annually
- Compare performance to benchmark or asset class average
- Keep a Fiduciary Audit File
- Review plan cost for *reasonableness*
- Benchmark investment results

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