Best practices for plan fiduciaries
Legally, the fiduciary standard of ERISA is one of the highest the law recognizes. Plan fiduciaries are held to an exceptional level of duty and care under the law, including the assumption of personal liability for fiduciary decision-making. All fiduciary responsibilities must be discharged solely in the interest of the plan’s participants and beneficiaries.
To be effective in today’s ever-changing fiduciary environment, you need an experienced partner for knowledge, insight, and support. As head of Vanguard Strategic Retirement Consulting (SRC), I can assure you that our team of actuaries, attorneys, and benefits professionals can help you fulfill your fiduciary responsibilities.

In this booklet, SRC provides a perspective on fiduciary duties and recommends best practices you should consider implementing to minimize risk and achieve positive results with your retirement plans. This guide to best practices will serve as a road map to your fiduciary duties. We hope to clarify—and simplify—what it means to take on ERISA fiduciary responsibility.

While Vanguard provides many services to help clients satisfy ERISA duties, there are certain steps employers need to take on their own. These steps are presented in this guide, as well as in a companion piece that provides a concise checklist to best practices. Vanguard and SRC’s team of strategic consultants are available to help you and your fiduciary committees understand and execute these requirements.

The guide and checklist also summarize many ways Vanguard helps you satisfy your fiduciary responsibilities. Beyond the list of specific services, Vanguard’s unique corporate structure, which helps us avoid conflicts of interest and maintains our singular focus on meeting the needs of our shareholders, is a tremendous advantage for employers.

In short, this Fiduciary Best Practices booklet is designed to educate you and your retirement-plan committee on the key fiduciary duties related to the investment management and administration of your retirement plans.

We hope you find this guide useful. Please contact your relationship manager to discuss any questions.

Sincerely,

Ann L. Combs, Principal
Vanguard Strategic Retirement Consulting
> Introduction
In 1974, Congress enacted the Employee Retirement Income Security Act (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.

> A brief history of pension law
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. More than 80% of all 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, 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. A principal purpose of PPA was to improve the overall funded status of DB plans. The PPA changes represent a complete overhaul of existing funding requirements. Additionally, PPA reflects the evolution of the participant as active decision-maker and provides much-needed protections for plan fiduciaries and participants in DC plans.

More than 80% of all private-sector workers with employer retirement plans have defined contribution accounts.
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 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 (See Figure 1).

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, and monitoring the activities of plan fiduciaries and the plan’s daily operations. The DOL is the regulator and enforcement agency for ERISA and is responsible for the reporting and disclosure provisions of the law.

Figure 1. The U.S. pension regulatory framework

The principal regulatory authorities

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<th>Area</th>
<th>Fiduciary law</th>
<th>Tax law</th>
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<tbody>
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<td>Regulator</td>
<td>Employee Benefits Security Administration</td>
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<td>U.S. Department of Labor</td>
<td>U.S. Department of the Treasury</td>
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Other regulatory authorities

<table>
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<th>Area</th>
<th>DB plan funding</th>
<th>DB accounting</th>
<th>Company stock in DC plans</th>
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Internal Revenue Code and the IRS. The Internal Revenue Code (IRC) governs the tax benefits offered by “qualified” retirement plans. 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 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 SEC.

1 The IRC also contains rules for certain “nonqualified” arrangements; however these plans are generally outside the scope of this guide.
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, a fiduciary is defined in ERISA as someone who: 1) exercises discretion over the management of the plan or 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.

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

- **Exclusive benefit.** Fiduciaries must act for the exclusive purpose of providing benefits to participants and beneficiaries and 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. Fiduciaries must follow the “prudent expert” rule—acting as an experienced or knowledgeable expert might.
**Diversification.** Fiduciaries have a duty to ensure that plan assets are well-diversified in an effort to “avoid large losses.” (There is an exception to this diversification requirement for company stock in DC plans. See the company stock section.)

**Documents.** Fiduciaries must follow the terms of the plan document and other documents governing the plan unless inconsistent with ERISA.

Courts also shape the definition of what it means to be a good fiduciary. In cases against plan fiduciaries related to company stock or plan expenses, the courts are not judging fiduciaries against a standard of perfection but rather a standard of prudence in decision-making. The prudence standard is measured in a normative manner (e.g., customary fund lineup, range of fund choices, relevant disclosure, and procedural due diligence). 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**

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 (See Figure 2).

**Organization of committees.** A fiduciary committee should be carefully organized and staffed with qualified individuals.

**Investment selection and monitoring.** The fiduciaries must set overall objectives and investment strategies for the plan, select appropriate investments in light of these goals and strategies, monitor investment performance on an ongoing basis, and add or remove investments when warranted over time.

**Administrative oversight.** 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.

**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.

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**Figure 2. Overview of fiduciary best practices**

**Principal best practices**

- Organization of committees
- Investment selection and monitoring
- Administrative oversight
- Plan costs

**Additional responsibilities**

- DB plan funding
- Section 404(c) status
- Participant education and advice
- Company stock
- Brokerage accounts

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

**Additional fiduciary considerations**

In addition, 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 in the third section of this guide. These include:

**DB funding.** For DB plan sponsors, a critical duty is to oversee the plan’s funding and its compliance with IRS and the PBGC rules.

**Section 404(c) status.** 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.

**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. Offering such programs is a way of minimizing the plan sponsor’s fiduciary risk, while increasing the likelihood of adequate retirement savings for plan participants.

**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.

**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.
Fiduciary best
practices
Four best practices

at the heart of the fiduciary role include having a well-organized and effective committee, selecting and monitoring plan investments regularly, overseeing plan administration, and monitoring plan costs for reasonableness.

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. 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. 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 (See Figure 3):

• 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.

> Organization of committees
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. 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.

Under ERISA, the members of the fiduciary committee are personally liable for their fiduciary decisions. 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. 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—Documentaton**

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.
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, and according to some court rulings, if fiduciaries are unsure what to do, they are expected to retain professional advisors to make recommendations.

Figure 4. Investment selection and monitoring

- Purpose, objective, and measures of success
- Investment strategy
- Manager evaluation
- Investment Policy Statement

In this section, we summarize best practices around investment selection and monitoring (See Figure 4):

- 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 DC plan.
- Create a well-defined process for hiring, evaluating, and terminating investment managers.
- Adhere to an Investment Policy Statement (IPS).

**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 return) . . .”
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, on the investment side, 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.

In addition, Congress recently provided guidance affording plan sponsors fiduciary protection for the selection of a Qualified Default Investment Alternative (QDIA). This is discussed later in this section.

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—which may offer higher returns in the long run. Menus of options offered by DC plans often contain many different equity funds.

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.

DB plans will often have the flexibility to invest in a range of less-liquid investments—subject to the proviso that they are part of a prudent and diversified portfolio. Liquidity requirements need to be considered if large amounts of benefits 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 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, plan sponsors offer participants professionally managed, diversified portfolios by offering one target-date fund. Fiduciaries also can offer advice services, which provide both personalized asset allocation strategies and specific investment recommendations to participants.
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, most 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. A small number of plan sponsors may offer even more choices, perhaps through a mutual fund window or 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.

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 the last section of this guide.

Best practice—Qualified Default Investment Alternative

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 alternative. 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 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. Below are four key considerations in evaluating and implementing a target-date fund as the QDIA.

**Asset allocation glide path.** The chosen funds’ asset allocation shift through time should match the investment committee’s view of the appropriate risk/return trade-off for participants at each stage of life, as well as include exposure to asset classes the committee believes can add value.

**Passive versus active management.** The costs and benefits of an index (passive) versus active approach should be carefully considered, keeping in mind expected performance, risks, and fiduciary responsibilities.

**Packaged or customized solution.** 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.

**Impact on participant portfolios.** Research shows that sponsor decisions play a critical role in influencing target-date fund adoption rates. Our research also shows that participants use target-date funds in a variety of ways, and that individual participant decisions through time drive the overall impact of target-date funds on plan asset allocations.

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**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.

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.

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2 For a complete discussion on target-date fund construction, see the Vanguard Investment Counseling & Research publication *Evaluating and implementing target-date portfolios: Four key considerations.*
Investment performance should be reviewed quarterly, or at the very least annually, 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 monitoring the investment manager. Vanguard assists fiduciaries by providing detailed performance and portfolio information on the plan’s investments.

Having Vanguard as your investment provider gives you an additional level of scrutiny and protection. 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 portfolio review team is highly qualified to assist plan fiduciaries with their duty to monitor investments. Our use of independent money managers for many funds also allows us to negotiate portfolio and fee relationships at arm’s length.

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.

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.
Vanguard recommends all plan sponsors use an Investment Policy Statement and can assist in the development and review of this document.
Broadly speaking, it is the duty of plan fiduciaries to maintain plan and employee records, adjudicate benefits claims and appeals of claims’ 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 four best practices in this area (See Figure 5):

- 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.
- Ensure the timely investment of employee contributions, recognize the importance of participant notifications, and implement a well-defined claims appeal process.
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 memorialize the reason the plan was not followed, and then either amend the plan or change the procedure.
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), 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. *Reports on the Processing Transactions by Service Organizations* is a report prepared in accordance with the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 70 (SAS70). The report, provided to plan sponsors annually, offers a description of the procedures designed for achieving the control objectives and ensuring effective operations.

**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 plan rules. 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*, SRC bulletins, webcasts, and videos. These resources identify strategies to help plan sponsors respond to legal and regulatory changes.

**Best practice—Nondiscrimination and compliance testing**

For most plans that permit employee elective deferral rules, plan fiduciaries must ensure the plan complies with federal nondiscrimination testing rules. Under such rules, highly compensated employees are not permitted to contribute disproportionately to the plan compared with 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.
- Safe-harbor plan designs, where in exchange for meeting certain vesting, eligibility, and contribution requirements, a plan sponsor is able to avoid the requirement of nondiscrimination testing.
- Targeted education programs to boost participation among the nonhighly paid.

SRC 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.

**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 employee 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

The law requires that participant contributions be deposited in the plan trust as soon as they can be reasonably segregated from the employer’s assets.
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. Recently, the DOL created a new safe-harbor period for plans with fewer than 100 participants. Specifically, 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 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 summary plan description is a critical document for participant communication. Fiduciaries should focus on how the summary plan description is worded; making certain that it is accurate, understandable, and clear. When there is a discrepancy between the plan document and the SPD, courts have tended to rely on the language in the SPD. 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.
ERISA requires oversight by plan fiduciaries to 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. As a hypothetical illustration, a participant in a DC plan will have an additional $182,000 in retirement savings if his employer offers a low-cost rather than a high-cost retirement plan (See Figure 6).

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. 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.
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 initiated a three-step approach to ensure plan fiduciaries satisfy their obligations to determine whether fees paid with respect to plan services are “reasonable.”

Figure 6. The importance of costs

*Savings in a DC plan accumulated over 40 years.*

- **Low-cost plan** (0.30%): $869,800
- **High-cost plan** (1.30%): $687,800

*Assumes a 25-year-old participant saving for 40 years; a starting salary of $30,000 and annual wage increases of 2.5%; gross return of 8%; and net returns of 7.7% and 6.7% for the low- and high-cost plans, respectively.

This hypothetical illustration does not represent the return on any particular investment.

The DOL’s regulatory approach involves disclosure to:

- The government through enhanced Form 5500 reporting that will require plan sponsors to disclose additional information about fees paid to service providers.
- Plan fiduciaries through greater transparency regarding fees and expenses—including disclosure to plan fiduciaries of revenue sharing received by service providers.
- Plan participants through detailed communications regarding fees and other investment-related information.

The DOL guidance serves as a basis for plan sponsors to use in evaluating the reasonableness of plan costs. It should also be noted that, in addition to the DOL’s regulatory approach, there continues to be significant legislative and regulatory focus on fee disclosure.

Regardless of legal and regulatory changes, there are several fiduciary best practices to consider with respect to plan costs (See Figure 7):

- Ensure fees charged against the plan are legitimate plan expense and not a business expense of the sponsoring employer (i.e., settlor versus plan costs).
- Evaluate the fees being paid from trust assets and ensure they are reasonable.
- Review the disclosures made to participants to ensure complete and accurate disclosure.

**Best practice—Settlor versus administrative costs**

The law generally views plan costs in two broad categories: settlor versus 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, as a normal business expense, must pay these expenses. Plan fiduciaries have a duty to ensure that no settlor costs are ever paid by the plan.

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. Payments may be deducted from individual participant accounts or the plan’s forfeiture account in a DC plan.
Best practice—Determine fees are reasonable

ERISA is clear that plan fiduciaries have a duty to evaluate the fees incurred by the plan for reasonableness. Thus, plan fiduciaries should benchmark their fees as a way to determine reasonableness. It is important for sponsors to remember that “reasonable” is not necessarily the lowest cost—it involves an evaluation of cost and value.

As part of the reasonableness analysis, it is imperative that plan fiduciaries have a clear understanding of all direct and indirect fees paid by the plan. These costs include not only those obvious costs related to plan administration and investments—but also all fees, reimbursements, rebates, subsidies, and other payments (including revenue sharing paid to third parties), which may be charged against plan assets. Because it is often easier to overlook fees paid indirectly, such as asset-based investment management fees, a best practice for the fiduciaries is to review all investment-based fees on at least an annual basis, as part of the review of overall all-in fees.

In benchmarking fees, it is important that plan fiduciaries make an “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 a range of higher-cost activities—including payroll processing and individual recordkeeping services, participant education and advice, individual statements, and telephone and Web account services for participants. Such costs are not generally incurred by DB plans.

To compare overall fees, some sponsors rely on averages published in surveys by plan consultants, professional associations, or publications. Others will benchmark their...
fees with other non-DC investment programs, such as DB investment fee schedules or mutual fund expense ratios, while making adjustments for the additional costs incurred by the DC plan for administrative activities. Some sponsors solicit a “request for information” or a “request for proposal” in order to obtain current fee information from a list of competitive vendors.

**Best practice—Participant disclosure**

In DC plans, any participant charges—such as an annual charge for recordkeeping or a fee for a loan—should be disclosed. By and large, participants become fully aware of direct fees at the time they are incurred. However, participants may fail to consider asset-based investment fees charged against their accounts. As noted, the DOL is concerned about the transparency of participant fees and encourages full disclosure to participants of both transaction-related fees (e.g., loan fees) and investment-related fees so that participants may make informed decisions concerning their individual accounts.

Participant decisions should not be based solely on fees, and sponsors should seek to educate participants on risk and return. Vanguard believes that plan fiduciaries should make an effort to encourage awareness of all plan fees, including asset-based fees. Vanguard facilitates participant disclosure through the use of fund fact sheets, detailed information regarding plan investments and fees on Vanguard.com, and through quarterly benefit statements.
> Additional fiduciary
considerations
For both DB and DC plans, there are other fiduciary responsibilities to consider. These include minimum contributions to DB plans as well as ERISA Section 404(c) compliance and fiduciary protections, participant education and advice, company stock, and brokerage accounts in DC plans.

Maintaining a well-funded DB plan is important to both plan participants and the plan sponsor. Making required contributions and investing plan assets appropriately is an important fiduciary duty.

The funded status of a pension plan is determined by comparing the assets with the present value of benefits that have been earned at any point in time (the obligation or liability). There is more than one way to measure asset values and pension liabilities because there is more than one regulatory framework used to assess the plan's funded status. One set of rules is based on the IRS definitions originally established in 1974 by ERISA and amended several times, most recently by the PPA legislation in 2006. Other rules under the Financial Accounting Standards Board (FASB) are used to assess the funded status for accounting purposes, which is of interest to investors, and governed ultimately by the SEC. There are also rules used by the PBGC to determine funded status for their purposes, for example, when a plan terminates.

Our discussion of funding status looks at the question from four distinct perspectives—the three regulatory frameworks and the
plan actuary. Understanding these perspectives is important for the employer to appropriately discharge fiduciary responsibilities on behalf of plan participants. These perspectives include (See Figure 8 on page 41):

- The actuary.
- Funding—governed by IRS.
- Company accounting—governed by FASB and SEC.
- Plan termination—governed by PBGC.

**Actuary’s role.** A plan actuary will ordinarily conduct an actuarial valuation on an annual basis. The actuarial report(s) contains information on funded status for funding and accounting purposes, as well as possible information for the PBGC.

The actuary’s report provides details about the plan’s liabilities and its funding status. A best practice is for plan sponsors to meet with the plan’s actuaries and review the numbers, assumptions, and findings in the annual actuarial report. The actuary can help the plan sponsor assess how well the plan is funded by interpreting the numbers and explaining the differences between the regulatory frameworks. The

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Green DB™ is Vanguard’s approach to creating sustainable DB pension plans through low-risk plan design that provides appropriate levels of guarantees and liability-driven investing.
actuary may also provide estimates of future funded status under various scenarios so that the plan sponsor can plan for upcoming cash contributions and identify potential issues which might be addressed with funding, investment, or plan design strategies.

**Funding perspective, governed by IRS.** Employer contributions to a DB plan are subject to minimum funding requirements under the IRC and ERISA (recently revised by PPA). These rules are designed to ensure plan assets are sufficient to pay plan benefits. In addition, the IRC provides upper limits on the amounts that a plan sponsor can contribute and deduct in a tax year.

A failure to satisfy the minimum funding requirements, or contributing amounts in excess of a DB plan’s deductible limit, does not result in disqualification of the plan (i.e., the loss of the plan’s tax benefits). Instead, an excise tax is imposed on the employer. In addition to the excise tax, the plan sponsor may be subject to civil action for failing to make the minimum required contributions. As a result, understanding the IRS minimum funding requirements and contribution limits is essential for DB plan fiduciaries.

One of the critical assumptions used in calculating a plan’s funding obligation under the code is the interest rate used to calculate the present value of future plan payments. PPA introduced a yield curve based on corporate bonds, making the funding calculations more similar to the accounting calculations. However, the PPA yield curve is divided into three segments and averaged over 24 months by most plan sponsors, making it different from the single-point-in-time corporate bond rate used for accounting purposes. Further, asset values under PPA may be smoothed by averaging them over a 24-month period.
Information related to minimum funding requirements is reported to the IRS and DOL on Schedules SB and MB of Form 5500. Participants also receive basic information on the funded status each year in a Funding Notice.

**Accounting perspective, governed by FASB and SEC.** A different set of standards applies in reporting the funding status of a DB plan to a public company’s shareholders.

Employer pension accounting determines the proper pension expense that is part of the employer’s income statement and the asset or liability reflected on the plan sponsor’s balance sheet. FAS 87 governs how pension accounting calculations are performed and how results are included in the income statement and balance sheet. FAS 158 modified FAS 87 to fully reflect the funded status of each plan as a component of the company’s assets and liabilities. FAS 132R describes information that must be shown in footnotes to the company financial statements. Pension accounting rules are likely to be revised further in coming years and there is an effort under way to harmonize the United States with international standards.

For public companies, understanding the pension accounting information and how it impacts the overall corporate financial situation has become increasingly important as pension plans have grown. Keeping the plan well-funded and the sponsoring company healthy are both significant aspects of ensuring the security of plan benefits for participants. External parties interested in the company’s financial status—such as investors, debt-rating agencies, equity analysts, and the SEC—may all be interested in not just the results, but the assumptions underlying the pension accounting results.

FAS 87 requires that companies use a rate reflecting the yields on high-quality corporate bonds to discount the value of future pension payments in calculating the pension accounting liability. The discount rate is selected on the day the plan liabilities are measured and is not averaged (unlike the discount rate used for funding, which is smoothed). Additionally, for pension expense calculations, but not the balance sheet, asset values may be smoothed by averaging them over a five-year period.
Plan termination perspective, governed by PBGC. A plan termination by a company in financial distress is the only way for participants to lose benefits in a tax-qualified pension plan. The PBGC provides insurance protection for participants and beneficiaries under DB plans. It effectively offers a federal guarantee of most pension benefits in the event that the plan sponsor goes out of business or otherwise must terminate the plan without adequate assets.

Employers pay a premium to the PBGC for the insurance provided and must also report information on funded status so that the PBGC can identify potential problems. Sponsors pay an annual insurance premium to the PBGC. The amount of the required annual PBGC premium for 2010 is $35 per participant. For an underfunded plan, as measured under the PBGC’s rules, additional premiums are required in the amount of $9 per $1,000 of unfunded vested benefits. (The rates are indexed for inflation.) Employers with plans that are underfunded must provide information about all related companies and all of their pension plans to the PBGC by filing a Form 4010.

PBGC’s calculations are focused on identifying the funded status in the event of a plan termination, but the calculations used to report to the PBGC on an ongoing basis are somewhat different from the calculations used in an actual plan termination. The ongoing calculations use a discount rate similar to the funding discount rate, but it is not averaged over 24 months. Asset values used for PBGC purposes are not smoothed or averaged.
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 DOL regulations limit an employer’s liability for the 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 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 number of well-known features of 404(c) (See Figure 9 on page 47). 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. However, 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.
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. Vanguard assists clients in conducting 404(c) analysis for DC plans.

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.

**Additional fiduciary protections—QDIA, reenrollment, fund mapping**

**QDIA.** Plan sponsors should select a QDIA as the default fund to shield plan fiduciaries from liability for investment losses when participants do not make an affirmative investment election. Additionally, a QDIA is important for sponsors who have already adopted or are considering an automatic enrollment program for their DC plan. The “Investment Strategy” section of the guidebook provides additional information regarding a QDIA and evaluating target-date funds.

**Reenrollment**<sup>3</sup>. As a result of the PPA, reenrollment has emerged as a new plan design strategy to improve portfolio diversification. With reenrollment, current participants are reenrolled and their 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 might be used in a variety of settings including conversions to a new record-keeper, or menu changes to a plan’s investment lineup. Importantly, if the 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 investment losses incurred by these participants.

**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.

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<sup>3</sup> For additional details on reenrollment, see Improving plan diversification through reenrollment in a QDIA, Vanguard Strategic Retirement Consulting, September 2008.
ERISA originally contained no explicit requirements regarding fiduciary standards for participant education and advice. However, over the years, with the growth of individual account plans, the DOL has undertaken a number of efforts to promote participant education. For example, the DOL outlined the types of educational programs that would be appropriate for plan participants, issued regulations that encourage the use of personalized advice services, and affirmed the use of independent third-party advice for DC plan participants. Additionally, PPA provided prohibited transaction exemptions for service providers who offer investment advice to DC plan participants.

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. Others may be comfortable with investment decision-making but struggle with setting appropriate savings targets for retirement.

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 ensure that all participants have access to education and advice programs that will enable them 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 the risk of litigation.

The PPA and subsequent DOL guidance confirms 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.

Vanguard believes that offering advice to participants is one way to create a record that the plan fiduciary took appropriate steps to help participants toward a more secure retirement.
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.

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.

**Best practice—Update 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.

**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-deferred contributions to the employer’s plan.
- Basic investment education on diversification and investment asset classes.
- Tools, such as an investor’s 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.

Because there is no specific legal requirement, plan fiduciaries have wide discretion in deciding on the appropriate level of ongoing education for their plan participants. 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.

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.

**Best practice—Set objectives and measurement**

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, low savers to increase deferral rates, or participants who are invested too conservatively or too aggressively to take steps to diversify their portfolios.
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 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, though plan sponsors were generally permitted to phase this diversification requirement in over three years. 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 early 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.

How should this dual allegiance play out in practice? Fiduciaries are not permitted to take any action on the plan (say, removing company stock as an investment option) based on nonpublic information—information that is not made available to all shareholders. The company’s board and executive management must first determine when it is appropriate to issue such information to all shareholders.

At the same time, once such information is made available, plan fiduciaries need to determine how they must act with respect to plan assets. It would be a mistake for plan fiduciaries to assume that, once the company has made information available, they do not need to evaluate the interests of plan participants independently. Under ERISA, all public information about the stock should be evaluated to determine prudence. The dual role of management in these two processes represents the crux of the conflict. Thus, many organizations exclude senior executives from the fiduciary committee.

In the area of company stock, there are several best practices that we recommend 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 income invested in a single stock.

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 exclusively 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. Ignoring company stock may suggest that the committee is ignoring its fiduciary duty to monitor all investments.

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 decisions involving company stock.
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.

In Vanguard’s view, 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. In a sense, diversification is 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.

**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 that Vanguard recommends 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 is rising in value. Include these messages not only on statements as required, but also in education materials or in periodic communications to participants.

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.

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4 Source: Based on numerous class-action lawsuits filed in federal court against plan fiduciaries in recent years.
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, 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. In Vanguard’s view, plan fiduciaries still retain some investment oversight responsibilities, whether for the plan’s core investment lineup or its brokerage option.
How might plan sponsors balance the fiduciary risks with their desire to offer expanded choice to some participants? We recommend the following best practices:

- Determine whether the brokerage option is a prudent investment.
- Develop good communications and education about the risks of a self-directed brokerage option.
- Consider limiting the percentage of a participant’s account that may be invested via the brokerage option.

**Best practice—Evaluate prudence**

When offering a self-directed 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 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

In 2008, two-thirds of Vanguard DC plans offered between 11 and 20 fund options, yet 60% of participants used only 1, 2, or 3 of them.

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, he or she will want to make sure that it is included in the IPS, and clearly note 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 account 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 account to specific sources of money—for example, only employee contributions.

Vanguard remains committed to these best practices and seeks each day to ensure that the idea of good fiduciary conduct remains the cornerstone of our relationship with plan sponsors and participants.
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, bringing the highest levels of ethical conduct and fiduciary care to the operation and ongoing management of a retirement program.
For more information about Vanguard funds, visit www.vanguard.com or call 800-523-1036 to obtain a 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.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money by investing in such a fund.

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. Investments in bond funds are subject to interest rate, credit, and inflation risk.

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.

Vanguard Strategic Retirement Consulting (SRC) is a valuable resource that can help both defined contribution and defined benefit plan sponsors optimize their plan design, develop fiduciary best practices, and achieve regulatory compliance. The strategies developed by SRC consultants are grounded in expert analysis of broad-based data and are informed by Vanguard’s highly respected research teams, including the Vanguard Center for Retirement Research.