

Managing Fiduciary Risk for Plan Sponsors



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Plan Sponsors: Managing Fiduciary Risk

Managing fiduciary risk should be the priority of any plan sponsor that offers a Defined Contribution (DC) plan. DC plans have evolved from a retirement supplement into a key source of retirement income from employer-sponsored plans. This growing use of DC plans now requires participants to take on greater responsibilities in saving for retirement and making their own investment decisions. Additionally, policymakers and regulators have taken concerted action to encourage participant savings and support plan sponsors’ fiduciary role. These changes have created an environment in which plan sponsors must know their fiduciary responsibility, their potential risks, and how to mitigate these risks.

TOPICS:

Who is a Fiduciary?

What are the Responsibilities of Plan Fiduciaries?

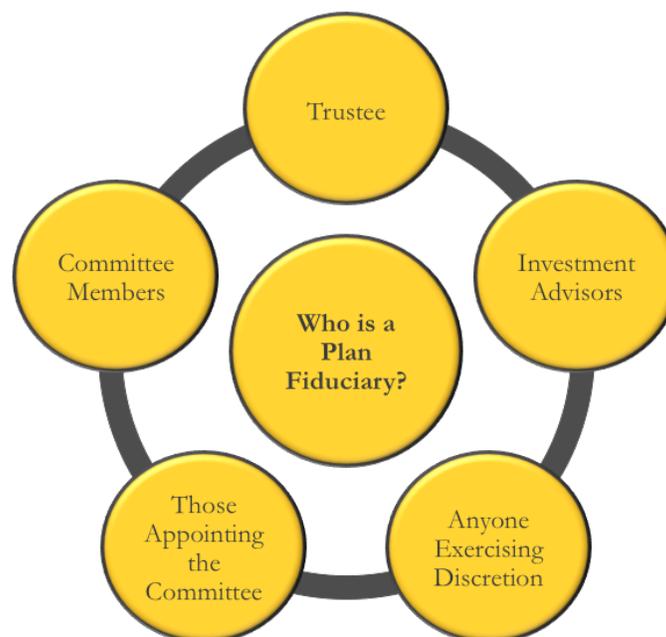
What Steps Help Manage Fiduciary Risk?

Who is a fiduciary?

According to ERISA [Section 3(21)], a fiduciary is anyone who:

1. Exercises any discretionary authority over the management of the plan or management or disposition of its assets;
2. Provides or has the authority or responsibility to render investment advice for a fee or other compensation, direct or indirect; or
3. Is a named fiduciary or is appointed as a fiduciary within the plan document.

Basically, factors that determine fiduciary status include: 1) a person’s title within the company and 2) his or her function in the retirement plan. The plan document that establishes the company’s retirement plan must name at least one fiduciary. This fiduciary may be a person or group of people, such as an investment committee, as fiduciaries.

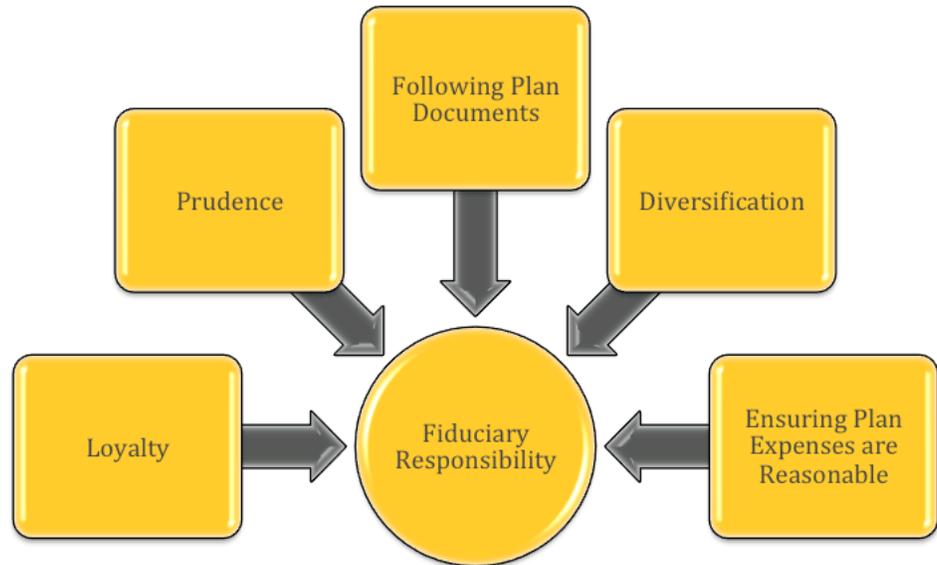


DEFINING RESPONSIBILITIES:

- Loyalty: Acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them.
- Prudence: The Employee Retirement Income Security Act of 1974 (ERISA) requires that a fiduciary manage a portfolio “with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

What are the responsibilities of plan fiduciaries?

According to the Department of Labor (DOL), the responsibilities of fiduciaries include:



In February 2012, the DOL released a publication titled *Meeting Your Fiduciary Responsibilities*¹. In this publication, they noted that the duty to act prudently, following the plan document, and diversification were among the key fiduciary duties.

Understanding who is a fiduciary and what responsibilities are associated with being a fiduciary is extremely important, because breaching one’s role may cause them to be personally liable to restore any losses to the plan. We believe there are several steps plan sponsors and fiduciaries can take to help meet these responsibilities while also reducing liability.

Steps to Help Manage Fiduciary Risk

1. Documentation:

Documentation is vital for an organized and effective committee and helps mitigate fiduciary risk. Documentation begins with the plan document which should:

- Define the structure of the committee and its responsibilities;
- How the committee is established;
- Who the committee reports to;
- How investments are selected and monitored;
- Frequency of meetings;
- Voting procedures (if company stock is involved); and
- Guidelines for generating minutes.

The minutes of each meeting should contain a clear and concise description of who attended the meeting, items discussed, action items agreed upon, and the rationale for any decisions made. Documentation is important for every organization as it is a key factor in demonstrating effective governance and helps minimize any personal liability.

2. Establish and Follow an Investment Policy Statement (IPS):

Within a DC plan, the IPS acts as the governing document and describes the investment strategies and alternatives available to plan participants. Specifically, an IPS should define the purpose, investment objectives and guidelines, and how to measure the success of the plan. It should also include the following:

- Whether a company intends to comply with ERISA section 404(c) (discussed more in #6 below) if the plan permits participants to direct investments;
- Acknowledge who the fiduciaries are and the responsibilities among them;
- Describe the due diligence process for selecting and monitoring managers;
- Process for reviewing and considering manager changes; and
- Specify the relevant benchmarks and time periods for performance review.

While establishing and adhering to an IPS is not mandatory, the DOL has issued guidance stating that an IPS is consistent with the fiduciary obligation of loyalty and prudence and thus can demonstrate a level of prudence, meet one's fiduciary responsibility, and protect fiduciaries from legal actions.

3. Selecting and Monitoring Investment Options:

When selecting and implementing investment options, the DOL states that a plan should offer "a broad range of investment alternatives." Section 404(c) elaborates on this by stating a broad range of alternatives is achieved if a participant has the opportunity to:

- Materially affect their potential risk and return;
- Choose from at least three different diversified investment options;
- Choose among options that must have materially different risk and return characteristics; and
- Diversify investments to minimize risk.

(Note – Highland Associates believes that real and effective diversification requires broadening the allocation to include multiple asset classes that exhibit different risk and return drivers. We plan to focus on diversification and how we believe this can be implemented among defined contribution plans in our next paper.)

When selecting investment options, committees should make sure to follow and choose options that are consistent with the objectives stated in the IPS. Decisions should be documented in the meeting minutes and should include the rationale for any decisions made to demonstrate a level of prudence.

DEFINING KEY ROLES OF INVESTMENT ADVISORS:

3(21) Fiduciary - Advisor shares the fiduciary responsibility with the Plan Sponsor for determining & monitoring investment options (traditional investment advisory).

3(38) Fiduciary - Advisor assumes full fiduciary responsibility for determining & monitoring investment options (discretionary advisor) while Plan Sponsor's responsibility is to select and monitor the advisor.

After investment options are selected, fiduciaries also have the responsibility to oversee and monitor performance. These investments should be monitored on a regular basis for performance, changes in the people, philosophy, or process at the manager, and fees.

Selecting and monitoring investment options is a key responsibility among fiduciaries. Fiduciaries must remember that “prudence” is among their top responsibilities so selecting and monitoring investment options must not be taken lightly. Therefore, if fiduciaries lack familiarity, it may be beneficial to seek professional assistance. Please note that some advisors will not take on co-fiduciary responsibilities, some will become a co-fiduciary under Section 3(21) of ERISA, and others will accept full fiduciary responsibility under ERISA section 3(38).

4. Holding Regular Committee Meetings:

The frequency of meetings is important. It is generally recommended that meetings be held at least quarterly with the ability to hold impromptu meetings in times of extraordinary events. If an organization decides to hold semi-annual or annual meetings, it is recommended that at least one plan fiduciary be responsible for overseeing the investments and administrative issues between meetings. Fiduciaries are expected to attend the meetings regularly and can still be held accountable if they did not participate in a particular decision.

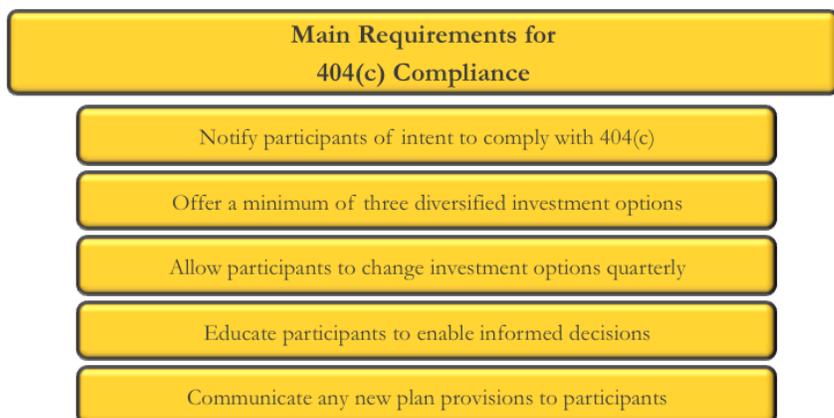
5. Plan Expenses:

Fiduciaries have the responsibility to oversee the plan expenses. ERISA law does not specify a permissible level of fees, but instead requires that fees charged to the plan be “reasonable”. In determining if the plan’s fees are reasonable, plan fiduciaries can benchmark their fees versus peers. Fiduciaries should remember that “reasonable” may not mean lowest cost, but instead should be an evaluation of cost and value.

Fiduciaries should review and understand any fees for services paid out of the plan and the services provided. Fees have been a main area of focus for the DOL, as such, plan sponsors should make sure they provide appropriate disclosures. Examples include making disclosures in the enhanced Form 5500, to plan fiduciaries through better transparency on fees and expenses, and to plan participants in communications regarding fees and other investment-related information. The plan’s document should state how fees are to be paid – by the employer, the plan, or both.

6. 404(c) Compliance – Additional Fiduciary Protection

Complying with ERISA section 404(c) is optional, but can be an important tool for managing fiduciary risk as a plan sponsor. This section of ERISA provides plan sponsors some fiduciary relief for investment decisions made by participants or when participants are automatically enrolled in a qualified default investment alternative (see #7 below for more detail). It is important to remember that plan sponsors and fiduciaries are still responsible for selecting and monitoring the investment options.



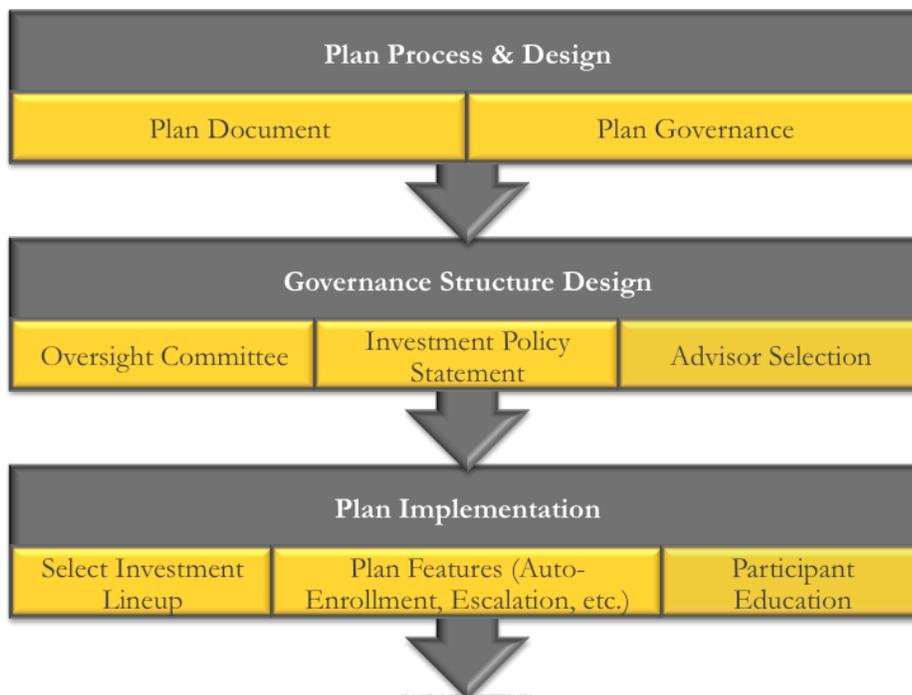
7. Qualified Default Investment Alternative (QDIA):

The Pension Protection Act signed into law in 2006 provided plan sponsors the opportunity to adopt automatic enrollment without worrying about legal liability as long as the “default” investment meets one of four options.



Summary & Suggested Action Plan

Fiduciary risk is a real risk that should not be taken lightly given the growing importance of DC plans among retirees. Fiduciaries must know who they are, what their risks are, and their responsibilities. This paper has laid out several steps that can help fiduciaries meet their obligations. The following outline provides an example of how to implement a governance process to help fiduciaries fulfill their responsibilities and reduce their risk.

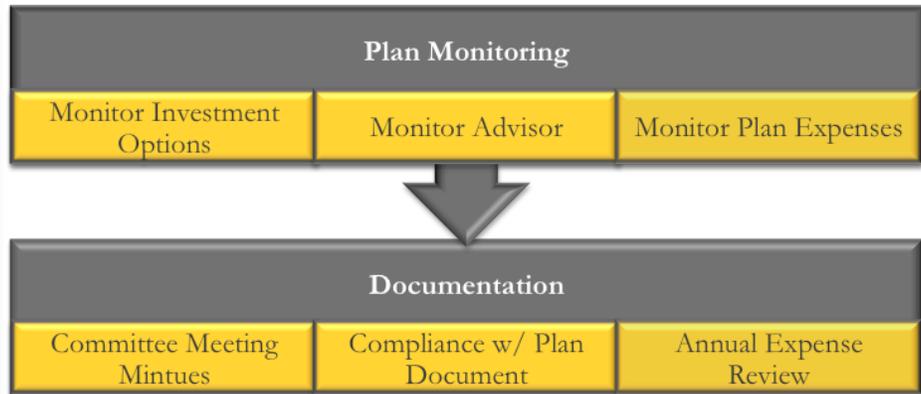


**ABOUT
HIGHLAND:**

Highland Associates, Inc. was founded in 1987 as an independent institutional investment advisor to assist not-for-profit institutions in the development, implementation, and maintenance of treasury and investment management programs.

The firm is headquartered in Birmingham, AL and, as of December 31, 2013, serves as investment consultant on approximately \$18 billion in assets.

The information provided herein is not intended to be, nor shall it be construed as, investment advice or a recommendation of any kind. To the extent that this communication contains information as to the historical performance of a particular investment or strategy, no representation is being made that an investor will or is likely to achieve any results shown or will make any profit at all or will not suffer losses, including loss of principal. Past performance is not indicative of future results. The information provided is furnished as of the date shown, and no representation is being made with respect to its accuracy on any future date.



Closing

Please contact us to schedule a time to discuss how this paper applies to your specific plan and how Highland can help.

Please note that this paper is not all-inclusive and plan sponsors should always consult with legal counsel about managing fiduciary liability.

References & Additional Resources:

¹ <http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html>

Vanguard: Best Practices for Plan Fiduciaries

<https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvComFidBestPractices>

Highland Associates: Keys to Effective Governance: Investment Committees & Decision Making

<http://www.highlandassoc.com/insight/white-papers/>



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Mr. Terry is an original founder of Highland Associates. He is a principal of the firm and a shareholder. Prior to forming Highland Associates, Mr. Terry co-founded and co-managed the Investment Management Consulting Group of Interstate/Johnson Lane securities. Mr. Terry is a member of the Board of Directors for Protective Life Corporation, a NYSE listed company, where he serves on both the Finance and Investment, and Audit Committees. In addition he serves as immediate past Chairman of the Executive Board of the Greater Alabama Council of Boy Scouts of America and on the Finance Committee of the Birmingham Museum of Art. Mr. Terry holds a Bachelor's of Arts degree from Davidson College and is a CFA Charterholder. Mr. Terry has 31 years of investment experience.



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Mr. Lytle joined Highland Associates in 2006 as a consultant to the firm's institutional client base. He is a shareholder in the firm. Prior to joining Highland Associates, he worked as a fixed income portfolio manager in AmSouth Bank's Asset Management Department. Mr. Lytle is the Chairman of the Investment Committee of the Greater Alabama Council of Boy Scouts of America, serves on the advisory board for the Department of Economics, Finance and Quantitative Analysis at Samford University and is a past president of the Vestavia Hills Library Foundation. He is also the Chairman of the Finance Committee and Vice-Chair of the Deacon Board at Dawson Memorial Baptist Church. Mr. Lytle earned his Bachelors of Science from Berry College. He is a CFA Charterholder and past board member and president of the CFA Society of Alabama. Mr. Lytle has 15 years of investment experience.



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