

Best Practices for Investment Committee Members

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The logo for Brightscape Investment Centers features a stylized, curved orange and yellow swoosh above the company name. The name "BRIGHTSCAPE" is written in a large, bold, blue, sans-serif font, and "INVESTMENT CENTERS" is written in a smaller, blue, sans-serif font below it.

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This paper identifies best practices for 401(k) investment committee members in order to reduce potential personal liability as a result of being plan fiduciaries.

Best Practices for Investment Committee Members

by Eric Weiss, CFP®, AIF®

Members of a 401(k)'s investment committee are fiduciaries of the plan by virtue of their power and responsibility to:

- I. Select and monitor the plan's investment options
- II. Delegate the authority to select and monitor plan investment options to a "prudent expert"
- III. Create, or delegate authority to create, an Investment Policy Statement (IPS) for the plan
- IV. Comply with one of ERISA's Safe Harbor provisions

As fiduciaries committee members are, therefore, responsible for managing the plan in the best interests of the participants; failing that will give rise to potential personal liability. These *Best Practices for Investment Committee Members* are designed, if followed, to transfer the potential liability to either "prudent experts" or to the participants themselves. Committee members, however, will still retain the potential liability for selecting the "prudent expert."

I. Investment Committee as a "Prudent Expert"

If committee members elect to retain the authority to select and monitor investment options then they will need to demonstrate they are "prudent experts" and institute a due diligence process for selecting and monitoring plan investment options.

Fund Selection

Listed below are various due diligence screens which should be employed to select a fund:

1. *Regulatory* – all mutual or exchange traded funds (ETFs) selected should be managed by one of the following:
 - a. Regulated Investment Company (RIC)
 - b. Registered Investment Advisor (RIA)
 - c. Bank
 - d. Insurance company
2. *Size* – all options selected should have at least \$100,000,000 of assets
3. *Trading Volume* – funds and ETFs should trade a minimum of 10,000 shares per day
4. *Track Record* – the management team should have been in place for at least two years
5. *History* – the fund or ETF should have at least three years of operating performance
6. *Style Consistency* – there should be no deviations in the fund or ETF's current style box from its stated investment objective
7. *Performance* – the fund or ETF should have one, three and five years returns equal to or better than the median of its peer group

8. *Risk Adjusted Performance* – the fund or ETF should have one, three and five years Sharpe and Alpha statistics equal to or better than the median of its peer group
9. *Expenses* – the fund or ETF’s expense ratio should be in the 75th percentile or better when compared to its peer group
10. *Manager incentives* – for any actively managed fund or ETF the management team should have at least 10% of their net worth invested in the fund
11. *Independent directors* – independent directors should constitute a majority of the fund’s board

Very few funds will satisfy all the screens; therefore, a selection criteria should be developed. One such criteria assigns one point to each of the due diligence screens and funds receive one point for each criteria satisfied giving rise to a ranking system:

<i>Acceptable</i>	funds having 8 or more points
<i>Recommended</i>	funds having 5 to 8 points
<i>Suggested</i>	funds having 3 to 5 points
<i>Not Acceptable</i>	funds having less than 3 points

Separate from these quantitative measures there should be qualitative screens, which apply more to the fund family than to the individual fund. These qualitative screens include:

1. Regulatory History – no regulatory action taken against fund family for the past five years
2. Staff Turnover – senior management of the fund company has been stable for the past three years
3. Organizational Structure – no ownership change over the past three years

Once again one point is assigned for the satisfaction of each qualitative screen.

<i>Acceptable</i>	3 points
<i>Recommended</i>	2 points
<i>Not Acceptable</i>	1 point

Decision Criteria:

- Funds rated Acceptable on both the quantitative and qualitative screens can be used without a committee vote
- Funds rated Acceptable on the quantitative screen but Recommended on the qualitative screen require a majority vote by the committee to be used
- Funds rated Acceptable on the quantitative screen but Not Acceptable on the qualitative screen cannot be used
- Funds rated Recommended on the quantitative screen and Acceptable on the qualitative screen require a majority vote by the committee to be used

- Funds rated Recommended on the quantitative screen and Recommended on the qualitative screen require a majority vote by the committee to be used
- Funds rated Recommended on the quantitative screen but Not Acceptable on the qualitative screen cannot be used
- Funds rated Suggested on the quantitative screen and Acceptable on the qualitative screen require a majority vote by the committee to be used
- Funds rated Suggested on the quantitative screen and Recommended on the qualitative screen cannot be used

Fund Monitoring

If the committee will be monitoring the investment options on an on-going basis a due diligence process is also necessary.

The monitoring process uses the same screens as the selection process such that when a fund fails to satisfy a screen criteria it receives one point. From there a monitoring procedure is developed:

Quantitative Screens

<i>Excellent</i>	0 to 3 points
<i>Satisfactory</i>	4 to 6 points
<i>Unsatisfactory</i>	more than 6 points

Qualitative Screens

<i>Excellent</i>	0 points
<i>Satisfactory</i>	1 point
<i>Unsatisfactory</i>	more than 1 point

Funds rated Excellent on both screens are appropriate requiring no further action. Any fund with an Excellent and a Satisfactory rating will be “watch listed” requiring a majority vote of the committee members to continue using the fund. Any fund having an Unsatisfactory rating must be replaced.

Fund monitoring should be done at least annually.

II. Delegating to a “Prudent Expert”

If the Investment Committee decides to delegate investment selection and monitoring to a “prudent expert” then liability can be transferred to an Investment Fiduciary. While the liability for the investment decisions per se is transferred, committee members will retain liability for the selection of the “prudent expert.”

In choosing the “prudent expert” the following factors should be reviewed:

1. Registration Status – is the entity a Registered Investment Advisor (RIA) or is it a Broker-Dealer? A RIA is subject to fiduciary standards while brokers are subject to a suitability standard. That means a broker’s duty of responsibility is focused on whether an investment is “suitable” for the investor. A fiduciary standard, on the other hand, requires the advisor to act in the best interest of the client. RIAs hold the Series 65 license which authorizes providing advice for a fee, while brokers hold the Series 7 license which authorizes selling a product for a commission.
2. Disciplinary History – if you go to the FINRA website (www.finra.org) and input the broker’s name you will be able to see any disciplinary action taken against the broker; for information about investment advisors click: “Investment Advisor Search” on the FINRA “Investors” page.
3. Education/Certification/Designations – most to all advisors will have a B.A. and many also have M.B.A.s; a college degree is not required for registration purposes. Some advisors hold the Certified Financial Planner™ PROFESSIONAL (CFP®) designation, while others in the accounting profession hold the Personal Financial Specialist or PFS designation. Some advisors also hold the Accredited Investment Fiduciary® (AIF®) designation. Other relevant designations are the Chartered Financial Analyst (CFA) and the ChFC or Chartered Financial Consultant designations.
4. Professional Associations/Memberships – many RIAs and brokers are members of the Financial Planning Association (FPA), this is the largest financial planning organization. A smaller organization is the National Association of Personal Financial Advisors (NAPFA) which consists of only RIAs who are “fee-only” meaning all of their compensation comes from fees paid directly by the client with no compensation from commissions or fees from selling products.
5. Flexibility to Assume an ERISA Fiduciary Role - transfer of fiduciary liability to the “prudent expert” requires that the “prudent expert” acknowledge in writing its fiduciary status. Because brokers are not held to a fiduciary status it may be difficult for some broker-dealers (firms which employ the individual broker) to agree to such an acknowledgement.
6. Areas of Retirement Plan Expertise – the primary functions delegated to the advisor are the selection/monitoring of investment options and creating/monitoring the Investment Policy Statement (IPS). Does the advisor have a well-defined due diligence process for selecting/monitoring mutual funds? Does the advisor have access to the data in order to provide on-going monitoring? Does the advisor have experience in creating and following an IPS?
7. Menu of Retirement Plan Services – can the advisor provide plan level as well as participant advisory and or education services? Many times an advisor will first be contracted to provide plan level services, e.g. fund selection/monitoring and or IPS creation/updating as an Investment Fiduciary. Later these services may be expanded to provide participant advisory services e.g., personalized investment advice to participants as a Fiduciary Advisor.
8. Benchmarks for Success – for plan level services having a well defined and well documented process for selecting/monitoring fund options as well as strict adherence to a well written IPS will be important measures of success. Benchmarks for a successful Fiduciary Advisor will be satisfied employees making informed investment decisions consistent with their goals and risk tolerance.

9. Disclosure – investment committee members should perform a complete review of the RIA’s Form ADV Parts I and II which are available on-line at: www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_OrgSearch.aspx or directly from the advisor.
10. Service Agreements – advisors acting as an Investment Fiduciary will sign an Investment Advisory Agreement with the plan. In addition to acknowledging the advisor’s fiduciary status, this agreement will disclose all forms of compensation, both direct and indirect, as well as any conflicts of interest. Fees should be charged on a “level” basis meaning the advisor’s compensation will not vary according to investment options selected by the participants. At a minimum all service agreements must be reviewed every three years. Committee members should judge whether the fees being paid are reasonable for the services provided. It is not necessary that the fees be the lowest only that they are “reasonable.”
11. References – request the advisor to provide client references relevant to the retirement plan services under consideration

III. Creating an Investment Policy Statement

While ERISA does not strictly require an Investment Policy Statement, the duties and responsibilities of a plan fiduciary will require due diligence processes that are best codified in an Investment Policy Statement (IPS).

An Investment Policy Statement should contain the following sections:

1. *Executive Summary* – describes the plan and its objectives
2. *Roles & Responsibilities* – the roles/responsibilities are:
 - a. Investment Committee – selects/monitors investment options; delegates to a “prudent expert”
 - b. Investment Fiduciary (if used) – manages the investment process, selects/monitors investment options
 - c. Money Manager – buys and sells securities for the plan’s investment options
 - d. Custodian – holds the plan’s investment assets
3. *Diversification* – ensures that the investment options cover at least three distinct asset classes
4. *Due diligence for investment selections* – screens to select investments
5. *Due diligence for investment monitoring* – criteria to replace plan investments
6. *Investment expenses* – procedures to account for and control the plan’s investment expenses both direct and indirect

The IPS should be reviewed annually and it is the responsibility of either the Investment Committee or the Investment Fiduciary to ensure that the plan is operated in accordance with the IPS. A well crafted IPS is important because it will provide an audit trail showing the how and why decisions were taken. It will also help to avoid chasing the “hot” fund or investment theme by insulating the managers from “market noise.”

IV. ERISA Safe Harbors

Investment committee members have the choice of pursuing one of ERISA's Safe Harbor provisions in order to lessen their fiduciary liability. The four Safe Harbors address two forms of liability:

- Protect the plan from liability arising from the actions of "prudent experts"
- Protect the plan from liability arising from the actions of participants

As of March 2010 there were four Safe Harbor ERISA provisions:

1. General: Section 404(a) – ERISA provides for the delegating of investment decisions to a "prudent expert"; certain conditions are required to effectively transfer liability and they include the Investment Fiduciary being an ERISA Section (3)(38) advisor by providing written acknowledgement of its fiduciary status and being given discretion to make investment decisions
2. Participant Control: Section 404(c) – if the plan does certain things with respect to providing participant's control over the investments then the plan transfers liability to participants for actions they take:
 - a. Provides written notice to participants the plan is seeking 404(c) status
 - b. Provides at least three different investment options
 - c. Provides information/education about the investment options
 - d. Provides the participants with the ability to make investment changes consistent with market volatility; best practice for this is to permit daily changes
3. Qualified Default Investment Alternatives (QDIAs) – if a participant fails to make an investment selection then the plan can make one for him or her using a QDIA provided that:
 - a. Participant is given 30-days written notice
 - b. Participant is provided information about the QDIA
 - c. Participant is provided information about other options
 - d. Participant is provided information about automatic enrollment
 - e. The QDIA is a:
 - i. Life-cycle fund
 - ii. Age-based fund
 - iii. Balanced fund
 - f. Using a money market or a stable value fund is not considered an appropriate QDIA and can only be used as a temporary investment for up to 120 days
 - g. Participants defaulted into money market or stable value funds prior to December 2007 are grandfathered
4. Participant Advice – if the plan contracts with a Fiduciary Advisor to provide participant advice liability for participant investment decisions is transferred to the participants. Participant advice can be delivered through a computer model provided the model is certified as an "eligible advice arrangement" by an "eligible investment expert" at least annually.