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# JOURNAL

## **More Heads Are Better Than One: The Role of Committees in Maximizing DC Plan Effectiveness and Minimizing Exposure**

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*Given today's increasingly regulated environment and the growing focus on the importance of retirement savings, most sponsors of defined contribution plans—including Section 401(k), Section 403(b), and Section 457(b) plans<sup>1</sup>—have established or are in the process of establishing a structured process for overseeing plan operations.*

**M**ost sponsors are struggling to provide and manage an efficient program that promotes retirement savings at the same time it:

- Avoids potentially costly litigation over issues such as fees charged to participants; and
- Improves the organization's ability to attract, motivate, and retain top talent.

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In Sibson Consulting's experience, the most effective way for employers to manage a defined contribution (DC) plan is through a well-defined process of plan governance and management with clear allocation of roles and accountability. Organizations that establish and maintain retirement and investment committees give themselves the best opportunity to meet their obligations in overseeing the plan.

## **CALL TO ACTION**

Why are employers playing a more active role in managing their DC plans? Reasons include:

- The litigious climate;
- A stronger focus on plan governance;
- Greater fee transparency;
- Significant investment losses in recent years; and
- The plan's critical role as a source of retirement income.

### ***The Litigious Climate***

Employees have filed class-action lawsuits concerning fees, fund choices, and other aspects of DC plans if they think their plans have underperformed due to improper management.

### ***A Stronger Focus on Plan Governance***

Plan sponsors are required to exercise appropriate due diligence to ensure that plans are administered correctly and cost-effectively. Fiduciaries who oversee the plan directly have an even higher responsibility. An expanding regulatory environment presents additional challenges.<sup>2</sup>

### ***Greater Fee Transparency***

Detailed service-provider fee disclosures to plan fiduciaries are now mandatory under final regulations on participant and plan sponsor Section 401(k) fee transparency recently published by the Department of Labor (DOL). In addition, this information is now required to be reported on Form 5500, Schedule C. Fee disclosure requirements from fiduciaries to participants are on the horizon.

### ***Significant Investment Losses in Recent Years***

The economic downturn and the lingering malaise have had a huge impact on savings and investments, including participant

account balances in DC plans. Declines of 20 to 40 percent were common during the initial downturn, and accounts took another hit from late 2009 through the early part of this year. As a result, many employees have become much more risk averse. Plan sponsors who want to mitigate participant backlash and bitterness are looking into and adding investment education and/or advice programs and best-in-class investment alternatives to their DC plans.

### ***The Plan's Critical Role as a Source of Retirement Income***

DC plans are now the primary retirement vehicle for many employees. The decline in availability of the defined benefit (DB) plan and the decline of the final-average-pay format for those DB plans remaining, means that most individuals will have to self-fund a large portion of their retirement income.

### **THE RETIREMENT COMMITTEE: ROLE, STRUCTURE, AND IMPORTANCE**

A properly structured and resourced retirement committee serves as the bedrock on which a DC plan is anchored. A committee rather than one person overseeing the plan provides a broad base of talent, a wider range of input, and different points of view, which will all improve plan management. In general, the committee's activities should focus on the following areas:

- **Alignment of the Plan Design with the Organizational Objectives of the Plan Sponsor.** This is often addressed through a process of competitive benchmarking focused on specific talent segments that support the plan sponsor's recruitment and retention objectives. For example, if a plan sponsor wants to improve the retention of experienced, long-service colleagues, an age/service-based contribution formula may be considered. Alternatively, if a plan sponsor is more concerned with the recruitment of younger, more mobile talent, a uniform/incentive-based formula may be more appropriate. Although the retirement committee generates plan design recommendations, those recommendations are implemented only if the plan sponsor agrees.
- **Oversight of Plan Operations.** Is the plan being run in accordance with the plan documents? Ongoing operational oversight in accordance with the terms of the plan and governing regulations should be conducted and documented. This is best supported by internal and external reviews of the plan's recordkeeper, which should focus on specific

areas that have the potential for errors (*i.e.*, loan administration, withdrawal processing, enrollment notification, and default administration).

- **Oversight of Administrative Functions.** Are transactions being processed correctly? Ongoing administrative oversight of plan operations in accordance with governing regulations should be conducted and documented. Oversight should focus on disclosure of plan expenses, hardship and unforeseen emergency withdrawals, qualified domestic relations orders, blackout periods, and other factors. It is essential that all administrative processes and committee decisions are documented, appropriate, and consistent with the terms of the plan and governing regulations.

Although the size and makeup of the retirement committee will vary from organization to organization, in most cases, it should include four or five members with backgrounds in HR, management, law, and finance. In some cases, an employee representative may be appropriate, especially if the plan is collectively bargained. Internal and/or external legal counsel should be available to support the operations of the committee.

The retirement committee typically is responsible for deciding how the plan is to be administered and selecting service providers. It must establish and agree to contractual terms with the selected vendors and then monitor their services to ensure they are operating the plan in compliance with its provisions, regulatory requirements, and contractual terms.

Any delegation of responsibility by the plan sponsor or by the committee as to specific employees (HR or benefits personnel) or third-party providers must be clearly distinguished and documented. Appropriate levels of liability insurance should be in place to cover the members of the committee and any employees who are delegated to perform plan-related tasks. Fidelity bonds also are required for the members of the committee, among others.

The retirement committee must regularly monitor plan outcomes to watch for issues of concern, such as:

- A sudden inflow or outflow of participant dollars to or from individual funds;
- Participants whose investment allocations may suggest a need for enhanced investment education/advice (such as young employees investing solely in stable value funds);
- “One funders”—employees with all their money in only one fund other than an asset allocation fund;

- A marked increase in hardship withdrawals and loans; and
- Changes in the rate of participation.

The committee is responsible for monitoring benefit payment processes and procedures. In some cases where the committee is responsible for deciding appeals, it may even have to override the recordkeeper and approve a hardship distribution. The committee also needs to ensure that an independent auditor conducts the required annual financial audit and then carefully review the audit results for any actionable items.

Communication with participants is another of the retirement committee's most important responsibilities. The committee must oversee the delivery of appropriate plan information to participants as well as take steps to inform participants about their retirement savings and investment decisions.

The organization's retirement committee should meet periodically, usually quarterly or semiannually. It is important for a member of the committee to take notes and document the meeting proceedings. Any decisions made by the committee that affect the plan must be documented as they may ultimately lead to the creation of plan amendments, written procedures, written policies, and defined processes.

Like any plan fiduciary, the retirement committee must maintain the plan and its assets for the exclusive purpose of providing retirement benefits for participants and beneficiaries and defraying the reasonable costs of administering the plan, with the care, skill, and diligence that a prudent person would use in similar circumstances.

### **THE INVESTMENT COMMITTEE: ROLE, STRUCTURE, AND IMPORTANCE**

The investment committee focuses on selecting and monitoring the performance of the various investment vehicles that the plan offers. It may require a different set of skills from the retirement committee.

The investment committee, which can be a subcommittee of the retirement committee or an independent committee, should include representatives from HR and the organization's executive suite. As with the retirement committee, there may be employee representation. Internal and/or external legal counsel should be available for support. The investment committee should meet two to four times a year and must document its meetings and decisions. It can augment the participant communications efforts by providing investment-focused information and guidance.

It is crucial for the investment committee to develop a formal investment policy that will guide all decisions about the plan's investment options. This policy must clarify the responsibilities of all parties

and identify the types of investments the plan will offer along with the criteria and processes to select and obtain the chosen investment vehicles in the DC plan.

Investment choices are becoming increasingly complex and may include stable value funds (general, commingled, or separate), target date funds (custom or “off the shelf”), guaranteed income products (inside and outside of the plan), managed-account products, and self-directed brokerage accounts. The policy itself should be periodically reviewed and updated to evolve along with the plan and the financial environment.

The investment policy defines how funds are monitored and when funds should be replaced or removed, when necessary. The committee should continually evaluate fund performance, given the context of the dynamic investment climate. In addition, the investment committee must ensure that the plan administrator has received the full, required disclosure of the myriad of administrative and investment related fees as well as any revenue sharing agreements, and must review their appropriateness in the marketplace.

Service providers charge fees for a variety of services, including recordkeeping, custodial trustee services, and participant communications/education. Although vendors may not charge a direct fee for these services, depending on the size of the plan, these service fees may be imbedded in the investment fund expense charges. Other fees may include charges for investment advisory services, participant loans, processing qualified domestic relations orders, managed account services, a discount brokerage window, and compliance services. There are also investment fees, which can include charges for management and operations, sales, redemptions, wraps, mortality risk and administration, broker of record, contingent deferred sales, subtransfer agencies and, at least for the time being, Section 12(b)-1 fees.<sup>3</sup>

Although the fee monitoring process can be laborious, the best way to ensure appropriate due diligence on fee levels is to:

- **Document how the vendor was chosen.** The selection process should include competitive bidding and negotiations for both lower fees and a more transparent contractual fee structure with appropriate benchmarking.
- **Expressly request full fee disclosure.** By law, the service provider must disclose all indirect and direct fees, but an explicit request may elicit better and timelier compliance.
- **Provide plan participants with information.** Participants need to be informed of information relevant to their investment options.

## **THE ROLE OF THE INDEPENDENT ADVISOR: EXPERTISE AND PERSPECTIVE**

A growing number of plan sponsors have retained independent advisors to support the operations of their retirement and investment committees. The independent advisor, as a resource, should possess broad market knowledge, insight into market trends, and be capable of providing investment, compliance, administrative, and communications advice to support decisions on investment fund offerings, vendor selection, and appropriate administrative and investment-related fees, as well as administrative efficacy and overall plan compliance. In short, the independent advisor acts as a watchdog and a bulldog, serving as the plan sponsor's advocate to keep vendors responsive to the plan's needs.

## **COMMON MISTAKES—AND HOW SPECIFIC EMPLOYERS CORRECTED THEM**

Seemingly small oversights in DC plan management can grow into costly problems if left uncorrected. In many cases, rectifying these mistakes offers plan fiduciaries an opportunity to improve plan management and save money.

### ***Mistake Number One: Not Changing When Change Is Needed***

As plans grow, they may need to change providers to ensure that their needs are being met. For example, an organization that launches a 401(k) plan with a brokerage firm as both recordkeeper and investment advisor should, at some point, as assets grow, think about switching to a separate recordkeeper and investment advisor to gain independence, reduce administrative expenses, and offer funds with lower expense ratios in the investment lineup. Some plan sponsors may resist changing, even though there may be much to gain. Going out to bid and transferring a plan to a new provider is never easy and requires a thorough understanding of the marketplace.

**One Employer's Correction:** One organization sought an assessment of its 403(b) plan's current state. The resulting appraisal recommended taking a look at the DC marketplace for comparative evaluation of services, fees, and investment alternatives. After a comprehensive vendor search, the organization decided to make significant changes to its plan, including eliminating two long-standing vendors and redesigning the investment options.

Because the current vendors had been in place for many years, the organization was concerned that employees would resist the changes and be suspicious of the new program. Understanding that effective

communications would be crucial to ensuring that the transition to a single new vendor and new investment options proceed smoothly, the organization hired an independent advisor to communicate the plan and fund lineup changes, ensure that participants received appropriate education and information to use the plan effectively, and help the participants appreciate the new program's many positive attributes.

The independent advisor took primary responsibility for drafting and finalizing certain key transition communications, including the initial announcement to employees and preannouncement presentations to the board of trustees, union leaders, and other key constituencies. The outside advisor also advised the organization on the communications aspects of plan implementation throughout the process, serving as the organization's resource for reviewing, evaluating, and (where necessary) revising vendor-provided communications materials—including brochures, Web site content, transition flyers, investment flyers, and answers to frequently asked questions—to ensure they met the organization's needs and goals.

### ***Mistake Number Two: Offering Participants “Too Much Choice”***

Many sponsors think that the more funds they offer their participants the better, but offering too many funds can lead to “investor paralysis” and needlessly increase recordkeeping, administration, and costs—especially if the funds are serviced by a large number of different providers.

**Two Employers' Corrections:** A large organization significantly lowered the number of DC plan service providers it used and the number of funds it offered. When the evaluation began, it had more than 80 investment providers servicing its 403(b) and savings plans. The organization issued a request for proposals, received responses from 11 service providers and selected four, one of which would provide compliance/common remittance services for the plan with the other three vendors.

Another organization with 2,200 plan participants and approximately \$106 million in plan assets consolidated from three service providers to one, which established a multi-tiered investment structure.

### ***Mistake Number Three: Investing in the Wrong Share Classes***

Sponsors that offer investment choices in retail share classes rather than in institutional share classes incur higher fees. The difference in fees for a vendor's retail share classes compared to its institutional

share classes can exceed 100 basis points (a basis point is one hundredth of one percent).

**One Employer's Correction:** Where economically feasible, switching from retail to institutional share classes can save 401(k) plans a significant amount of money. For example, the fee for the retail version of one vendor's balanced fund is 119 basis points while the fee for the institutional version of the same fund is only 63 basis points. To the extent that such a switch can occur on a number of a plan's investment alternatives, these fee savings, which directly increase participants' retirement savings, can be substantial.

### ***Mistake Number Four: Failing to Monitor Vendor Fees***

Given these turbulent economic times, plan sponsors need to take a hard look at their fees and expenses and validate them in the marketplace to protect themselves from lawsuits and enhance participant outcomes. This should be done at least every five years, and now is a good time to do so, with participant and plan sponsor Section 401(k) fee transparency final regulations recently issued by the DOL.

**One Employer's Correction:** A DC plan with approximately \$130 million in assets and 3,000 participants with an average account balance of \$45,000 was able to reduce its fees significantly by going to market with a comprehensive RFP (request for proposal).

Although the organization kept its current vendor, it was able to lower its overall costs (20 basis points, down from 34 basis points), saving approximately \$1 million, and establish a more refined investment lineup (18 funds, down from 50 funds). Moreover, by retaining their current provider, they avoided a costly transition.

## **CONCLUSION**

Requirements and expectations for DC plans are becoming more complex and the plans are increasingly critical to the financial security of participants and, as a corollary, to the organizations that sponsor them. Plan sponsors need to be aware of this shift in focus and acknowledge their importance in supporting their employees' ability to make the best use of the opportunities offered via the plan. DC plans that are overseen by a retirement committee and an investment committee, both served by an independent advisor, will be well prepared to deal with what lies ahead.

## **NOTES**

1. A Section 401(k) plan is a tax-advantaged retirement savings plan available to for-profit corporations. A Section 403(b) plan is a similar type of plan available (in addition to 401(k) plans) to public education organizations and tax-exempt charities.

A Section 457(b) plan is a somewhat similar type of plan available (in addition to the other two types of plans) to government employers.

2. Recent regulations and other government pronouncements have been wake-up calls to plan sponsors. For example, the IRS's issuance of the final Section 403(b) regulations, combined with the DOL's clarification of Form 5500 reporting requirements for Section 403(b) plans subject to the Employee Retirement Income Security Act (ERISA), have placed more obligations on Section 403(b) plan sponsors. The historical "hands-off" approach provided too much leeway to Section 403(b) plan vendors to offer investment products that may not have been the best choices for the employees.

3. The Section 12b-1 fee is an annual marketing or distribution fee on a mutual fund. It is considered an operational expense and, as such, is included in a fund's expense ratio. It is generally between 0.25 and one percent (the maximum allowed) of a fund's net assets. The amount can be used to offset administrative or recordkeeping expenses in addition to paying for third-party providers.

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