Top Ten Questions that New 401(k) Committee Members Shouldn't be Afraid to Ask

"SMALL OPPORTUNITIES ARE OFTEN THE BEGINNINGS OF GREAT ENTERPRISES."—DEMOSTHENES

Being chosen to serve as a member of your company's 401(k) retirement plan's investment committee provides you with a wonderful opportunity to positively impact your co-workers and their beneficiaries as they save for retirement. As a member of the investment committee, you will have the important and serious fiduciary responsibility to help select and monitor the different investment alternatives under the plan.

As you know, Section 401(k) plans are typically subject to various provisions of the Internal Revenue Code and the Employee Retirement Income Security Act ("ERISA"), as each has been amended to date. To help you understand your compelling new role, this brief summary focuses on selected questions that we encourage you to ask about your responsibilities under ERISA, and its broad fiduciary provisions as they relate to choosing plan investments and related services. (There are other provisions under the Internal Revenue Code that relate to the tax-exempt status of the plan and the trust holding the plan's assets, including rules on eligibility and discrimination, which we will not cover in this summary.)

Of course, these questions are intended to stimulate further thought and you should see them as only a helpful first step—at a very general and preliminary level—in familiarizing yourself with the many important considerations you will want to master.

HOW SHOULD I BEGIN TO EDUCATE MYSELF? READING, WRITING AND (FEE AND OTHER) 'RITHMETIC.

A good way to introduce yourself to your duties and obligations as a plan fiduciary is to read your company's plan's governing documents (e.g., the plan document, trust agreement, investment policy statements, etc.). It will be helpful to begin reading the summary plan description, and also summary annual reports and filings made to the Department of Labor on Form 5500. These will begin to give you an overview and understanding of how your company's plan operates.

You should also carefully review the plan's investment policy statement, as well as your plan's policy and parameters on fees and expenses. You should walk through the provisions of the governing documents of your plan to confirm that you understand how they identify the roles for the trustees, investment committee, and areas of oversight and responsibility. If there are any gaps or areas you do not understand, ask for or suggest clarifications where appropriate.

If it is not already a part of your plan's governance, you may consider suggesting that a policy be established to assess ongoing plan expense and fee monitoring, and benchmarking. Separately, in consultation with your committee's counsel, you should review and consider the policies and procedures relating to memorializing committee decisions and actions, including through minutes or other formalized writings. Of course, it is important to balance an appropriate attention to detail with a thorough understanding of the macro issues and considerations.

WHAT ARE MY RESPONSIBILITIES?

Most 401(k) plans contemplate that participants are able to direct their plan accounts into one or more investment alternatives selected by the named fiduciaries, or other fiduciaries appointed under the plan's governing documents. Because as a member of your company's 401(k) investment committee, you will be charged with selecting and monitoring different investment alternatives under the plan, you will generally be acting as a "fiduciary" under ERISA with respect to those activities. This is a responsibility that you should take proudly, but seriously, because as an ERISA fiduciary you must:

- Act solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of

providing benefits to them (i.e., fiduciaries must act only with a "eye single" in the interest of plan participants and beneficiaries);

- Carry out your duties with "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 (the so-called "prudent expert" standard—generally regarded as one of the highest standards in the law);
- Follow the plan documents (unless inconsistent with ERISA);
- Diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so;
- Pay only reasonable plan expenses; and
- Not engage in "prohibited transactions" (generally: transactions between the plan and fiduciaries or their affiliates, as well as transactions between the plan and "parties in interest" (as defined in Section 3(14) of ERISA) absent an applicable exemption).

WHAT LIABILITIES MIGHT I HAVE? HOW MIGHT I MITIGATE THEM?

"Risk comes from not knowing what you are doing."—Warren Buffett

Being an ERISA fiduciary may entail personal liability. In addition to making the plan whole for any losses resulting from a breach of fiduciary duty, a fiduciary may be required to disgorge any profits obtained in committing the breach, and be subject to "such other equitable or remedial relief" as a court may decide. Furthermore, the Department of Labor can impose on a fiduciary a penalty of 20% of any civil recovery.

Fiduciary duties under ERISA cannot be limited contractually, by participant waiver or otherwise (i.e., fiduciary exculpatory provisions are legally null and void). That is why many fiduciary committee members focus on the following important points:

- **Prudence Means Knowing What to Know**
  "Common sense is not so common."—Voltaire

In general, ERISA focuses more on a prudent process, rather than a prudent result. Being fully aware of your responsibilities (certainly in greater detail than set forth in this short summary) will help you best discharge your responsibilities prudently. This includes understanding the plan documents and their general operations. Established practice at many companies is to provide fiduciary "training" for new members, as well as refreshers at least annually. You should consider taking advantage of these and other available resources, as they will help familiarize you with the standards and obligations applicable to you. In addition, many fiduciaries also find a periodic compliance "audit" of plan documents, administrative processes and other matters helpful. Of course, you must act prudently in all of your plan-related activities.

- **Prudence Means Knowing What You Don't Know**
  "The only real knowledge comes when you recognize what you don't know."—Socrates (adapted)

As discussed below, sometimes the prudent thing is to conclude that you aren't an expert on a given subject or responsibility. In other words, the prudent thing may be to seek help. As the Department of Labor notes "[t]he duty to act prudently is one of a fiduciary's central responsibilities under ERISA. It requires expertise in a variety of areas, such as investments. Lacking that expertise, a fiduciary will want to hire someone with that professional knowledge to carry out the investment and other functions especially given the standards to which fiduciaries are held under ERISA."

- **Prudence Means Knowing When to Delegate**
  "Who is wise? He who learns from all people." Babylonian Talmud, Avot.

ERISA provides that to the extent a named fiduciary delegates investment management authority to any third-party service provider, "then such named fiduciary shall not be liable for an act or omission of such [hired third party] in carrying out such responsibility," except to the extent that the delegation itself is imprudent. This applies to a variety of service providers, such as investment managers, custodians, recordkeepers, third-party administrators and others. Some functions may

most properly remain "in house." For other functions, the committee will most certainly wish to delegate.

For example, if a named fiduciary or fiduciary investment committee prudently hires an investment manager to manage all or a part of the assets of a plan in a separate account, the named fiduciary or investment committee would generally not be liable for the portfolio-level transactions effected by the investment manager in the account; although it would still need to be prudent in monitoring the manager's performance. By contrast, were no such delegation in place, or if the delegation were made of one or more persons that do not meet the ERISA definition of an investment manager, the named fiduciary or investment committee could be personally liable for each and every plan investment under its care, as well as for the imprudent decision not to retain a statutory investment manager or leverage other service providers.

- **Fiduciary Insurance**

Many fiduciaries are covered by their employer's insurance policy against certain claims of fiduciary breaches. It may be appropriate for you to check your company's coverage as to whether it covers your activities as a member of the plan's investment committee and the amount of coverage it affords. (Separately, you may also wish to confirm that your employer will make sure that you will be appropriately "bonded" under ERISA—a separate requirement.)

HOW CAN WEARING TWO HATS STILL LEAVE ME IN THE COLD?

As an ERISA fiduciary, you must act solely in the best interests of plan participants and beneficiaries. While you may have two distinct roles—one, as an employee of your company, the plan's sponsor, and two, as an investment committee fiduciary to the plan—ERISA requires you to act with a "eye single" for the interests of the plan participants and beneficiaries. You may wear two hats, but only one counts under ERISA.

Thus, company considerations should generally be left at the door when you are acting in the capacity of an ERISA fiduciary. For example, considering a vendor for the plan based on the company's (and not the plan's) financial interests could result not only in a breach of your fiduciary duties, but could also result in a nonexempt prohibited transaction and impose other liabilities. As you start your new role, you should consider whether you understand what it means to act "solely" in the best interests of plan participants and beneficiaries and the extent to which you have considered potential conflicts that may interfere with the discharge of your duties—and the steps to take to resolve them.

IF PARTICIPANTS LOSE MONEY, AM I ALWAYS RESPONSIBLE?

"My desire to devolve authority has nothing to do with a wish to shirk responsibility."
—Dalai Lama

If your plan is like most 401(k) plans, it probably permits participants to direct their investments among several alternatives offered under the plan. Under Section 404(c) of ERISA, fiduciaries are limited in liabilities associated with investment losses in participant accounts where certain conditions of Section 404(c) and its regulations are met. Under that provision, participants must have control over their individual accounts, and they must be given the opportunity to choose from a broad range of investment alternatives.

Under the Department of Labor regulations, the plan must offer at least three different investment options, so that employees can diversify investments within an investment category, as well as diversify among the investment alternatives offered. In addition, participants must be given sufficient information to make informed decisions about the options offered under the plan and allowed to give investment instructions at least once a quarter, and perhaps more often if the investment alternative is considered more volatile. The theory behind Section 404(c) is that participants may be properly empowered to make their own investment choices, given enough choice, freedom, and appropriate information.

Now, complying with Section 404(c) doesn't mean a fiduciary escapes wholesale responsibility or liability. Note that while Section 404(c) provides some protection with respect to a participant's selection as among the plan's investment choices, Section 404(c) does not exempt a plan fiduciary's liability associated with the prudent selection and monitoring of the investment alternatives that are available under the plan. Absent a specific mandate from the plan document, the prudent selection and monitoring responsibility would extend to such matters as selecting the number of investment alternatives available under the plan, the number of and

types of asset classes, styles, and products per "bucket" that may be offered—as well as the selection of the actual investment manager or product associated with any such investment alternative.

Fiduciary responsibility may also include decisions about how to deal with participants in the plan who do not give investment directions. Many plans provide for so-called "qualified default investment alternatives" that meet certain conditions and are designed to provide participants who do not choose how to allocate their accounts with a default investment, while mitigating fiduciary responsibilities associated with the consequences of any such investment "elections by default." These are all considerations that you should evaluate.

HOW DO I DEMONSTRATE THAT I WAS ACTING PRUDENTLY?

"Don't accept your dog's admiration as conclusive evidence that you are wonderful."
—Ann Landers

In fulfilling the duty of prudence, fiduciaries must undertake a rigorous, well-documented investigation with respect to each decision with which they are charged. In consultation with your committee's counsel, you should review and consider the policies and procedures relating to memorializing committee decisions and actions, including thorough minutes or other formalized writings.

Most committees find it appropriate to record not only official actions and decisions, but also the steps taken in each decision. Many committees find it best to identify in advance the process and the judgments that are necessary to inform decisions. Investment policy statements, fee-related policies, and standardized "requests for proposals" that identify the scope of services desired by the plan may not only help smooth the decision-making process and manage expectations, but also give voice to those particular aspects and features that are important to the plan.

WHICH INVESTMENT PROFESSIONALS ARE 'RIGHT' FOR OUR PLAN?

"You need to have a collaborative hiring process."
—Steve Jobs

Understanding that your financial sophistication may not match that of Warren Buffett's, ERISA permits, and in many cases demands, that you engage appropriate professionals where you and your committee lack the necessary expertise. These professionals may assist you in selecting investment providers, formulating the investment fund menu, monitoring investment manager performance, or helping you assess and understand market trends.

Where you and your fellow committee members have sufficient investment expertise to do your job without outside advisors, you may still turn to providers, such as banks or brokers who offer a wide variety of products and services for independent consideration. These service providers often also provide plans with information on overall market trends and general items of interest or potential solutions that can serve as jumping off points for further committee ideas and discussions.

In any case, it is important to determine the precise scope and role undertaken by any such providers. For example, ERISA's well-developed conflicts provisions may preclude some providers—such as investment advisers (who owe a duty of prudence and loyalty to the plan) from offering certain proprietary products and services (or using certain products or services of providers with certain relationships to the provider). By contrast, other service providers, such as broker-dealers and banks, may present platforms that offer a range of products and services in more cost effective ways, albeit without serving as fiduciaries with respect to the selection of such products or services. Both may also offer "bundled" services that combine many different services under an "open architecture" approach.

WHAT ABOUT EMPLOYER SECURITIES?

If your plan contains any employer securities as an investment alternative, or is a stock bonus plan or

employee stock ownership plan (an "ESOP"), special design, operation and fiduciary considerations will likely apply. Considerations include the extent to which the investment in any employer securities fund is "mandatory" or "voluntary," valuation of shares, voting and other pass-through rights, and other corporate and plan-related points. You and your committee members may wish to consult with qualified ERISA counsel to discuss all of these issues as they may relate to your plan.

SO MUCH TO DECIDE. HOW DO I KNOW WHAT SERVICES THE PLAN IS GETTING—AND FOR WHAT COST?

"Money often costs too much."
—Ralph Waldo Emerson

You may choose to hire professionals in terms of benchmarking other service providers such as recordkeepers, third-party administrators, custodians and trustees. Many plans find it useful to interview at least three service providers per product or service contemplated. This provides for opportunities to compare and contrast the relative merits and demerits of a given product or service.

In addition, the Department of Labor has issued a whole suite of new rules designed to assist plan fiduciaries like you in this regard—rules that help fiduciaries determine whether the amount your plan pays for specified services is "reasonable." These rules help fiduciaries evaluate and monitor the "bang for the buck" for the plan as they identify the services expected, the direct compensation received by the service provider, and certain other permitted indirect compensation.

Where you are considering services offered on a "bundled" basis, it is potentially all the more important to consider this information. With some investment products —mutual funds, for example—it will be important to determine which share class is appropriate for the plan. And, of course, because the Department of Labor wants plan fiduciaries to have highly detailed information, it would seem imprudent if you and your plan fiduciaries did not carefully examine it. With all of the details provided, you and your committee members may need a professional to assist you in just sifting through and evaluating all of this important data.

Finally, if you hire a pension consultant or certain other investment providers, you should consider the nature of their roles and responsibilities (i.e., are they acting as a fiduciary or as a non-fiduciary service provider/investment platform), and you should also consider potential conflicts of interest, including those described by the Department of Labor at http://www.dol.gov/ebsa/newsroom/fs053105.html.

WHEN WILL WE MEET AGAIN?

Committee meetings should be periodic. Many plan investment committees choose to meet at least quarterly (and sometimes more frequently in light of market conditions) to review underlying investment option performance, monitor service providers, and invite service providers in for questions and answers. Many invite service providers to present on their performance and trends, as well have outside investment professionals provide a "check in" and where appropriate, a "checkup."

BONUS QUESTION: SO, THIS SUMMARY ALONE PROVIDES ALL I NEED TO BE A GREAT FIDUCIARY?

No, but hopefully it's a good start. Winston Churchill once famously said he had nothing to give but "blood, tears, toil and sweat" to his calling. Such will be your role as an ERISA fiduciary, although hopefully, it will not involve either the challenges or front-page attention that Mr. Churchill's burdens occasioned.

Your actions as a plan fiduciary can be of enormous benefit and can be tremendously empowering for the good of your colleagues and their beneficiaries. As you consider your role in greater detail, and ponder the complex situations you will encounter as you engage in your responsibilities, do not hesitate to ask questions and seek greater understanding. Do not be afraid to consult competent counsel when appropriate. Do not hesitate to make a positive difference because you can.

Finally, Attachment A, which is attached, is a sample checklist of some (but clearly not all) of the considerations you may wish to think about in greater detail. Again, your plan's needs may call for some or all of these considerations, or others that are not listed here—the list should not be regarded as a "one size fits all" solution. The Department of Labor also has some very helpful materials at http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.

Steven W. Rabitz

By Steven W. Rabitz, a Partner in the Employee Benefits and Executive Compensation Practice Group of Stroock & Stroock & Lavan LLP, a law firm with a national and international practice serving clients that include investment banks, commercial banks, insurance and reinsurance companies, mutual funds, multinationals and foreign governments, industrial enterprises, emerging companies and technology and other entrepreneurial ventures.

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Neuberger Berman LLC
605 Third Avenue
New York, NY 10158-3698

www.nb.com

ATTACHMENT A: SAMPLE FIDUCIARY INVESTMENT-RELATED CHECKLIST QUESTIONS (PARTIAL LIST ONLY)

- Does the committee have ERISA counsel available for consultation? Has it historically engaged counsel and will it engage ERISA counsel where appropriate?
- Are you familiar with your roles and responsibilities as a fiduciary? Have you attended fiduciary training and refreshers? Do you understand what it means to act "solely" in the best interests of plan participants and beneficiaries and have you considered potential conflicts that may interfere with the discharge of your duties?
- Have you reviewed your plan's documents (i.e., summary plan description, plan document, trust agreement etc.)? Do they identify the roles for the trustees, investment committee, and areas of oversight and responsibility? If not, is that appropriate?
- Have you reviewed the plan's investment policy statement, if the plan has one (and if not, concluded it is appropriate that is not necessary)? What investment alternatives are permitted/proscribed? Are there parameters on asset classes, styles, restrictions or limitations on specific positions or types of financial instruments? What is the allocation of responsibility with respect to proxies? What is the policy (if any) on hard to value assets, and unrelated business taxable income ("UBTI")?
- Are you appropriately "bonded" for ERISA purposes and have you confirmed an appropriate level of fiduciary insurance to help mitigate potential personal liability?
- Where you have determined you are unable to act as a prudent expert on a plan-related matter, have you engaged other professionals to assist you? If you hire a pension consultant or certain other providers, have you considered potential conflicts of interest, including those described by the Department of Labor at http://www.dol.gov/ebsa/newsroom/fs053105.html?
- If applicable to your plan, have you reviewed the parameters of Section 404(c) of ERISA, and reviewed the plan's compliance therewith? (NOTE: This includes not only investment selection but also participant communications.)
- Have you considered what to do with participants who fail to direct their investments among offered investment options? Have you considered a "qualified default investment alternative?"
- Have you considered whether your plan in an ESOP or otherwise permits investments in employer securities as an investment alternative? Have you reviewed the issues and considerations that are particular to such a feature with ERISA counsel?
- Have you examined the processes to select and review service providers, including investment managers, brokers, custodians, recordkeepers, third-party administrators etc.? What processes (including documentation) are in place to "watch" or "monitor" sub-performing providers if ongoing?
- Are you proficient in understanding (and reviewing) the fee structures associated with products and services subscribed to by the plan, including items of direct and indirect compensation? Have you processes in place to benchmark and compare not only performance but also the adequacy of consideration? Have you consulted the Department of Labor's publication, "Understanding Retirement Plan Fees and Expenses at http://www.dol.gov/ebsa/publications/undrstndgrtmnt.html for background and http://www.dol/ebsa/fiduciaryeducation.html for ideas about how to most effectively compare fees?
- What are the criteria for benchmarking performance on both absolute and relative bases? How does the committee do this with respect to fees, expense ratios, the continuity and stability of organization or service provider or key personnel? For insurance providers, how does the committee evaluate creditworthiness and is there a diversification of credit, as well as investment risk through diversification?
- How often do fiduciary meetings occur? What mechanisms exist to address time-sensitive matters and what processes exist for keeping records of decisions?
- What is the committee's documentation process? Have you reviewed the contracts for services to ensure that all services are documented under written contracts?
- What is the process for review of participant-related communications concerning investment options, regulatory requirements (e.g., summary plan descriptions, summaries of material modifications, summary annual reports, Regulation Section 404(a)(5) related disclosure)?