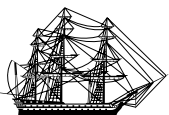


A photograph of two women sitting at a large wooden conference table in a modern office. The woman on the left, with dark hair and wearing a purple top, is looking towards the right with her hand near her face. The woman on the right, with curly hair and wearing a grey blazer, is looking out a large window with her hand on her chin. On the table are two white mugs, a small potted plant, and some papers. The background shows a city skyline through the window.

Best practices

for plan fiduciaries

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Executive summary

Since its enactment, the Employee Retirement Income Security Act (ERISA) of 1974, as amended has imposed one of the highest fiduciary standards under the law. Under ERISA, fiduciary responsibilities must be discharged solely in the interest of the plan's participants and beneficiaries. Furthermore, plan fiduciaries are held to an exceptional level of fiduciary duty and care, including the assumption of personal liability for fiduciary decision-making.

In today's evolving legal, regulatory, and litigation environments, it is more important than ever that employee benefit plan fiduciaries understand their roles and responsibilities. This guidebook serves as a roadmap to your fiduciary duties while providing Vanguard's perspective on recommended best practices. This book and its companion pieces provide plan fiduciaries with tools to assist in complying with ERISA's fiduciary responsibilities and in mitigating risk.

A brief history of pension law

Introduction

In 1974, Congress enacted ERISA. At the time, 80% of plan participants in private-sector retirement plans were covered by defined benefit (DB) programs, and the legislation was designed to strengthen the DB system with a national standard of fiduciary conduct. The fiduciary sections of ERISA set a new, nationwide standard for the management and oversight of private pension plans, including broad fiduciary principles and specific rules prohibiting conflicts of interest (referred to as prohibited transactions).

Additionally, a new federal agency, the Pension Benefit Guaranty Corporation (PBGC), was created to provide federal financial backing to private pension benefits if a plan failed. ERISA was enacted in an effort to address weaknesses in the DB system, including inadequate plan funding and overconcentration of plan investments in employer securities.

The shift from DB to DC plans

ERISA was designed with a specific model of pension-plan governance in mind. At the core of the decision-making process is a fiduciary, overseeing DB plan assets for an essentially passive and uninvolved group of plan participants. Pension plans were employer-funded and invested, with a committee making all decisions, assisted as needed by various professional advisors and service providers. While there were defined contribution (DC) plans in existence at the time of ERISA's adoption, most were also employer-funded and employer-invested. These DC plans were often intended as supplemental benefit programs, not as the core retirement benefit.

Today the world of private pension plans has been transformed. The vast majority of private-sector workers with employer retirement plans have DC accounts. In such plans, participant contributions account for the majority of plan funding (through elective salary deferrals), and participants are responsible for most saving and investment decisions.

Over the years, ERISA and its regulations have evolved to accommodate the growth of individual account plans. In 2006, Congress enacted the Pension Protection Act (PPA), the most comprehensive retirement legislation since ERISA. PPA reflects the evolution of the participant as active decision-maker and provides much-needed protections for plan fiduciaries and participants in qualified retirement plans.

The legal framework today

In the United States, the decision by an employer to offer a retirement plan is a voluntary one, although the law grants tax incentives to encourage the creation of such plans. The employer's decision to create a plan—and the level of its generosity—is thus outside the scope of federal law. This benefits-design decision is often called a “settlor” function, because the employer is acting as a settlor (or trustee) of an employee benefit trust under trust law. Once an employer decides to offer a retirement plan, the plan must be operated under the fiduciary and tax rules established by Congress and the regulatory agencies. Only then will the plan secure the full tax benefits available under the law.

Whether managing DB or DC plans today, plan sponsors can think of the legal framework as having two essential components.



The legal framework today

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ERISA and the Department of Labor (DOL)

ERISA requires prudent and appropriate operation of the plan by fiduciaries. It covers such issues as establishing and maintaining prudent procedures for operating the plan, investing the plan's assets, processing participant benefit claims, reporting and disclosure, and monitoring the activities of plan fiduciaries and the plan's daily operations. The DOL is the regulator and enforcement agency for ERISA.

Internal Revenue Code and IRS

The Internal Revenue Code (IRC) governs the tax benefits offered by "qualified" retirement plans.¹ Rules for funding the plan, whether with employer or employee contributions, and taking distributions, withdrawals, or loans, are provided in the IRC. The IRS, under the authority of the U.S. Department of the Treasury, is the regulator and enforcement agency for the tax rules.

Other agencies are involved as well. DB plan sponsors must comply with the rules of the DB plan insurance agency, the PBGC, including paying premiums and reporting funding status according to PBGC's rules. Publicly held companies also must report DB funding status to their shareholders, according to rules of the main accounting oversight authority, the Financial Accounting Standards Board (FASB). DC plan sponsors that permit employee dollars to be invested in company stock within their plan must comply with rules governing public securities, which are regulated by the Securities and Exchange Commission (SEC). Whether managing DB or DC plans today, plan sponsors can think of the legal framework as having two essential components (see figure below).

The U.S. pension regulatory framework

The principal regulatory authorities

Area	Fiduciary law	Tax law
Body of law	Employee Retirement Income Security Act of 1974 (ERISA)	Internal Revenue Code
Regulator	Employee Benefits Security Administration U.S. Department of Labor	IRS U.S. Department of the Treasury

Other regulatory authorities

Area	DB plan funding	DB accounting	Company stock in DB/DC plans
Regulator	Pension Benefit Guaranty Corporation (PBGC)	Financial Accounting Standards Board (FASB)	Securities and Exchange Commission (SEC)

Source: Vanguard, 2019.

¹ The IRC also contains rules for certain "nonqualified" arrangements; however, these plans are generally outside the scope of this guide.

Fiduciary duties

Fiduciary duties

Fundamentals of fiduciary responsibility

Who is a fiduciary and what does it mean to be a good plan fiduciary? In addition to a specific person (or title) being named in the plan document (the “named fiduciary”), a fiduciary is defined in ERISA as someone who:

- 1) Exercises discretion over the management of the plan or any authority over plan assets;
- 2) Renders investment advice for a fee—or other compensation, directly or indirectly; or,
- 3) Has discretion over plan administrative issues.

Anyone who meets this functional definition can be a plan fiduciary, regardless of their role or title. Common examples of plan fiduciaries include the plan sponsor, plan committee members, the plan’s investment manager, and the trustee.

Fiduciary duties

Underlying the conduct of fiduciaries in private pension plans are the core fiduciary duties drawn from ERISA:

Loyalty. Fiduciaries have an overall duty to always act in the best interest of plan participants and beneficiaries.

Exclusive benefit. Fiduciaries must act for the exclusive purpose of providing benefits to participants and beneficiaries, while defraying reasonable expenses of administering the plan.

Prudence. Fiduciaries have a duty to act with the care, skill, prudence, and diligence under the circumstances then prevailing

that a prudent person acting in like capacity and familiar with such matters would act, including ensuring investments remain prudent investments. In other words, fiduciaries must meet a “prudent expert” standard: They must act as an experienced and knowledgeable expert might.

Diversification. Fiduciaries have a duty to ensure that plan assets are well-diversified in an effort to “avoid large losses.” Such diversification is required unless it is clearly prudent not to do so under the circumstances. (There is an exception to this diversification requirement for company stock in DC plans.)

Documents. Fiduciaries must follow the terms of the plan document and other documents governing the plan, unless inconsistent with ERISA. The plan document’s provisions must be consistently applied.

Courts also shape the definition of what it means to be a good fiduciary. In cases against plan fiduciaries related to plan expenses or company stock, courts do not judge fiduciaries against a standard of perfection but rather a standard of prudence in decision-making. Recent court decisions have continued to reflect the idea that procedural due diligence is generally more important than the results attributable to fiduciary decisions.

In Vanguard’s view, it is critical for fiduciaries to apply personal experience, judgment, and knowledge to maximize the welfare of the plan’s participants. Above all, fiduciaries must bring the highest levels of ethical conduct and fiduciary care to the operation and ongoing management of a retirement program.

Fiduciary best practices

Fiduciary best practices

Whether an employer is offering a DB or a DC retirement program, there are four principal best practices at the heart of good fiduciary conduct:

- 1) Organization of committees.
- 2) Investment selection and monitoring.
- 3) Plan costs.
- 4) Administrative oversight.

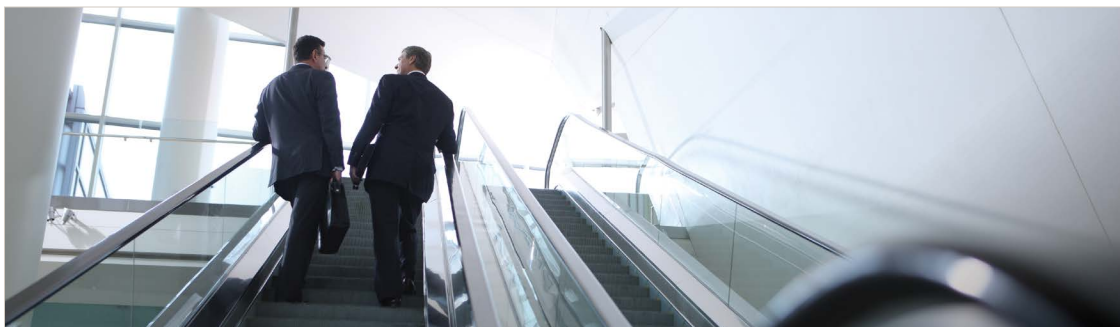
Have a well-organized and effective committee. A fiduciary committee should be carefully organized and staffed with qualified individuals.

Select and monitor plan investments regularly. The fiduciaries must set overall objectives and investment strategies for the plan, select appropriate investments in line with these goals and strategies, monitor investment performance on an ongoing basis, and add or remove investments when warranted over time, in accordance with plan policies. In addition, regulations under Section 404(c) of ERISA provide important fiduciary protections for DC plan sponsors. Sponsors should seek to comply with the rules, even though they are technically an optional provision of the law that provides protection in the event the plan fiduciary is sued.

Be attentive to plan costs. The fiduciaries must ensure that costs are appropriately allocated between the employer and the plan, and that all costs incurred by the plan and paid out of plan assets are reasonable. Reasonableness includes an assessment of the quality of the services provided, as well as the cost. Plan fiduciaries should also consider different fee allocation methods that may be available.

Oversee plan administration. The fiduciaries must oversee the creation of plan documents; ensure that the plan is operated strictly according to those documents; and satisfy all the legal and regulatory rules issued by the relevant agencies, including the DOL, IRS, PBGC, and SEC.

Collectively, these four best practices constitute the essential elements of good retirement plan governance. They are addressed later in this guide.





In participant-directed plans,

effective plan design as well as ongoing education and advice are essential if participants are to make well-informed decisions. The DOL supports the offering of such programs as a way of minimizing the plan sponsor's fiduciary risk, while increasing the likelihood of adequate retirement savings for plan participants.

Additional fiduciary considerations.

There are other best practice considerations that arise depending on the type of retirement plan the fiduciaries are overseeing. An explanation of responsibilities in this area is detailed later in this guide. These include:

- 1. DB Plans.** DB plan fiduciaries have additional responsibilities, including: ensuring that the plan's minimum funding requirements are being satisfied, making sure plan benefits are being calculated correctly and paid timely, and prudently selecting annuity providers.
- 2. Education and advice.** In participant-directed plans, effective plan design as well as ongoing education and advice are essential if participants are to make well-informed decisions. The DOL supports the offering of such programs as a way of minimizing the plan sponsor's fiduciary risk, while increasing the likelihood of adequate retirement savings for plan participants.
- 3. Company stock.** When ERISA was adopted, Congress continued to allow employers to utilize company stock in DC plans as an employee-ownership vehicle. But the presence of company stock in the plan poses one of the largest sources of fiduciary risk for sponsors. This guide discusses steps that can be taken to mitigate this risk.
- 4. Brokerage accounts.** How do plan sponsors fulfill their duty to select and monitor investments—while providing participants an option to invest in tens of thousands of securities in a brokerage account? Some simple steps can help mitigate these risks.
- 5. Lifetime income.** With the shift from DB plans to DC plans, an increasing number of workers will not have the benefit of a guaranteed stream of income in retirement. Plan sponsors have begun to examine ways of educating participants about lifetime income and how best to provide participants with access to lifetime income options. There are a number of fiduciary considerations plan sponsors should take into account when deciding how to address the issue of lifetime income for participants.

Fiduciary committee

Organization of committees

The employer's senior management team appoints individuals to oversee operation of the plan or plans and to be the employer's designated ERISA fiduciaries.

Under ERISA, many types of individuals or entities—employers, service providers, investment advisors, and consultants—can be plan fiduciaries. But in this guide, we take the perspective of the typical employer who has chosen to sponsor an IRS tax-qualified DB or DC retirement plan. These individuals may delegate their duties from time to time to others. However, these appointed individuals maintain the fiduciary responsibility for the plan in the sponsoring organization, and we will focus on their responsibilities in our guide.

Employers should think carefully about the organization of the fiduciary committee and incorporate the following best practices:

- Have a clear appointment process of one or more committees, and specify the relationship to the company's board of directors and executive management team or officers.
- Determine the structure of the committee, including appropriate size, membership, designated responsibilities, and frequency of meetings.
- Appoint qualified committee members and ensure appropriate ongoing training.
- Document all committee actions and decisions.

Best practice—Appointment of the committee

Sponsors can take different approaches to appointing a committee. One is for the senior leadership of the sponsoring organization to select individual members of the fiduciary committee. Another is for sponsors to determine committee membership by designating in the plan document certain functional titles of persons within the organization who will form the committee (e.g., director of human resources, assistant treasurer). Whatever the practice, it is important that committee members are well-positioned by their job responsibilities and expertise to function effectively. While members of the committee are not required to be experts with regard to retirement plans or investments, they should have some relevant experience and should be willing to work to satisfy ERISA's strict standards. In addition, the fiduciary committee should be designated in the plan document as the "named fiduciary."

In addition to appointing a committee, the sponsoring employer should have a mechanism for overseeing the committee. Typically, the committee reports on a regular basis to a senior management team or the sponsoring organization's board of directors. Increasingly, the trend is to report to the senior management team, on the theory that the board is not as well-positioned to focus on the level of detail that effective oversight entails.



A committee might be

as small as two or three individuals in a small firm, or as large as ten in a big company. It is a better idea to have a smaller, well-identified committee with a clear sense of “who is a fiduciary” rather than placing everyone involved with the plan on the committee.

Under ERISA, the members of the fiduciary committee are personally liable for their fiduciary decisions. For this reason, committee members should accept and acknowledge their fiduciary roles in writing. Fiduciary insurance can help mitigate some of the risk, yet even fiduciary insurance has its limits and exclusions. Many insurance policies have clauses that relieve the insurer of any responsibility in the event of a willful breach of duty by plan fiduciaries. While important, fiduciary insurance can offer only limited protection in certain circumstances. In addition, ERISA also requires that plan fiduciaries maintain bonding to protect the plan against losses due to fraud or dishonesty.

As a result, to limit personal liability, it is critical that fiduciaries conduct themselves with an exceptional level of care—and that senior management provide appropriate oversight to their deliberations and decisions.

Best practice—Structure of the committee and regular meetings

In small organizations, it is a common practice to have a single committee of plan fiduciaries responsible for overseeing all aspects of the plan. Large organizations often have such complex plans that they create two committees: an administrative committee responsible for daily operations of the plan and an investment committee responsible for investment selection and monitoring.

A committee might be as small as two or three individuals in a small firm, or as large as ten in a big company. In Vanguard's experience, committees with ten or more members often become unwieldy from a group-decision-making perspective. Often, their sense of responsibility can be too diffuse.

It is a better idea to have a smaller, well-identified committee with a clear sense of "who is a fiduciary," rather than placing everyone involved with the plan on the committee. Committee meetings can be expanded to include other individuals as needed. But there should be a clear, focused, and small group of qualified individuals who know they are the plan's fiduciaries—and are legally responsible for its operation and for making critical decisions.

In large organizations with two committees, an important question is the reporting relationship between those two groups. It is a fairly common practice for plan sponsors to have two committees organized in a parallel fashion, with certain core treasury and human resources (HR) individuals participating on both committees. In such cases, coordination and cooperation is essential. Each committee should be governed by a charter that clearly delineates respective duties.

Frequency of meetings is important. Large organizations with complex plans may meet monthly or every other month, depending on the length of agendas and the complexity of the investment and administrative issues. A good discipline is to meet quarterly. In addition, committees should call off-schedule meetings when necessary (e.g., in cases of extraordinary market or plan events).

Many small organizations may find quarterly meetings unnecessary if plan administration is relatively simple and the investment program is operating well; instead, they may decide to meet semiannually or annually. However, if the committee meets infrequently, at least one of the plan fiduciaries should be responsible for more regular oversight of investment or administrative issues.

Committee members should understand the importance of their role and should be expected to attend meetings regularly. Plan fiduciaries are collectively responsible for the plan's oversight. In the event of a problem, committee members cannot distance themselves from responsibility by maintaining that they did not participate in the committee's decision-making.

Best practice—Qualification and training of fiduciaries

Individuals chosen for the committee should have relevant experience, either in investments, plan administration, or both. They should be familiar with their duties and responsibilities under the law. Committee

members should be chosen for the variety of perspectives they can provide on administrative and investment issues, and the committee should generally not rely on a single individual as the source of expertise.

Appointments to the committee should be for a specific time, and the period should be relatively long (e.g., five years) to allow for continuity of thinking and oversight. Some positions will be permanent and by position (e.g., senior vice president of HR), while others may rotate and be based on current knowledge and experience.

If an organization lacks individuals with appropriate qualifications, the committee members should pursue relevant knowledge through training programs or professional counsel. In fact, investigations by the DOL have requested evidence of fiduciary training. Plan professionals such as attorneys, accountants, plan consultants, service providers, and investment managers can provide professional and technical assistance. However, the ultimate responsibility and decision-making always lie with the fiduciary unless this authority has been specifically delegated.

Best practice—Documentation

Using a committee charter or incorporating relevant language into the plan document is a best practice for plan sponsors. The plan document or charter should define the committee structure and its responsibilities.

Documentation should include the number of members, the required presence of senior officers, the reporting relationship to senior management (or board, if applicable), the selection and removal process of members, the purpose and frequency of meetings, voting procedures and guidelines, as well as the procedure for generating minutes for each meeting.

The level of detail in these governing documents will vary. More is not necessarily better. What's essential is the framework. If the committee finds it helpful to be guided

by more details, that is fine, but it's critical to ensure that the committee is actually operating as the documentation describes.

Written documentation extends to committee meetings. Each meeting should be documented with minutes to be reviewed and approved by the committee. Once again, copious detail is not required. What is important is to have a clear and concise record of who attended the meeting, high-level descriptions of issues discussed, and action items agreed upon.

Vanguard encourages plan sponsors to take documentation seriously. Litigants, courts, and regulators will look at meeting minutes when assessing cases of potential fiduciary breach. Careful documentation is critical in establishing procedural due diligence—a key factor in demonstrating good fiduciary practices. By maintaining careful minutes and holding regular meetings, plan fiduciaries can keep their focus on their duties as well as help minimize personal liability.

Vanguard
encourages
plan sponsors
to take
documentation
seriously.



Plan investment

Investment selection and monitoring

Under ERISA, fiduciaries are held to an extremely high standard—the “prudent expert” standard as discussed in the fundamentals section. A plan fiduciary must act: “. . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use . . . ”

ERISA’s standard of prudence for fiduciaries is not that of a prudent layperson, but rather that of a prudent investment professional. A lack of familiarity with investments is no excuse; according to some court rulings, if fiduciaries are unsure what to do they are expected to retain professional advisors to make recommendations.

In this section, we summarize best practices around investment selection and monitoring:

- **Ensure** an understanding of your investment portfolio’s purpose and objective, with a clear definition of success.
- **Adopt** an investment strategy with expectations for both risk and return, including selecting a default fund in a participant-directed DC plan.
- **Create** a well-defined process for hiring, evaluating, and terminating investment managers.
- **Adhere** to an Investment Policy Statement (IPS).



ERISA embraces a modern portfolio view

and recognizes the benefits of diversification. What matters is not the individual risk of a specific investment, but how the entire portfolio seeks to manage risk and return.

Best practice—Investment purpose, objective, and measures of success

Investment committees should have a well-articulated view of the goals and objectives for the plan assets they are overseeing, and well-defined metrics for success. This concept is incorporated in the regulations issued under ERISA, written originally in the context of DB plans. Plan fiduciaries should select investments:

“ . . . reasonably designed . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other returns) . . . ”

The DOL goes on to say that plan fiduciaries should take into account the diversification of plan assets, the plan’s liquidity and current income needs, as well as the projected rate of return on the portfolio relative to the plan’s funding objectives. In other words, plan investments should be based on the program’s goals and objectives—to fund the obligations promised to participants under the plan—while factors such as liquidity, risk, return, and funding status should be metrics of success.

Although these regulations were drafted in the context of managing a DB trust, they also provide a helpful framework for DC plan sponsors. In the end, each DC plan participant’s savings objective is to accumulate adequate savings for retirement, and fiduciary decisions should be made with this goal in mind. Sponsors can assess participants’ progress toward this goal by using a variety of metrics: participation rates for plans with voluntary deferrals; combined participant and employer contribution rates; and both asset allocation and contribution-allocation decisions.

At one level, all DB and DC plans have similar objectives—the provision of collective (DB) or individual (DC) assets for retirement. At another level, however, there will be differences among the plans. For example, DB plans will have differing needs for liquidity and current income depending on the ratio of retirees to employees. While DC plans are used primarily for retirement, some plans may have secondary objectives—such as promoting employee ownership through company stock. Vanguard works with plan sponsors to develop plan objectives and measures of success that reflect the unique needs and goals of each specific retirement program.

Best practice—Investment strategy

Under ERISA, plan fiduciaries are given wide latitude in their investment discretion, as Congress did not want to create a set of authorized or government-approved investments for pension plans. Instead it opted for a decentralized approach, relying on the experience and judgment of the individuals serving as fiduciaries in each employer-sponsored plan. Still, the law and regulations provide guideposts to help fiduciaries select appropriate investments.

ERISA embraces a modern portfolio view and recognizes the benefits of diversification. What matters is not the individual risk of a specific investment, but how the entire portfolio seeks to manage risk and return. Thus plan fiduciaries are not prohibited from offering or investing in high-risk assets—such as volatile common stocks, illiquid private equity, or real estate investments—if in the fiduciaries’ judgment the portfolio in its entirety presents a prudent level of risk and return.

Most fiduciaries will structure their investment program around diversified pools of publicly traded, marketable securities or mutual funds in the three major asset classes: common stocks (equities), bonds, and short-term reserves.

DB investment strategies typically will carefully weigh bond investments—which match the nature of the pension liability—against equity investments that may offer higher returns in the long run. Some pension sponsors are moving toward liability-driven investment (LDI) strategies, which seek to minimize funding volatility by aligning movements in plan assets and liabilities with duration-matching strategies. Investment options offered in DC plan menus often contain multiple equity funds diversified across the asset class.

Because DC plans receive regular payroll contributions and must be able to pay out accounts when participants change jobs, retire, or exercise withdrawal options in the plan, it is more difficult for DC plans to hold illiquid assets. Mutual funds are highly regulated under the Investment Company Act of 1940 and are often desirable in DC plans for a variety of reasons. Participants appreciate the daily pricing of mutual fund shares, which are published and widely available. Also, mutual funds enhance diversification because the funds invest in a variety of underlying securities. In addition to diversification, another benefit of mutual fund investing is the oversight provided by mutual fund providers and their regulator, the SEC. Mutual funds are required to set forth a

well-defined investment objective in a formal prospectus so that investors know the kind of investment they are choosing and the risks involved. In addition, the mutual fund's board of directors has a fiduciary duty to ensure that the fund is operated in accordance with the fund's prospectus. Plan fiduciaries should review the prospectus and the fund's performance as they select and monitor plan investments.

In light of participant fee disclosure regulations and the attention paid to plan costs, some plan sponsors offer collective trusts as options in their core investment lineup instead of mutual funds. Collective trusts are pooled investment vehicles created and maintained by a bank or a trust company, subject to regulation by banking regulators, and available only to certain tax-qualified retirement plans. Collective trusts are not mutual funds and,

A fundamental responsibility of plan fiduciaries is to hire, evaluate, and, as necessary, terminate money managers for the plan.

therefore, are not subject to regulation by the SEC. The expense ratios may tend to be lower than analogous mutual funds because of lower regulatory reporting costs and larger initial investment requirements. In addition, vehicles such as collective trusts may have more flexibility than mutual funds with regard to the structure of fees. Plan sponsors are not required to select the lowest-cost investment. Instead, plan fiduciaries are required to make sure the investment is prudent based on a variety of factors as discussed throughout this guidebook.

DB plans will often have the flexibility to invest in a range of less-liquid investments—subject to the provision that they are part of a prudent and diversified portfolio. Liquidity requirements need to be considered if large amounts of benefit payments may need to be made in a short time frame. Again, mutual funds can play a role in a prudent investment structure to enable certain DB plans to diversify holdings and meet their investment objectives.

Whatever investments are chosen, it is fairly clear what plan fiduciaries should not do—they should not choose investment asset classes or money managers based on “hot” past performance. Instead, they should examine risk-and-return characteristics with a long-term view of performance.

Because risk-and-return characteristics are strongly influenced by a portfolio’s asset allocation, an important decision for plan fiduciaries is to determine an overall asset allocation for the plan’s investments. Risk for a DB plan is related to the funded status, so the asset allocation policy should consider

the pension obligation being covered. In the case of a DB plan, there is a single asset allocation policy, although the policy may be designed to change the asset allocation upon the occurrence of designated events, such as when funded status reaches a certain level. In the case of participant-directed DC plans, plan fiduciaries should offer a broad range of investment options covering multiple investment categories and asset classes.

Developing an investment strategy for a DC plan involves several other aspects. First, sponsors have wide latitude about the number of investment options offered to participants. Technically, to comply with 404(c) regulations, a sponsor need only offer a minimum of three diversified options designed to enable the participants to create an investment portfolio based on risk and return characteristics appropriate for them. However, plan sponsors offer an average of 18 funds in a balanced array of investment options covering four major investment categories: equities, bond funds, balanced or life-cycle funds, and money market or stable value options.² A small number of plan sponsors may offer even more choices, perhaps through a brokerage option.

Second, plan sponsors should evaluate the complexity of the plan investment menu in light of the demographics and investment experience of the participant population. A less-experienced population more likely calls for a simple menu and easy-to-understand choices, such as a target-date fund. For a more knowledgeable and experienced employee population, a wider array of choices may make sense. At the same time, plan fiduciaries are not under any obligation to satisfy every investment desire of the most sophisticated employees in the plan.

² Source: *How America Saves 2019*. Each target-date or target-risk series offered counted as a single fund.

DC plan sponsors should also design their investment menus in concert with their employee education and advice programs. It does little good for a committee to add investment options that participants do not understand. We return to this topic of education and advice in a later section of this guide.

Best practice—Manager evaluation

A fundamental responsibility of plan fiduciaries is to hire, evaluate, and, as necessary, terminate money managers for the plan. This means having in place a disciplined process for manager selection and evaluation. Without such a strategy, plan fiduciaries risk overreacting to the latest performance trends, either positive or negative. If the fiduciaries don't have the proper expertise to select and monitor plan investments they should seek external experts to help.

Evaluation of investment managers incorporates four key elements:

- Evaluating the manager's team and organization.
- Understanding the philosophy that guides the manager's firm.
- Understanding the firm's process and its consistency over time.
- Analyzing performance over time in light of the firm's philosophy and process.

No single qualitative or quantitative factor will determine whether an investment option should be added, retained, or eliminated; however, certain factors may carry more weight in the final analysis. When evaluating investment managers, other considerations include changes in the fund manager's investment philosophy and changes within the manager's organization.

On an ongoing basis, investment committees should evaluate whether investment managers are achieving the goals set for them within the plan's investment strategy. Committees should examine performance relative to indexes and peers, as well as look at style consistency.

Investment performance should be reviewed regularly on a benchmark and peer-group basis. Monitoring the plan's investments is fundamentally the fiduciary's responsibility. Even in cases where an ERISA investment manager is appointed, the plan fiduciary retains ultimate responsibility for selecting and monitoring the investment manager. Vanguard assists fiduciaries by providing detailed performance and portfolio information on the plan's investments.

Vanguard meets regularly with all of our investment managers, monitors them carefully for consistency with portfolio strategies and style, and negotiates aggressively on fees. Our use of independent money managers for many funds also allows us to negotiate portfolio and fee relationships at arm's length. Our institutional advisory team is highly qualified to assist plan fiduciaries with their duty to monitor investments.

Best practice—Investment Policy Statement

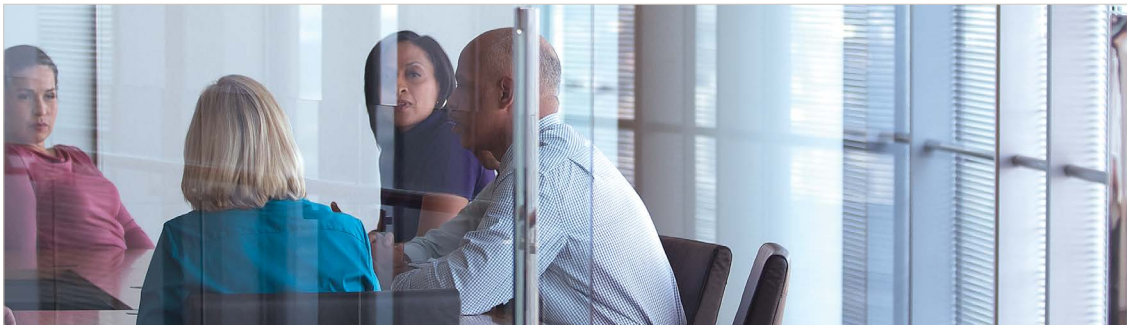
A simple best practice is to document your investment decision-making in your plan's Investment Policy Statement (IPS). The IPS defines the purpose, objectives, and measures of success for the plan; it summarizes the plan's investment strategy; and it describes the process for evaluating money managers. The IPS should detail performance measurement and the frequency of reviews. Parameters also should be established to determine when the committee should consider eliminating investments or managers.

Once an IPS is created, the committee must adhere to it unless it's imprudent to do so. Any departure from the IPS should be documented, including the reason why. Committees should review the IPS annually to ensure that it continues to reflect the plan's objectives and meet the needs of the plan's participants. While changes to the IPS are expected to be infrequent, possible causes for change may include major shifts in workforce demographics, significant growth of the plan, and the performance of existing investment options.

Section 404(c) compliance and other considerations

Under ERISA, a plan's fiduciaries assume all legal responsibility for a retirement plan's investments. Yet, with the growth of self-directed DC plans, it is clear that employers have effectively delegated investment control and discretion to plan participants. Plan sponsors have an indirect influence over a participant's investment results, principally by selecting the menu of options offered in the plan.

Acknowledging this shift in investment responsibility, Section 404(c) of ERISA and corresponding DOL regulations limit an employer's liability for investment losses resulting from investment decisions made by plan participants if certain requirements are met.



The 404(c) status is optional, but if an employer chooses to follow the requirements of 404(c), relief of some fiduciary responsibility for the investment decisions made by participants is available—an important shift in legal liability for a plan’s investment holdings. The liability relief is limited—employers are still responsible for selecting prudent and diversified investment choices, as well as for monitoring the investment options and managers provided to participants. The 404(c) relief applies when the participant assumes effective control of investments or when participant assets are invested in a qualified default investment alternative (QDIA). Employer contributions directed to company stock, or participant money invested in a default fund other than a QDIA, remain the full responsibility of plan fiduciaries.

Because 404(c) offers important fiduciary protections, Vanguard recommends all participant-directed DC plans follow these best practices:

- Seek to qualify as a 404(c) plan as well as offer a QDIA as the default fund.
- Conduct a periodic analysis of 404(c) status.
- Satisfy the 404(c) rules for company stock.

Best practice—Qualify for 404(c)

Section 404(c) offers important benefits in the event of any participant litigation regarding plan investments. From Vanguard’s perspective, this potential benefit alone justifies the relatively small effort needed to comply with the regulation.

There are a few requirements necessary to comply with section 404(c). The plan must offer a minimum of three diversified options designed to enable the participants to create an investment portfolio based on risk and return characteristics appropriate for them. Participants must have the right to change investment instructions (i.e., exchange investment funds or change contribution allocations) at least quarterly. Since DC plan fiduciaries may find that some participants abuse their daily trading privileges by engaging in market-timing, the DOL has stated that imposing appropriate trading restrictions does not interfere with 404(c) compliance.

Because 404(c) offers important fiduciary protections, Vanguard recommends all participant-directed DC plans follow these best practices.

The release of participant fee disclosure regulations under 404(a)(5), which apply to participant-directed plans regardless of whether such plans qualify for 404(c) protection, resulted in changes to ERISA 404(c). The disclosure requirements under 404(c), designed to enable the participant to be an informed investor, have been replaced by the participant fee disclosure rules. To qualify for 404(c) protection, plan sponsors must follow all of the requirements of the fee disclosure regulations under 404(a)(5).

Of course, satisfying 404(c) must go hand-in-hand with the other best practices listed in this document: ensuring that the committee understands the rules and provisions of 404(c); having a disciplined process for selecting plan investments; and ensuring that all plan documents and communications are up-to-date and reflect the plan's 404(c) status.

Best practice—Conduct a 404(c) analysis

Another best practice is for plan fiduciaries to conduct a periodic analysis of 404(c) compliance with external counsel or consultants. The review should include all aspects of compliance—not just the technical rules of 404(c), but the related issues of plan documentation, investment review processes, and training and awareness for the plan's fiduciaries. While the participant fee disclosure regulations may have simplified 404(c) compliance by governing many of the disclosures formerly required under 404(c), conducting periodic 404(c) reviews remains a good practice.

Best practice—Review company stock and 404(c)

As noted above, 404(c) protection is unavailable for any plan contributions that the employer directs into company stock. However, if a plan offers company stock as one of its investment options, and participants choose to direct money (their own or employer contributions) into the stock, those assets may be eligible for 404(c) protection.

There are additional rules that must be followed with respect to 404(c) protection for company stock:

- The employer securities must be publicly traded on a national exchange or other generally recognized market.
- The employer securities must be traded with sufficient frequency and in sufficient volume to ensure that participant directions to buy or sell the securities may be acted upon promptly and efficiently.
- Information provided to shareholders of the employer securities must be provided to participants whose plan accounts are invested in employer securities.
- Voting, tendering, and similar rights with respect to employer securities must be passed through to participants. In addition, a 404(c) plan must include procedures designed to safeguard the confidentiality of information related to participant-directed transactions involving the plan's employer securities.

The plan also must designate a fiduciary to monitor compliance with these procedures. If the designated fiduciary determines that a conflict exists (in the case of a tender offer or contested board election), an independent fiduciary must be appointed.

Best practice—Qualified default investment alternative (QDIA)

In an individual account DC plan, plan fiduciaries should select a default fund. The default fund is used when a plan participant fails to make an investment selection for his or her elective contributions or for an employer contribution, or in cases where participants are automatically enrolled in the plan.

Ordinarily, when the plan participant fails to exercise a choice, the plan fiduciaries are responsible for the investment of plan assets in the plan's default investment. As an exception to this general rule, plan sponsors are afforded fiduciary protection of ERISA Section 404(c) by utilizing a QDIA as the plan default fund. Generally, a default fund will qualify as a QDIA if it is a target-date fund, a balanced fund, or a managed account option—and if notice requirements are satisfied.

When selecting the type of fund to be designated as a QDIA, a plan sponsor is afforded fiduciary relief regardless of the type selected. This means, for example, that a sponsor cannot be second-guessed on whether a balanced fund would have been a "better" choice than a target-date fund. However, plan fiduciaries continue to have responsibility for the selection and

Plan sponsors are afforded fiduciary protection of ERISA Section 404(c) by utilizing a QDIA as the plan default fund.

monitoring of the investments offered under the plan as well as the selection and monitoring of the QDIA to be used as the plan's default investment.

In practice, the vast majority of plan sponsors select a target-date fund as a QDIA. It's important for sponsors who serve as plan fiduciaries to make a prudent decision about the target-date funds in their investment lineup. The DOL has published informal guidance, framed as "tips," addressing fiduciary responsibilities with respect to target-date funds. The tips are suggested best practices; they are not official regulatory guidance. In the tips, the DOL alerts sponsors to the considerable differences among various target-date fund investment strategies, glide paths, and investment-related fees and recommends the following steps fiduciaries should take when selecting target-date funds.

- 1. Establish a process for comparing and selecting target-date funds.**
- 2. Establish a process for the periodic review of selected target-date funds.**


In these first two points the DOL reminds plan sponsors to follow a prudent, deliberative process when selecting and monitoring target-date funds. The investments should be investigated fully and reviewed periodically. Consideration should be given to prospectus information, such as performance (investment returns), fees, and expenses. When selecting funds, sponsors should evaluate the costs and benefits of an index (passive) versus active approach, keeping in mind expected performance, risks, and fiduciary responsibilities. The review process should examine whether there have been any significant changes in the information fiduciaries considered when the funds were selected or last reviewed.

- 3. Understand the fund's investments—the allocation in different asset classes (stocks, bonds, cash), individual investments, and how these will change over time.**

Sponsors should understand how the target-date fund is constructed. It is critically important to be comfortable with the underlying investments and to be conscious of the glide path, including when the fund will reach its most conservative asset allocation and whether that will occur at or after the target date. The chosen funds' asset allocation shift through time should match the investment committee's view of the appropriate risk/return tradeoff for participants at each stage of life, as well as include exposure to asset classes the committee believes can add value.

- 4. Review the fund's fees and investment expenses.**

Small differences in investment fees and costs can have a big impact on reducing long-term retirement savings. See the Plan Costs section for further information.

The image shows a close-up of a report titled "How America Saves 2018". The report has a white cover with a large, stylized star logo in the center. The star is composed of several smaller stars, creating a layered effect. Below the star, the title "How America Saves 2018" is printed in a serif font. Underneath the title, in a smaller font, it says "A report on Vanguard 2018 defined contribution plans". The report is resting on a surface, and its edges are slightly blurred. In the background, another document with a bar chart is visible but out of focus. The top left corner of the image features a light blue background with a white geometric pattern of overlapping triangles.

How America Saves 2018
A report on Vanguard 2018 defined contribution plans

Small differences in investment fees

and costs can have a big impact on reducing long-term retirement savings.

5. Inquire about whether a custom or nonproprietary target-date fund would be a better fit for your plan.

Generally, plan fiduciaries should consider all reasonable options when selecting the plan's investment lineup. Sponsors considering a customized approach should be convinced that either (1) the approach offers a significant expected performance advantage—net of costs—versus a packaged solution or (2) their participants differ both systematically and significantly from typical plan participants in such a way that a unique approach at a fund level adds value.

6. Develop effective employee communications.

The DOL points out that just as it's important for the plan fiduciary to understand target-date fund basics, the employees who will be investing their retirement dollars also require sufficient information.

Best practice—Reenrollment into a QDIA

As a result of the PPA, reenrollment emerged as a plan design strategy to improve portfolio diversification. With reenrollment, current participants' account balances in the plan are transferred into the plan's QDIA, with an opt-out right for participants preferring to retain their existing asset allocations. This strategy has the dual benefit of improving diversification of plan assets and assisting plan sponsors in limiting fiduciary liability. Such a

strategy may be used in a variety of settings, including conversions to a new recordkeeper, menu changes to a plan's investment lineup, or when there are participant portfolio construction concerns. A plan sponsor's decision to reenroll participants into the QDIA may relate to: a specific investment option; a subgroup of participants; or the entire plan. Importantly, if the plan sponsor follows this reenrollment approach, and adheres to the procedural requirements in the QDIA regulations, participants will be deemed to have exercised control over their accounts and plan fiduciaries will not be liable for any investment losses incurred by these participants related to the reenrollment.

Best practice—Fund mapping

The PPA extends the fiduciary protection of ERISA Section 404(c) to plan sponsors who are mapping participants' assets from one investment option to another, provided the mapping is a "qualified change in investment." A qualified change in investment occurs if assets invested in the eliminated option are reallocated to a remaining or new option in the plan that is "reasonably similar" to the old option in terms of risk and return, and participants are notified of the change at least 30 days—but no more than 60 days—before the change. The notice must provide participants with an opportunity to make an affirmative election to move money to another investment option before the mapping occurs.



Costs matter

Plan costs

The law generally views plan costs in two broad categories: costs derived from settlor functions and plan administrative costs. Settlor functions include discretionary activities that relate to the establishment, design, and termination of plans. Expenses incurred as a result of settlor functions ultimately benefit the employer and cannot be paid from plan assets. The plan sponsor must pay these expenses as it would any normal business expense. In fact, plan fiduciaries have a duty to ensure that no settlor costs are ever paid by the plan. ERISA's fiduciary duty rules require that plan sponsors ensure that plan assets are used exclusively for paying plan benefits or defraying reasonable administrative expenses.

Costs of plan administration matter. Generally, lower costs will lead to higher after-expense investment results. As a result, for a DB plan, required employer contributions will be lower, and for a DC plan participant,

retirement savings will be higher. Over a working career, the benefits of a low-cost retirement program can be substantial.

Research suggests that investors tend to be aware of direct costs, but not indirect fees. In the case of retirement plans, our experience is that plan sponsors who write a check for a service are often well aware of the fee they are paying. Similarly, participants are well aware of fees that appear as direct charges on their statements. What some sponsors and many participants ignore, however, are the indirect fees deducted as investment charges against their plan assets.

Plan costs, both investment and recordkeeping, continue to be the focus of ERISA litigation. It is important for plan sponsors and participants not only to understand the direct plan costs but also to understand the less-visible, indirect costs.

A close-up photograph of a hand typing on a black computer keyboard. The background is blurred, showing a computer screen with a geometric pattern of white lines. The lighting is soft and blue-toned.

The challenge for plan sponsors and participants

is not only to understand the direct plan costs
but also to understand the less-visible, indirect costs.

Best practice—Disclosure

The DOL has recognized that plan sponsors and participants need better tools to evaluate the costs associated with the plan and its investment options. The DOL has implemented a three-step approach to assist plan sponsors in fulfilling their fiduciary obligations with respect to fees by requiring disclosures to:

- The government—through enhanced Form 5500 reporting—that requires plan sponsors to disclose additional information about fees paid to service providers.
- Plan fiduciaries by service providers—through a description of all direct and indirect compensation (e.g., revenue sharing) received from plan assets for services provided to the plan.
- Plan participants—through annual and ongoing notices detailing fees for individual participant transactions and other investment-related information.

Plan sponsors have a fiduciary obligation to complete the disclosures to the government and to participants, and to ensure receipt of the disclosures from all of the plan's service providers. These materials can serve as a basis for plan sponsors to use in evaluating the reasonableness of plan costs.

Best practice—Determine whether fees are reasonable

Unlike settlor costs, costs relating to the administration of the plan and the investment of its assets can be charged to the plan. Administrative costs include: plan amendments to comply with tax-law changes; nondiscrimination and compliance testing; legal, accounting, and actuarial fees to maintain the plan's qualified status; and complying with ERISA's reporting and disclosure requirements. Investment costs include fees paid to investment advisors, as well as expenses for trustee and custodial services. Generally, if the expense relates to the administrative or investment activities of the plan, it can be paid from the plan's assets. In a DC plan, payments may be deducted from individual participant accounts or the plan's forfeiture account.

But even if costs relate to administration of the plan or the investment of its assets, ERISA is clear: Plan fiduciaries must determine that any fees paid by plan assets are reasonable based on the facts and circumstances relevant to that plan. The plan sponsor must obtain and consider the relevant information and then make a prudent decision supported by that information. As with all fiduciary duties under ERISA, it is important that plan sponsors follow a prudent process when making a determination about the reasonableness of fees. Both the DOL and the courts generally defer to a plan sponsor that follows a prudent process and can demonstrate the rationale for its decisions.

The duty to pay only reasonable fees for plan services and to act solely in the best interest of participants has been a key tenet of ERISA since its passage.

Plan sponsors should develop and follow a deliberative process for evaluating the reasonableness of fees. This includes understanding the sources, amounts, and nature of recordkeeping and investment management fees paid by the plan. Under DOL fee disclosure regulation, plan sponsors should be sure they receive service and fee information from each covered service provider, and they should diligently review this information as part of the reasonableness evaluation process.

In addition, there are several important points that a plan sponsor should keep in mind when evaluating fees for reasonableness:

- **Costs are not dispositive.** While it is natural to focus on costs, ERISA does not require a plan sponsor to select the lowest-cost provider or investment option. Other factors, such as service levels, reputation of the provider, and investment performance, may be considered when determining if fees are reasonable.
- **Understand what is included.** The plan sponsor needs to understand what is included in the fee being charged and whether other charges for “a la carte” services will be incurred at a later date.
- **Duty to ask.** Plan sponsors must understand the content of the fee disclosure materials received from service providers. If the disclosure is not clear, or if the plan sponsor believes the information is incomplete, they must request additional information or clarification. Additionally, the plan sponsor may have an obligation to inquire as to the availability of lower-cost investment alternatives, such as lower-cost share classes for mutual funds or the availability of collective trusts.
- **Document, document, document.** Plan sponsors should build a record to document the information and factors used to determine the reasonableness of plan fees. Prudence likely dictates that the plan sponsor review fees and services on at least an annual basis.

Tools for determining reasonableness

In support of a prudent process, plan sponsors and service providers have worked together to develop tools and methodologies for analyzing plan fees, ranging from periodic review of fee disclosures to requests for proposals.

Benchmarking is one of the most widely used supplements to fee disclosure reports and can help plan sponsors put into context the information contained in the reports. The use of third-party studies provides a cost-effective way to compare plan fees with the marketplace. Plan sponsors may elect to engage a consultant to assist in the benchmarking process. For a fee, consultants can give plan sponsors a third-party perspective on quality and costs of services. It is important to understand the plan (e.g., plan design, active or passive investment management, payroll complexities, etc.) as it relates to the benchmarking information in order to put the results in an appropriate context. By understanding all of the fees and services, a plan sponsor can make an accurate “apples-to-apples” comparison.

For example, it would not be appropriate to compare the investment advisory fee for a DB plan with the expense ratio of a commingled fund or separate account in a DC plan. The latter is typically higher because it includes both investment

management and administrative services fees (such as daily transaction activity) that are generally not incurred by DB plans.

Although not required under ERISA, plan sponsors seeking additional data specific to their particular plans may issue a request for information (RFI) or request for proposal (RFP) from the current or other service providers. Generally, an RFI is used to gather written responses to specific questions while an RFP seeks detailed information from respondents, resulting in the submission of competitive bids for services. While these tools are comprehensive ways to benchmark plan fees and services, they are also the most expensive and time-consuming. Before proceeding with either of these approaches, plan sponsors should consider the costs (economic and time) as compared to the benefit of conducting an RFI/RFP.

The duty to pay only reasonable fees for plan services and to act solely in the best interest of participants has been a key tenet of ERISA since its passage. Plan sponsors employing a disciplined and diligent approach to reviewing and negotiating fees can feel confident in their compliance with these duties.

ERISA does not specifically address how plan sponsors should allocate fees for services.

Best practice—Fee allocation

In addition to determining the reasonableness of plan fees, plan sponsors should adopt a philosophy for allocating those fees to participants and review their plan's method for allocating fees to ensure it complies with that philosophy. ERISA does not specifically address how plan sponsors should allocate fees for services. Recognizing this lack of guidance, the DOL issued a field assistance bulletin that provides a framework for making fee allocation decisions. Under this guidance, plan sponsors have considerable discretion in determining how to allocate fees, provided that the method used for apportioning costs is reasonable based on each plan's specific facts and circumstances.

Although not common practice, some plan sponsors have elected to incorporate their fee allocation methodology in the plan document. Where the plan document sets forth the methodology, plan sponsors should follow the rules of the document. Absent such plan document direction, plan sponsors should use a reasonable method to apportion costs.

In line with the DOL guidance, the most common methods of fee allocation are:

- **Per capita.** Fees are spread equally across participants using a per capita methodology. All participants pay the same fee regardless of account balance.
- **Pro rata.** Fees are allocated on an asset basis. Participants with a lower account balance pay less for plan services while participants with a higher account balance may pay more.
- **Per use.** Fees are charged to an individual participant for certain services he/she elects to utilize (e.g., a loan fee).

Understanding the fee structure and sources of revenue generation is critical in determining not only if fees are reasonable, but how those fees should be allocated. When selecting a fee allocation methodology, plan sponsors should be aware of various ways that plan revenue may be generated and ultimately utilized to offset other plan fees. For example, certain funds may pay a portion of their expense ratio to a recordkeeper for the administration, distribution, or marketing costs related to offering the fund on a recordkeeper's platform (i.e., revenue sharing). The amount of revenue sharing generated by an investment may vary depending upon the share class selected by the plan sponsor. Often, all or a portion of this revenue is used by the recordkeeper to offset or reduce recordkeeping fees that would otherwise be charged to the plan.

While not required under ERISA or the DOL guidance, some plan sponsors may also try to offset the impact of revenue sharing by “rebating” the amounts to participants invested in the fund generating the revenue share. Alternatively, a plan sponsor may implement a “wrap fee” to equalize the revenue sharing structure by layering an additional cost component over the expense ratio to ensure that all investments generate the same level of revenue sharing.

Plan sponsors should carefully consider which method, or combination of methods, is most appropriate for their plan and its participants based on their particular facts and circumstances. Generally, plan sponsors should assess the types of fees being charged to the plan, allocation options, plan design, asset size, participant demographics, and the philosophy of the benefits program.

Throughout the review process the facts considered, evaluation process, and allocation method selected should be well-documented. Even though plan sponsors have broad discretion in the selection of allocation method, they must be cognizant of other related issues, including disparate treatment of active employees versus terminated employees and compliance with the exclusive benefit rule.

Regardless of which allocation method is selected (i.e., per capita, pro rata, per use, or a combination thereof), ERISA demands that the fees themselves be reasonable and the DOL guidance requires that there be a rational, prudent basis for the method chosen for allocating fees.

Plan administration

Administrative oversight

Broadly speaking, it is the duty of plan fiduciaries to maintain plan and employee records, adjudicate benefits claims and appeals of claim denials from participants, and file all reports, notices, and statements required by law.

The cornerstone of effective plan administration is the plan document, which stipulates how fiduciaries will handle administrative features of the plan. There are five best practices in this area:

- Ensure that the administration of the plan conforms to the written plan document and any administrative policies and procedures for the plan.
- Maintain an up-to-date plan document and conduct a periodic compliance review.
- Comply with nondiscrimination testing and other compliance rules.
- Exercise prudence in selecting and monitoring service providers.
- Prudently select and monitor service providers.

Best practice—Plan documents and the management process

Plan fiduciaries should ensure that the processes used to administer the plan conform to the written plan document, unless the plan does not comply with ERISA or unless following the document would otherwise conflict with the fiduciary duties imposed by ERISA. In the rare instance where the plan document conflicts with ERISA's fiduciary duties, the plan fiduciary may need to deviate from the plan document provided they take steps to detail the reason the plan was not followed, and then either amend the plan or change the procedure as appropriate.

One of the simplest measures of quality for plan fiduciaries is the extent to which there is alignment between procedures and the plan document. To ensure that the plan document and procedures are aligned, a good practice is for employers to review plan transactions periodically—for example, employee contributions, employer contributions, withdrawals, terminations, loans (if offered), DB pension calculations, qualified domestic relations orders (QDROs), uncashed check/missing participant procedures, and so forth. Working with their recordkeeper, plan fiduciaries can ensure that transaction processing conforms to the plan document language.

At Vanguard, an independent accounting firm audits the internal controls of our recordkeeping system annually. The Service Organization Control 1 (SOC 1) Report is prepared in accordance with the American Institute of Certified Public Accountants (AICPA) AT Section 801 (AT 801), *Reporting on Controls at a Service Organization*. The report, provided to plan sponsors annually, offers a description of the controls designed for achieving the control objectives and ensuring effectiveness of those controls operations that are most likely relevant to the plan financials. An independent audit firm is also engaged to evaluate Vanguard's security controls against the Trust Services Principles published by the AICPA. The results of this evaluation and a description of our Information Security Program is published in a Service Organization Controls Report (SOC 2) and available to plan sponsors.

Best practice—Current documents and compliance reviews

Plan fiduciaries should review and maintain their plan document in compliance with current regulations. This means updating or amending documents as necessary in a disciplined fashion and making sure that the plan document and the summary plan description (SPD) are current.

Congress and the regulatory agencies periodically update and modify rules applicable to plans. Plan fiduciaries are responsible for ensuring that the plan document continues to conform to all laws and regulations. Most notably, these include tax rules from the IRS and fiduciary and disclosure rules from the DOL. As we have noted before, plan fiduciaries should also ensure compliance with PBGC rules (in the case of DB plans) and any SEC regulations (for mutual funds and company

stock). As a result, it is important that plan fiduciaries keep apprised of legislative and regulatory changes and make modifications to the language in the plan document and the administration of their plan when warranted.

Vanguard has a strong presence in Washington, D.C. Vanguard clients can rely on our legislative and regulatory updates, including our regulatory briefs, Strategic Retirement Consulting commentaries, webcasts, and videos. These resources identify strategies to help plan sponsors respond to legal and regulatory changes.

Plan fiduciaries should review their plan document for compliance with current regulations. This means updating or amending documents as necessary, in a disciplined fashion, and making sure that the plan document and the summary plan description are current.

Best practice—Nondiscrimination and compliance testing

All qualified retirement plans must satisfy complex coverage and nondiscrimination testing requirements in order to qualify for the special tax treatment afforded these plans under the Internal Revenue Code. In addition, most plans that permit employee elective deferrals must satisfy a special nondiscrimination test designed to ensure that highly compensated employees are not permitted to contribute disproportionately to the plan compared to nonhighly compensated employees. If highly compensated employees make contributions at a significantly higher rate, the plan must refund their contributions, make additional contributions on behalf of the other employees, or risk losing the plan's status as a tax-qualified retirement plan.

There are a variety of strategies that plan sponsors can pursue to satisfy these requirements. A simple approach is for plan sponsors to limit the highly paid to a contribution rate (e.g., 6% or 8% of pay) that will allow the plan to satisfy testing requirements each year. In Vanguard's view, this is the least attractive strategy, as it frustrates the retirement objectives of highly paid employees and accommodates the low savings rates of nonhighly paid employees.

Plan fiduciaries who face testing issues can pursue alternative approaches that will lead to better retirement outcomes for plan participants instead of "capping" the highly paid, including:

- Automatic plan design strategies, such as automatic enrollment and automatic annual increases, to raise participation and savings rates among the nonhighly paid.
- Modernize existing automatic plan design strategies to increase the plan's automatic enrollment and automatic increase default rates.



- Safe-harbor plan designs, where in exchange for meeting certain contribution, vesting, distribution, and notice requirements, a plan sponsor is able to avoid the requirement of nondiscrimination testing.
- Targeted education programs to boost participation among the nonhighly paid.

Vanguard is able to assist our clients in evaluating all of these strategies. Other Vanguard departments assist with ensuring that plans are administered in compliance with all other federal tax limits and restrictions.

Timely remittance of contributions is an important priority for DOL enforcement, and all employers should do everything possible to remit employee contributions as soon as reasonably possible.

Best practice—Contributions, notifications, and claims

Three other administrative responsibilities are worth highlighting: the timeliness of remittance of employee contributions to the plan, participant notifications, and the claims appeal process.

Employee contributions. Employee contributions (including any applicable loan repayments) that are deducted from employees' pay are plan assets, not employer assets. The DOL requires timely remittance of all contributions to the plan's trust as soon as they can be reasonably segregated from the employer's assets. In large organizations, timely remittance typically means that contributions occur on payday or a few days later. However, the rule is that employee contributions must reach the trust no later than the 15th business day in the month after the month the contributions were withheld. The 15 business days of the following month set forth in current regulations is not a safe harbor, it is an outer limit. The DOL has created a safe-harbor period for plans with fewer than 100 participants. Under the safe harbor, participant contributions will be deemed to comply with the law if those amounts are deposited to the trust within seven business days after the date the amounts were withheld. Timely remittance of contributions is an important priority for DOL enforcement, and all employers should do everything possible to remit employee contributions as soon as reasonably possible.

Participant notifications. There are a variety of notice requirements imposed on plan sponsors under ERISA. Generally, changes in benefits must be communicated in a disciplined fashion in accordance with regulations, by updating the summary plan description (SPD) or providing separate notice. ERISA has specific rules indicating how these changes should be incorporated in plan documents and communicated, so that participants understand what rights and features they have under the plan. The SPD is a critical document for participant communication. Fiduciaries should focus on how the SPD is worded, making certain that it is accurate, understandable, and clear.

DOL regulation also requires the plan administrator (typically the plan sponsor) to disclose specific information about fees and investments to participants. These disclosures regarding rights and responsibilities related to the self-direction of investments are intended to allow participants to make better-informed investment decisions. Disclosure must be made to participants in all participant-directed DC plans, not only plans that seek ERISA 404(c) protection. Notice must be provided on or before the date participants can first direct investments and at least annually thereafter, with additional notice required prior to any change to plan-related information. (See the Disclosure portion of the Plan Costs section).

Additionally, fiduciaries should ensure that required annual notices are provided to participants for certain plan designs, including safe-harbor plan designs and plans with a QDIA. Vanguard can provide assistance to help plan sponsors satisfy these notice requirements.

Claims appeal process. Plan documents, and especially the SPD, should contain detailed information regarding how a participant files a claim for benefits and the appeal process for a denied claim. ERISA has specific rules on the steps a sponsor must take to deny a claim, including the timing of the notice of denial and the contents of the notice. Communicating and following the claims process is important because participants may not pursue a lawsuit in the retirement-plan context until the claim's remedy procedures are exhausted. Plan sponsors should also consider adding a provision in the plan document that clearly defines a limitations period for initiating lawsuits that assert claims for benefits under the plan. ERISA does not contain an explicit statute of limitations for initiating such lawsuits. However, recent court decisions support a limitations period that is reasonable, that may begin prior to the plan's claims appeal process, and that does not conflict with any other controlling statute.

Best practice—Selecting and monitoring service providers

Under ERISA, the obligation of prudent selection and monitoring extends beyond the investments offered under the plan. Plan fiduciaries must ensure that advice fiduciaries, consultants, record keepers, and other service providers are prudently selected and monitored on a regular basis. Selection should be based on multiple factors, including level and quality of service provided, cost for services, and the provider's industry reputation. Plan fiduciaries should also create a process to regularly monitor the provider to ensure that the provider continues to deliver the services for which it was engaged and is performing up to or beyond the agreed-upon standards.

Additional fiduciary considerations



For fiduciaries of both defined contribution and defined benefit plans, there are additional fiduciary topics to consider, including minimum funding requirements for DB plans, the use of alternative investments, investment advice, and retirement solutions.

DB plan sponsors have a fiduciary duty to make required contributions to the plan and to invest plan

assets appropriately so that the plan can fulfill its payment obligations to plan participants and beneficiaries. DC plan sponsors should contemplate the fiduciary implications of offering other investments, such as company stock and brokerage accounts. Finally, plan sponsors should consider the importance of participant education, investment advice, and the availability of lifetime income solutions, both inside and outside of the plan.



Pension benefits

Defined benefit plans

The core fiduciary duties that have been discussed to this point are applicable to both defined contribution and defined benefit plan fiduciaries. These duties include:

- Ensuring that plan assets are used for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan;
- Meeting the “prudent expert” standard;
- Prudently investing plan assets, making sure that they are properly diversified so as to avoid large losses; and
- Administering the plan in accordance with the plan document and all applicable laws.

In addition, defined benefit plan fiduciaries have other responsibilities. These include:

- Monitoring plan funding to ensure that the plan sponsor is satisfying the minimum funding standards;

- Ensuring that benefits are being calculated correctly and that benefits are being paid to participants when due; and
- Prudently selecting an annuity provider for benefit distributions.

Monitoring plan funding

Employer contributions to a DB plan are subject to minimum funding requirements under the IRC and ERISA. These rules are designed to ensure plan assets are sufficient to pay plan benefits.

A failure to satisfy the minimum funding requirements does not result in disqualification of the plan (i.e., the loss of the plan’s tax benefits). Instead, interest accrues on the missing contribution until payment is received, and the plan sponsor may be subject to civil action for failing to make the minimum required contributions. More importantly, though, this underfunding could jeopardize the plan’s ability to pay all promised benefits to participants and beneficiaries.

As a result, ensuring that the plan sponsor is satisfying its obligation to fund the plan is essential for DB plan fiduciaries.

Ensuring correct calculation and payment of benefits

Benefits under a DB plan are generally determined in accordance with a formula outlined in the plan document. Plan fiduciaries will greatly benefit from a “self-audit” to review different aspects of their plan’s operation (including benefit calculation and payment) to ensure that the plan is operating in accordance with the plan document. This self-audit can include assessing the accuracy of census data (including demographic and compensation data), along with spot-checking a sample of benefit payments and participant communications. These steps will greatly aid DB plan sponsors in reducing fiduciary risk.

Selecting annuity providers

In some cases, the fiduciaries of a defined benefit plan may decide to purchase annuities from an insurance company to provide monthly pension benefit payments to plan participants and beneficiaries instead of making the disbursements directly from the trust each month. This can be done as an administrative convenience, or as part of a risk transfer strategy. When doing this, plan fiduciaries are required to prudently evaluate and select the annuity provider, and must take steps calculated to obtain the safest annuity available, unless under the circumstances it would be in the interests of participants and beneficiaries to do otherwise. Fiduciaries should conduct an objective, thorough, and analytical search to select the provider from which they will purchase annuities. In conducting this search, it is not appropriate to simply rely upon a company’s rating as

reported by insurance rating services. Rather, defined benefit plan fiduciaries are required to evaluate a number of factors relating to a potential annuity provider’s claims paying ability and creditworthiness, including:

- The quality and diversification of the annuity provider’s investment portfolio;
- The size of the insurer relative to the proposed contract;
- The level of the insurer’s capital and surplus;
- The lines of business of the annuity provider and other indications of an insurer’s exposure to liability;
- The structure of the annuity contract and guaranties supporting the annuities, such as the use of separate accounts; and
- The availability of additional protection through state guaranty associations and the extent of their guaranties.

Unless they possess the necessary expertise to evaluate such factors, fiduciaries should obtain the advice of a qualified independent expert to assist them.

Situations may occur where the safest available annuity is only marginally safer but disproportionately more expensive than competing annuities. In these situations, particularly where the participants and beneficiaries are likely to bear a significant portion of that increased cost, it may be appropriate to instead choose a competing annuity other than that which was identified as

the safest available annuity. However, when making these decisions, it is critically important that plan fiduciaries avoid potential conflicts of interest. An example of where this could occur is when terminating an over-funded defined benefit plan in which any excess assets will revert back to the plan sponsor after all benefit liabilities have been satisfied. A fiduciary's decision to purchase more risky, lower-priced annuities in order to maximize a reversion of excess assets would violate the fiduciary's duties under ERISA to act solely in the interest of the plan participants and beneficiaries.

Situations may occur where the safest available annuity is only marginally safer but disproportionately more expensive than competing annuities . . . it may be appropriate to instead choose a competing annuity other than that which was identified as safest.



Education and advice

Education and advice

To put it simply, we believe that plan sponsors and participants continue to benefit from advice. It seems unlikely that a plan sponsor will be taken to task by a court—or by the DOL—for offering too much education or too many advice programs.

Considerations

Clearly, many participants need investment education or advice. They are not schooled in the complexities of investment management or the principles of asset allocation and diversification—yet they still have responsibility for making investment decisions under most DC plan designs. Some may be comfortable with investment decision-making, but struggle with setting appropriate savings targets for retirement. In fact, DOL regulation recognizes the importance of investment education and has preserved the plan sponsor's ability to continue to provide educational tools and resources to participants.

In part because of participant inertia, plan sponsors are implementing design strategies intended to improve participation and portfolio diversification in participant-directed DC plans. These design strategies include automatic enrollment plan features and QDIAs. Plan design is critical, but in considering their overall design strategy, plan fiduciaries should also take steps to make informed choices.

While some plan sponsors worry about the legal consequences of offering advice programs, PPA and related DOL guidance continues to support education and advice programs. Vanguard's belief is that effective plan design will provide good alternatives for

participants, and effective education and advice programs will enhance the likelihood that participants will make sound decisions. The end result will be a reduction—not an increase—in fiduciary liability and risk of litigation.

The PPA and subsequent DOL regulations confirm that plan sponsors offering these types of advice programs do not have fiduciary responsibility for the advice provided under the program. The plan sponsor must, however, prudently select and periodically review the entity providing the advice.

Fiduciaries should also consider providing educational programs or tools—for example, a worksheet or an online calculator—to help participants establish their own asset allocation appropriate to their age, risk tolerance, and time horizon. To help simplify the decision-making process, many plan sponsors offer participants professionally managed, diversified portfolios by offering a target-date fund series. Fiduciaries also can offer advice services, which provide both personalized asset allocation strategies and specific investment recommendations to participants.

Vanguard suggests four best practices in this area:

- Focus on plan design.
- Provide an enrollment education program and comprehensive ongoing financial education.
- Offer participant advice.
- Measure and monitor results.

A man in a light blue suit and a woman in a grey suit are looking at a tablet. The man is pointing at the screen with his right hand, and the woman is pointing with her left hand. The tablet displays a financial news website with various articles and a red 'Vanguard' logo. The background is slightly blurred, showing a modern office setting.

Clearly, many participants need investment education or advice.

They are not schooled in the complexities of investment management or the principles of asset allocation and diversification—yet they still have responsibility for making investment decisions under most DC plan designs.

Best practice—Focus on plan design

Plan design is the starting point for any discussion about education or advice. Plan sponsors should have a strong understanding of their employees' needs and work to design a plan that will provide the best alternatives for their participant population. The foundation of a good education and advice program begins with well-defined and diversified investment alternatives. A diversified investment lineup, a QDIA, and automatic enrollment are just some of the design strategies sponsors should consider. Appropriate plan design, coupled with education and advice, can empower participants to make informed decisions regarding retirement savings.

Investment tiering—the grouping of investment options into logical sets—can help simplify participant decision-making. A plan lineup generally includes at least two tiers—one for all-in-one investments such as target-date funds, and a second tier for core index investments. When applicable, the structure may contain two additional tiers—one for active funds and other supplemental investments, and another for a brokerage option. Tiering provides a better framework for participants, helping them to understand the investment options offered in the plan. At the same time, tiering may help plan sponsors fulfill their fiduciary duties by simplifying investment choices for participants and helping participants create more effective investment strategies.

Best practice—Implement education

One of the best practices in employee education—and by now a common practice throughout the United States—is to offer DC plan participants a comprehensive education program, beginning at enrollment. As more plans utilize automatic enrollment, a good enrollment program includes a description of the plan defaults, key dates, and clear information on how a participant can take action on their account.

A traditional enrollment program, if a participant needs to make an affirmative election to enroll, includes:

- Discussion of the tax and savings benefits of salary deferral contributions to the employer's plan.
- Basic investment education on diversification and investment asset classes.
- Tools, such as an investor questionnaire, to help participants set their own portfolio strategy or asset allocation.
- Information on investment options in the plan.

Plan sponsors should also review plan design alternatives to assist participants in saving for retirement. A combination of great plan design and investment information will provide participants with the opportunity to make informed investment decisions for retirement savings.

In terms of ongoing education, best practices are varied, depending on the employer's assessment of their workforce's needs, as well as the methods devoted to ongoing education. At a minimum, ongoing education programs should provide general information about savings rates, risk and reward, and asset classification. The programs can be delivered in a wide range of media and on a range of topics—savings, investments, and retirement planning—related to the plan's objectives.

In Vanguard's view, any additional programs can help mitigate fiduciary risk and assist fiduciaries in acting in the best interests of participants by helping participants construct well-diversified portfolios.

Best practice—Offer advice

Investment education alone does not adequately prepare all participants to make informed investment decisions. Research suggests that some participants are either unwilling or unable to assume responsibility for making decisions about their future. Instead, they need explicit advice on how to make the best use of their DC plan.

Employers are not liable for the specific investment advice delivered if the employer has met its fiduciary duties.

There are many types of advice programs offered by investment managers and others. Some programs provide investment recommendations and leave it up to participants to implement them. Others, such as managed accounts, take control of the participant's account and directly manage the investments. Many managed accounts utilize a third-party advisor to develop customized investment recommendations and implement the program on an ongoing basis.

While some advice programs are provided for no additional fee, others have additional charges and expenses. In keeping with their broad duty to understand all fees and expenses, plan fiduciaries should be aware of the fees and charges being assessed, both explicit and implicit, and should assess whether the costs are reasonable.

Both at the outset and on an ongoing basis, plan sponsors retain an oversight responsibility for advice programs and must ensure that the advisor's skill and methodology are consistent with "prudent" investment practice. In some ways, fiduciaries can think of advice programs as an investment advisor whom they must select, supervise, and, if necessary, terminate. Employers are not liable for the specific investment advice delivered if the employer has met its fiduciary duties. The plan fiduciary is responsible for the prudent selection and periodic monitoring of the designated advisor, and they must engage in an objective process to assess the provider's qualifications, quality of service, and fees.

When making a prudent selection of an advice provider and monitoring that provider on an ongoing basis, plan fiduciaries should assess, at a minimum, the following criteria:

- The advice provider's qualifications, including experience and registration in accordance with applicable federal and/or state securities laws.
- The quality of the advice services provided.
- Willingness of the advice provider to assume fiduciary status and responsibility under ERISA with respect to the advice provided.
- Use of generally accepted investment theories as the basis for the advice provided.
- Reasonableness of fees for the services provided.

Best practice—Set objectives and measure

Our final recommendation is that plan fiduciaries set specific objectives and measurable results for their education and advice programs, particularly for DC plans. Plan fiduciaries should examine high-level measures to gauge the success of their DC programs—including plan participation rates, savings rates, and asset allocations and contribution allocations for investments.

In our experience, plan fiduciaries are most successful coupling effective plan design with their education programs when they set goals for specific behavioral change among targeted groups—for example, getting nonparticipants into the plan or low savers to increase deferral rates.

Employer securities

Company stock

As a plan investment option, company stock provides participants with the means to establish an ownership position in their company in a tax-efficient, convenient manner. Yet it also is fraught with investment and fiduciary risks. From an investment perspective, concentrating a portfolio in company stock can lead to large losses in the event of poor stock performance or company bankruptcy. Because of these risks, company stock has been the basis for the largest number of lawsuits filed against DC plan fiduciaries.

Background

Within DB plans, Congress set an explicit limit for company stock. Plan fiduciaries may invest up to 10% of plan assets in company stock (measured at the time of acquisition). Congress introduced such a rule to decrease the exposure of DB plans to single-stock risk, as well as to protect the PBGC from financial exposure in the event of plan sponsor bankruptcy. Congress did not impose the same rule on DC plans, however, because DC plans were viewed as supplemental savings programs rather than a primary retirement program. Congress also sought to encourage employee ownership.

Although there are generally no investment limits for company stock in DC plans, there are diversification requirements. Under the PPA, participants with employee contributions invested in publicly traded employer securities (other than in employee stock ownership

plans (ESOPs)) must be able to diversify these investments immediately. Amounts invested in publicly traded employer securities that are attributable to employer matching and nonelective contributions must be diversifiable after three years of service. The PPA also requires that notice be provided to affected participants no later than 30 days before the participant first becomes eligible to diversify investments in company stock.

Additionally, plan fiduciaries are still generally subject to a “prudent investor” standard, and, in the wake of company collapses in the 2000s and the more recent economic turmoil, courts continue to define what it means to take “prudent” action with regard to company stock. Meanwhile, sponsors need to make choices in an ambiguous legal environment.

Conflicting duties

A major complication with company stock arises because companies are confronted with two conflicting duties. On the one hand, the company—its board and its management, including executive management and “insiders” on the fiduciary committee—has a duty under federal securities law to disclose any material information to all shareholders, not just plan participants. On the other hand, plan fiduciaries have a duty under ERISA to act exclusively on behalf of plan participants, not the shareholders.



Because company stock is the greatest source of litigation

for plan sponsors today, courts are looking at the process established as well as the documentation of decisions made regarding company stock as an investment option in a DC plan.

This conflict has given rise to a number of “stock-drop” cases where the plaintiffs claim that the company stock was not a prudent investment because the fiduciaries knew (or should have known) about events and circumstances adversely affecting the company stock and took no action with respect to the investment.

There are several techniques that can be used to mitigate the risks of concentrated single-stock holdings, including restrictions on contributions and/or exchanges into company stock. In addition, some plan sponsors require that company stock be included as an investment option by explicitly stating or “hardwiring” it in the plan documents, thereby changing the decision to offer company stock from a fiduciary decision to an employer (settlor) decision. However, in the U.S. Supreme Court decision of *Fifth Third Bancorp v. Dudenhoeffter*,³ the Court took away the effectiveness of “hardwiring” by holding that plan fiduciaries cannot simply defer to the plan document with respect to whether or not to offer and/or retain company stock. Instead, ERISA requires plan fiduciaries to independently determine whether the offering and/or retention of company stock remains prudent. This decision represents a dramatic shift from the lower courts’ decisions which established and applied a presumption of prudence providing deference to plan sponsors holding company stock in their retirement plans (i.e., the Moench⁴ presumption).

Under Dudenhoeffter, a plan fiduciary’s decision to offer and retain company stock is subject to the same standard of review as every other investment option decision for the plan. While company stock is subject to prudent process, the Court did acknowledge that plan fiduciaries need meaningful protections from meritless stock-drop claims. When evaluating the prudence of company stock based on available public information, plan fiduciaries are entitled to rely on the public market as the best estimate of the company stock’s value. If a fiduciary possesses nonpublic information, ERISA’s fiduciary duties would not require a fiduciary to act in an unlawful manner with respect to securities law when determining if company stock remains prudent.

In the area of company stock, there are several best practices for plan sponsors:

- Determine the prudence of company stock as an investment option in the retirement plan, including when the price falls.
- Evaluate the performance of company stock versus that of a market index or an index of similar companies.
- Discourage concentrated holdings in company stock through plan design.
- Communicate the risks of having too much retirement savings invested in a single stock.

³ *Fifth Third Bancorp v. Dudenhoeffter*, 134 S.Ct. 1536 (2014).

⁴ *Moench v. Robertson*, 62 F.3d 553 (1995).

Evaluating stock performance on a regular basis can provide fiduciaries with invaluable information about the stock's risk-and-return characteristics.

Best practice—Determine prudence

In light of ERISA's standards, plan fiduciaries should have a deliberative process, at least once a year but more frequently if needed, to determine the prudence of company stock as a plan investment. Fiduciaries should rely on publicly available information to evaluate the potential risks and returns of the stock and to determine whether the stock should remain an investment option within the DC plan.

In our experience, many committees offering company stock do not have a formal process for evaluating the prudence of the stock. They tend to do so informally and only in the event of a sharp drop in the stock price. Fiduciaries should convene and evaluate the ongoing suitability of the stock as a prudent investment within the plan. Having

a regular process in place, and documenting the decisions of the committee over time, is critical in the event of any problems with the stock or with participant litigation.

The law does not expect plan fiduciaries to be able to anticipate an unexpected collapse in a stock's price. Instead, once new information has become available about the stock, the law does expect fiduciaries to react to it, evaluate it, and determine the ongoing prudence of the stock as an investment option. Because the volatility of individual stocks varies, fiduciaries may want to discuss in advance what type of conditions might warrant an immediate meeting and review of the stock's prudence. For example, a price decline of 50% or more may be unusual for one stock but fairly common in a highly cyclical company. It is worth noting that much of the litigation surrounding company stock is a result of circumstances where the plan fiduciaries failed to carefully and deliberately evaluate the stock on an ongoing basis.

If the company stock no longer appears to be a prudent investment option, the plan fiduciaries can take a number of steps. One is to prohibit future contributions to the stock. Fiduciaries would then notify participants of the change, the risks and potential rewards of the stock, and the need for participants to evaluate the situation and take action if they deem it appropriate. In a more dire case, where there is the likely risk of the stock's collapse, plan fiduciaries may wish to sell the stock on behalf of plan participants and move it to another option. Certainly any dramatic steps should be taken with the

advice of both investment experts and legal counsel. In this situation, many employers retain an independent fiduciary to make the decisions on the participants' behalf.

Best practice—Evaluate stock performance

It is important to evaluate the stock's performance versus a market index and an index of similar companies on a quarterly or semiannual basis, just as fiduciaries do when reviewing the prudence of other investment options in the plan.

Evaluating stock performance on a regular basis can provide fiduciaries with invaluable information about the stock's risk-and-return characteristics. For example, while its long-term prospects may be positive, a stock might be performing poorly when the market is rising simply because of cyclical factors in the industry. Alternatively, the stock may be doing poorly because of substantive business problems, raising concerns about risks to participants and the suitability of the stock as a long-term investment.

Fiduciaries concerned about their ability to make these choices can choose to hire an independent consultant or advisor to guide them or to make the choices for them. In doing so, plan fiduciaries may be shielded from some liability in the event of litigation when participants believe that fiduciaries were conflicted or imprudent in making decisions involving company stock. Keep in mind that fiduciaries always remain responsible for prudently selecting and monitoring the independent consultant or advisor, even if they are not responsible for the decisions made by that consultant or advisor.

Best practice—Discourage concentrated holdings

Fiduciary risks are presumably higher when company stock represents a large percentage of plan assets, and those risks increase with greater exposure.



Fiduciary risks are also a concern when the plan-level concentration might be low, but a specific group of participants takes a concentrated position—for example, the plan-level concentration is 15%, but most of the long-tenured employees hold more than 50% of their assets in company stock.

If the plan or certain participants have a concentrated position, plan fiduciaries should take steps to encourage greater diversification. Diversification is not required legally—only “prudence” is—but any reduction in concentrated stock holdings reduces liability for the plan fiduciaries and the sponsoring employer. Diversification can be both a risk-management technique for plan fiduciaries as well as a good investment practice.

High-stock concentrations are likely to occur when the company matches employee contributions with company stock. Fiduciaries can end the matching contribution in stock entirely or shift to a match that is part stock and part “cash” (i.e., participant-directed). Some employers are reluctant to do this because of their desire to promote employee ownership of the company. Still, it is an effective way to combat concentrated stock positions, and it is also a way to gain 404(c) protection. (The plan cannot qualify for 404(c) protection on the contributions that the employer directs to company stock.)

Explain to participants the benefits of single-stock ownership versus the substantial downside risks, and discourage participants from simply buying the stock because it is rising in value.

Plan fiduciaries may also consider implementing a limitation, or cap, on the amount participants can invest in company stock. This can be done by either limiting the total percentage of a participant’s total account balance that can be invested in company stock or by limiting the percentage of future contributions that may be allocated to company stock.

Best practice—Communicate single-stock risk

Another factor driving concentrated employee holdings is that participants think their employer stock is safer than a diversified portfolio, and they tend to buy the stock after it has risen in value. One solution is to provide regular employee communications about the risks of company stock, making sure that company stock is ranked as the highest-risk asset in the plan. Explain to participants the benefits of single-stock ownership versus the substantial downside risks, and discourage participants from simply buying the stock because it's rising in value. Include these messages not only on statements and in required disclosures, but also in educational materials or in periodic communications to participants. Targeted communications may also be provided to participants who are heavily invested in company stock.

Because company stock is the greatest source of litigation for plan sponsors today, courts are looking at the process established as well as the documentation of decisions made regarding company stock as an investment option in a DC plan.



Brokerage option

Brokerage

As DC plans have grown in importance, sophisticated plan participants have increased their demand on plan fiduciaries for greater investment flexibility. Some plans have responded by increasing the number of fund offerings in their plans. Others have dramatically expanded investment choice by introducing a brokerage account option. The brokerage option may include a very wide universe of mutual funds only, or it may include mutual funds as well as individual stocks and bonds.

For plan fiduciaries and participants, the decision to offer a brokerage option comes with additional risk. Specifically, a plan participant might lose all of his or her retirement savings by failing to diversify—by investing in a concentrated specialty fund or in a volatile single stock. Excessive trading can also deplete retirement savings. From this perspective, a brokerage option might not be considered prudent.

Some legal analysts have suggested that in offering a brokerage option, fiduciaries have offered the universe of options to plan participants and thus are no longer responsible for investment oversight and monitoring. It has always been Vanguard's view that plan fiduciaries still retain some investment oversight responsibilities, whether for the plan's core investment lineup or its brokerage option. The DOL expressed a similar view in Q&A-39 of Field Assistance Bulletin 2012-02R in which it states *"a plan fiduciary's failure to designate investment alternatives . . . raises questions under ERISA section*

404(a)'s general statutory fiduciary duties of prudence and loyalty. Also, fiduciaries of such plans with platforms or brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan are still bound by ERISA section 404(a)'s statutory duties of prudence and loyalty to participants and beneficiaries who use the . . . arrangement." Although the DOL has not issued official guidance about the level of investment oversight necessary for investments offered through the brokerage option, unofficial comments have indicated that the DOL believes that investments held in the brokerage option should be subject to some level of fiduciary oversight. The DOL has indicated its intention to issue guidance on this subject in the future.

When deciding to add a brokerage option to the plan, the plan sponsor should:

- Determine whether the brokerage option is a prudent investment, and document the deliberative process and considerations that resulted in this decision.
- Develop good communications and education about the risks of a brokerage option.
- Consider limiting the percentage of a participant's account that may be invested via the brokerage option.



For plan fiduciaries and participants,

the decision to offer a brokerage option comes with additional risk. Specifically, a plan participant might lose all of his or her retirement savings by failing to diversify—by investing in a concentrated specialty fund or in a volatile single stock.

Best practice—Evaluate prudence

When offering a brokerage option within a plan, plan sponsors should determine whether offering it, and the manner in which it is structured, is consistent with the more general requirements that fiduciaries act prudently and in the best interests of participants.

And importantly, plan fiduciaries should have a detailed discussion about the potential impact of the brokerage option on their duty to ensure that plan assets are diversified. In Vanguard's view, low-cost pooled investment vehicles that are broadly diversified—such as many “core” stock and bond mutual funds—are the most appropriate investment solution for plan participants because of their inherent diversification. We believe that these options will best satisfy the retirement savings needs of the majority of participants.

For the average plan participant, the brokerage option may prove confusing or—even worse—hazardous because of access to nondiversified assets. Plan fiduciaries should evaluate this risk carefully and deliberately.

If the fiduciary does decide to offer a brokerage option, they should make sure that it is included in the IPS and clearly document how the decision was made.

Best practice—Communicate risks

As with the plan in general, good communications and education about the brokerage option are essential. Brokerage

enrollment materials should specifically warn participants of the potential risks, including the risks of failing to diversify or trading in excess.

Although it is not absolutely necessary, some plan fiduciaries go further and require that brokerage option participants sign a statement that they are aware of the risks and will seek to invest in a diversified and prudent manner.

Best practice—Set limits on brokerage assets

If a sponsor is concerned about excessive risk and lack of diversification in a brokerage account, one option is to limit the percentage of the participant's account that may be invested in the brokerage option. Such a limit would be especially appropriate if the brokerage option allows investments in individual securities or in very high-risk sector funds. Such a limit is obviously less necessary if the brokerage option is just a way to access a broad range of well-diversified mutual funds.

A simple percentage of account balance is one solution. Another is to limit the brokerage option to specific sources of money—for example, only employee contributions.



Retirement solutions

Lifetime income

Lifetime income

With the shift from DB plans to DC plans, an increasing number of plan participants are at risk of being left without the benefit of a guaranteed, lifetime stream of income in retirement. As a result, some plan sponsors are evaluating ways to provide workers with tools and products that will allow them to receive some form of lifetime income. Examples include annuities, guaranteed minimum withdrawal benefit features, longevity insurance, and managed payouts.

The regulatory landscape related to lifetime income solutions continues to evolve, but at a minimum, sponsors of DC plans that are not required to offer an annuity option should evaluate whether a lifetime income product is appropriate to offer within their plan, and if so, make sure that the plan document contains the language necessary to provide this optional form of benefit.

Best practice—Determine if an “in-plan” or “out-of-plan” solution is appropriate

Plan sponsors should determine whether it is appropriate to offer a lifetime income solution as a feature of the plan (an “in-plan” solution) or to leave the decisions regarding lifetime income solely to the participant (an “out-of-plan” solution). The introduction of an in-plan solution will require that the plan fiduciary engage in a prudent process for the selection of an annuity provider and that decisions be clearly documented.

Best practice—Follow a prudent process

When evaluating in-plan lifetime income options, plan fiduciaries should apply the same standard of care as they would with other fiduciary decisions (such as selecting investment options or service providers). Plan fiduciaries should assess available information on each option to reach a reasonable, informed decision about whether it is an appropriate option for the plan.

While the DOL has not provided comprehensive guidance on how plan sponsors should evaluate lifetime income options, it has issued a regulatory “safe harbor” related to the selection of annuity providers for DC plans. While this guidance applies specifically to the selection of annuity providers, the steps outlined in the guidance can be helpful in evaluating other types of lifetime income solutions as well.

In order to receive fiduciary protection under the safe harbor, a plan fiduciary must:

- Engage in an objective, thorough, and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;
- Appropriately consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;
- Appropriately consider the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract;
- Appropriately conclude that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract; and
- If necessary, consult with an appropriate expert or experts for purposes of compliance with these provisions.

Additional factors that should be considered when evaluating any lifetime income solution include (but are not limited to) the stability of the organization offering the product, the service provider’s experience with offering similar products, fees associated with the product, and any related services, including participant communications and education.

Data security

Data security

In recent years, plan sponsors have noted that cybersecurity concerns have become an increasingly larger area of focus, not only from an operational standpoint, but from a fiduciary standpoint. In addition to holding the retirement assets of millions of workers, retirement plans serve as repositories for vast amounts of personal information, including Social Security numbers, birth dates, addresses, and compensation data (among other things). Although specific legal or regulatory guidance on the topic is lacking, the fiduciary requirements to act in the best interests of participants and adhere to a prudent process suggest that plan sponsors have a responsibility to ensure that all plan information is kept safe. This includes data stored by the plan sponsor as well as information housed by any third-party service providers.

In its 2016 report *Cybersecurity Considerations for Benefit Plans*, the ERISA Advisory Council (an industry group established by ERISA to advise the Secretary of Labor) described a number of basic steps that plan sponsors can take to improve data security and mitigate the risks of cyber attacks. These include understanding the plan's data, developing and implementing a cybersecurity risk management strategy, considering the purchase of cyber insurance, and outlining obligations in contracts with third parties.

Best practice—Understand the plan's data

Before addressing data security concerns, plan fiduciaries need to have a solid understanding of what data is being collected, who has access to it, and how it is being used. It is recommended that plans should maintain and share only the data that is necessary to meet the needs of the plan. This will help to minimize the impact of any potential data breach. Furthermore, plan sponsors should understand how and where data is stored, as well as the length of time that

it is stored. This includes data stored by the plan sponsor as well as data stored by any third-party service providers.

Best practice—Develop and implement a cybersecurity risk management strategy

Plan sponsors should have a flexible, adaptable risk management strategy that is tailored to the needs of the plan sponsor and its service providers. It should identify who has ownership for strategy implementation and monitoring. Any strategy should include clearly outlined objectives; reporting mechanisms; training requirements and procedures; details on data storage, access, and retention; any limitations on how that data is shared; and information on how to evaluate the security programs of third-party service providers (for example, review of the provider's Service Organization Control 2 (SOC 2)), level and frequency of reporting, and type and frequency of testing.

Best practice—Consider purchasing cyber insurance

Traditional insurance policies associated with employee benefit plans may not cover all of the consequences of a cyber breach. For this reason, plan sponsors should evaluate whether it is appropriate to obtain a separate cyber insurance policy. Plan fiduciaries should have a good understanding of what is (and what is not) covered by the policy and how it coordinates with other plan-related insurance policies. Cyber insurance does not offer an all-encompassing solution for plan sponsors, but it can be a useful component of any cybersecurity risk mitigation strategy.

Best practice—Contract with third parties

Vendors selected to provide services should be vetted and services should be provided pursuant to a written contract with the vendor. Contracts should clearly define the obligations of each party and outline the information to which each party will have access.

Doing the right thing

In Vanguard's view, the fiduciary standards underlying ERISA can be summarized by a single phrase: "doing the right thing for plan participants." This means going beyond the technical meaning of a regulation and focusing on the spirit of the law, thereby bringing the highest levels of ethical conduct and fiduciary care to the operation and ongoing management of a retirement program.

About Vanguard Strategic Retirement Consulting

Vanguard Strategic Retirement Consulting drives differentiated outcomes for plan sponsors and participants through an integrated approach that draws upon our expertise, data, and thought leadership. With deep experience spanning plan design, legal and regulatory concerns, fiduciary best practices, investor behavior, and communication strategy, we take a comprehensive approach to retirement plan consulting. Our customized recommendations are backed by data, leading to better retirement outcomes.





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For more information about Vanguard funds, visit institutional.vanguard.com or call 800-523-1036 to obtain a prospectus or, if available, a summary prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

All investing is subject to risk, including the possible loss of the money you invest. Diversification does not ensure a profit or protect against a loss.

Product guarantees are subject to the claims-paying ability of the issuing insurance company.

Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in target-date funds is not guaranteed at any time, including on or after the target date.

Past performance is no guarantee of future returns.