Building an Investment Committee for Effective and Efficient Decision Making

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One of the most frequent questions I get from plan sponsors, in both their role as corporate employees and as individuals, is "how can I reduce the risks I have as a fiduciary with respect to my company's retirement plan?" One of the most important things a plan sponsor can do to minimize fiduciary risk, and one of the easiest, is to use a committee to perform essential fiduciary functions – such as selecting, monitoring and replacing investments within a qualified retirement plan. While many plan sponsors use a committee for this purpose, few have invested the time and effort to ensure the committee functions effectively and efficiently. By concentrating on three main areas of committee operation, plan sponsors can maximize the effectiveness of their investment committees and minimize the risks associated with being a fiduciary of their plan. Those three areas revolve around the structure and membership of the committee, the processes undertaken by the committee, and the documentation the committee keeps of its deliberations and actions. I will be address each of these issues, keeping in mind the requirements of ERISA, with an eye towards provoking thought and providing a practical guide to plan sponsors for having an efficient and effective investment decision making committee for *their* plan.

The Employee Retirement Income Security Act ("ERISA") sets a high standard.

Often plan sponsors ask me why they should empower committee when another individual in their organization is perfectly capable of making decisions by themselves. The answer lies in what is required by ERISA of planned fiduciaries, and how the dynamic of committee interaction helps fulfill that requirement. While ERISA does not specifically provide guidance on how investment decisions should be made, the statute provides a high bar of fiduciary responsibility that applies to fiduciary decision making – one of the most important being investment selection. ERISA mandates that all planned fiduciaries operate as "prudent experts" in making decisions that affect the plan, benefits promised, and participants. The "prudent expert" standard is higher than the standard typically applied to fiduciary dealings – that of a "prudent person" and emphasizes the significant role plan fiduciaries have in managing the plan for the benefit of its participants. Prudent experts don't just consider what is before them – they actively seek out additional relevant information that may impact their decisions. Prudent experts operate using structured processes that can produce replicatable results when provided with the same inputs. In other words, similar facts should produce similar results each and every time the fiduciary has to make a decision.

Prudent experts consider the purposes of the enterprise they are engaged in, and consider the impact of their decisions on those who will be affected. ERISA also imposes upon fiduciaries the obligation to operate the plan solely for the purposes of providing benefits

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to the plans participants and their beneficiaries. In order to comply with this "exclusive benefit rule," plan sponsors must have appropriate mechanisms in place to consider the impact each of their decisions will have on the benefits ultimately payable to the plans participants.

Only through the use of structured processes can appropriate information be gathered, all alternatives be systematically considered, and rational, prudent, decisions be made.

The question plan sponsors have to ask themselves when deciding whether to individually make investment decisions or utilize a committee is which process provides the greatest chance of producing a replicatable outcome appropriate under given circumstances. Individuals, especially those who have a wide variety of other corporate obligations may find it difficult to function solely as a plan fiduciary when the need arises and to totally remove the "corporate hat" and function under the precepts of ERISA's exclusive benefit rule. Committee's are well suited for this, as the interplay of committee members provides a "test environment" where information, ideas and solutions can be tested intellectually in a controlled environment, without the consequences of a "let's try it and see what happens" approach often undertaking by individuals. Through the use of a committee, plan sponsors obtain the benefits of varying viewpoints, experiences, predispositions, and information gathering that would overwhelm an individual. The result is that the committee process simply produces better outcomes than an individual, with singular predispositions and limited resources can achieve. Considering the responsibility is great, and the risks even greater, using a committee almost always appears more prudent.

Even in those cases where the responsible individual has special expertise in investment decision making, a committee can provide a better chance of an appropriate outcome. Plans operate for the benefit of all participants – and in most companies, that means that there will be a variety of education and experience levels, and investing philosophies. Individuals, especially those with expertise in the area, will naturally apply their own investment philosophy in making decisions that will affect all plan participants. Don't think this is a big deal? Just watch a debate between advocates of active investing syles and those who prefer passive, indexed based investing. Typically each will advocate the use only of investment meeting their philosophy. The truth is that both philosophies are correct, and both are wrong as it applies to different participants who themselves may have different personal needs and expectations – and who ultimately may have to decide for themselves which approach to take. In addition, as will be discussed below, high-ranking corporate officers and other interested parties may have conflicting loyalties requiring them to make decisions that inadvertently favor the plan sponsor over the plan. Prudent experts agree that the vetting of investment ideas with others while following a structured process results in better investment decision making as a result of the inherent discipline involved in the process itself.

With ERISA's mandates in mind, lets examine what makes an investment committee effective and efficient.

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I. Committee Structure, Role and Membership

A Committee structures is actually less important than defining exactly what the committee's role will be with respect to making ultimate decisions. The appropriate structure will be more dependent on the company culture and individual preferences, and may be very formal in approach (following strict parliamentary procedure) or rather free-flowing and operating just shy of anarchy. High functioning committees usually impose an appropriate level of structure to keep the process moving along, but don't overly structure their decision-making process in a way that stifles discussion. Structure can be imposed first by creating specialized functions, such as designating a chairperson, having regular meetings, appropriately documenting committee deliberations, and implementing rules for decision making. The role of a chairperson should be to facilitate consideration of all appropriate information, providing each member the opportunity with which to voice an opinion and to determine when it is clear that the committee has arrived at a decision. Decisions in most cases will be by consensus, but in order to prevent gridlock, the committee should have various rules to determine when a majority rule vote will be appropriate. A chairperson should not be perceived of as having any particular expertise merely because of their position, although they may have specialized expertise otherwise, and should not have more of authority in decision-making than any other member of the committee. The role of the chairperson is to facilitate decision-making, not to be the decision-maker.

Functions also vary from committee to committee. Many times committees are advisory only, investigating investment options, reviewing reports and monitoring information, and benchmarking the plan, and report those findings to other school ultimately make the decision to come. While there is nothing inherently wrong in this approach – as it still utilizes a committee dynamic to investigate, the lack of real authority may discourage members of the committee from giving their best. It also deprives the ultimate decision-makers of the value of the process, including interactions that results in better decision-making.

Many of the most successful committees function as the primary fiduciary responsible for making investment decisions, allowing the members to be fully engaged from start to finish. Independent committees tend to exhibit a greater commitment to their tasks and a passion for doing the right thing – which is a hallmark of a successful fiduciary.

Despite having to make decisions as a committee, many committees will delegate to individual members the responsibility for obtaining information and reporting back to the committee the fruits of their investigation. Some committees will break these responsibilities down along investment style specific lines, such as having one or two people be responsible for exploring "large-cap growth" investments, while others will be investigating "small-cap value" funds and the like. Other committees will delegate responsibilities along functional roles. For example a committee may designate several of its members as liaisons with consultants for service providers to obtain current information about existing funds while other members of the committee will be charged with responsibility for looking at potential replacement funds in various categories, and

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other committee members may be responsible for determining what if any alternative investments should be included within the mix. Regardless of how a division of labor is implemented, the entire committee needs to be prepared to discuss the conclusions of those reporting back to the committee, and be prepared to render a decision based on shared information. Many passionate committee members will do their own research on various matters to specifically challenge those to whom the task was assigned, and foster a more robust debate.

Successful committees also have regular meetings throughout the course of an investment cycle. I usually recommend the committees meet formally at least twice each year. Many committees will actually supplement formal meetings semiannually with the informal meetings between those meetings. The formal meetings will be the only meetings at which decisions typically will be made. Semiannual decisions work well with many committees to avoid having decisions being made on the basis of short term issues and to allow the committee to concentrate on the long term nature of retirement plan investing. Informal meeting on the "off-quarters" between the formal meetings can be used to update the information the committee is considering and to determine if any significant change has occurred in any of the plan investments or the economic climate that might require more immediate attention. Meeting more frequently than quarterly typically is going to result in less material to discuss, shorter less effective meetings, and the perception that being a member of the committee is more burdensome than it may be worth. In my experience, high functioning committee members continue their dialogue with each other on an informal basis almost continuously. Discussions take place over lunch, before or after other committee meetings, or after one member has distributed to other members news articles reports or other items of interest concerning investments. When you see committee members continuing discussions (sometimes vigorously) outside of committee meetings, you can be assured that you have selected committee, passionate members.

One of the best ways to ensure that the committee functions consistently is to have the committee adopts a "charter" that defines specifically its role as a fiduciary, the approach that it will take in decision-making, the general criteria to be applied in selecting its members, processes for removing and replacing members, and the roles and responsibilities of each individual such as the chairperson, in the functioning of the committee. This committee charter should not restrict the functioning of the committee, nor contain criteria used for actually selecting, monitoring, and replacing investments, but should facilitate resolution of issues that may arise in the management of the committee, its decision-making processes, and membership. I usually recommend that the committee charter be provided to each of the potential members invited to participate on the committee, and that upon acceptance of their role, return a signed copy of the charter to be kept with the records of the committee indicating their acknowledgment of their role in the committee, and the rules that will govern its operation.

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How many members should the committee have, and who should those member be?

The two most frequent questions I am asked concerning the structure of an investment committee are how many people should be on the committee and who should those people be. These decisions need to be answered in the context of each individual plan sponsor but several guidelines can help make the decision easier one. As a threshold, to deciding on the size of the committee, the plan sponsor should consider their corporate culture and how decisions are made within the organization. Many organizations have a culture that emphasizes consensus over expedience. If that is the case, smaller committees may be more efficient as decision-making may be bogged down if too many people with too many diverse perspectives are involved. On the other hand, an organization that accepts various opinions, and is adept at synthesizing them into a decision can function very well with larger committees. Companies that rely on a more dialectic decision making process, where it is common place to challenge others in committee sessions may want to have a larger committee to allow for the free pay of ideas without making the process too personal. Typically, high functioning committees will have an odd number of members ranging from 5 to 11 members in total. Some of these committees will supplement their ranks with various non-voting members who may provide special expertise to the committee process. These individuals may be subject matter experts on investments (such as advisors) or ERISA requirements (such as corporate or outside counsel), or be individuals who are their for specific functions – such as having communications specialists on-board to ensure committee decisions are properly communicated, if necessary to participants.

What probably is more important than the number of people on the committee is the type of people who form the committee. Often plan sponsors will designate a committee by the titles of various individuals the plan sponsor thinks should be on the committee. Typically the list includes the CFO, the head of HR, corporate counsel, and the others who are thought to have the skills necessary by virtue of the position they hold to make appropriate decision. The criteria for membership on the committee should be an individual's ability to aid the committee in the decision-making process, and not the position they hold within the plan sponsor's company. The true key criteria are aptitude, experience, and commitment to the work of the committee. In many cases the best committee members are those who have the passion and capability to understand complex investment information, and may be those who from outward appearances or position are not perceived as being investment savvy enough. Look throughout your organization at all of the individuals, at all levels, to seek out those who have that passion and ability. There are several specific things that need to be kept in mind, however, in selecting individuals to participate on the committee.

First, committee members must be able to remove their "corporate hat" and put on their plan "fiduciary hat" when making decisions about the investments within the plan. Often high-ranking officers and others within an organization will have divided loyalties, owing a duty of loyalty to the corporate directors, shareholders and other constituents of the company and may not be able to ignore those obligations when making decisions concerning the investments plan consistent with the "exclusive benefit rule." This is

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particularly clear in cases where the plan sponsor is involved in the investment industry and may wish to include its own proprietary investments as options, or where the company has, or wants to have company stock or other sponsor securities in the plan. These cases raise significant conflict issues beyond the scope of this article, but clearly show the potential for conflict if fiduciaries cannot successfully remove that "corporate hat." Similar conflicts can exist in other contexts – such as where executives would really like to use a bank investment product in the plan, especially when the bank is also a lender to the company sponsoring the plan.

Second, having high-ranking officers and others on the committee may actually work to stifle the discussion necessary to give effect to the committee dynamic and process of accepting various viewpoints, opinions and recommendations. We all know that in the presence of our superiors, our discussions become more measured if not outright curtailed, and we strive to determine the positions of those people prior to espousing our own. For a committee to function effectively, each member of the committee must be an equally to each of the others, at least with respect to the functioning of the committee, with all opinions being given due consideration without fear of reprisal or recourse.

Third, all fiduciaries under ERISA have personal liability for their actions. That bears repeating, all fiduciaries under ERISA have personal liability for their actions. In a committee structure, each member of the committee would have personal liability for the actions of the committee in making fiduciary decisions. Members of the committee must have ample appreciation of their responsibilities to the plan, the other members of the committee, and the risks involved, and have the ability to work towards decisions that are appropriate and defensible should they be challenged. In other words, members need to be able to work together without animosity moving the decision-making process forward and arriving at decisions that are in the best interests of the plan in its participants. The bottom line is that individuals who lack the commitment to the process and outcomes of the committee should not be on the committee. Conversely those who are excited about the opportunities, challenges, and the value the committee brings to the benefits offered under the plan are excellent candidates for the job.

Two specific types of individuals who may be considered for committee membership warrant special discussion. Many committees automatically include "C" level people, such as the CEO, CFO, or COO, on the committee by virtue of their exalted position within the organization and the belief that by including high-level officers of the company, committee decisions produced will be without question. Unfortunately there is a downside to including these individuals on the committee. In litigation surrounding the collapse of Enron Corp. and losses suffered by its retirement plans, including its 401(k) plan, the Department of Labor filed an *amicus curiae* brief supporting the notion that any individual who has the ability to hire or fire a plan fiduciary also a fiduciary when they hire or fire that person. Of course any individual who can hire or fire *that* person is also a fiduciary with respect to the plan. The Department of Labor's analysis extended this chain of fiduciary liability all the way up to the company's Board of Directors, who ultimately had the power to hire and fire those who have the power to hire and fire anybody within the organization. Under the Department of Labor's argument, it would be almost

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impossible for senior corporate executives to skate fiduciary liability. Actively participating in fiduciary decision-making at the committee level raises special issues of conflict. How can an executive function as a fiduciary in the hiring and firing of other plan fiduciaries when functioning as a fiduciary on the same committee and the other individual? In other words, would an executive hire individuals to work on the committee who always agree with their position on the committee? Conversely, would they fire one with whom they always disagree? Doing so may be perceived of as "stacking the committee" in contravention of the "exclusive benefit rule" – which would require that the executive hire or appoint the best people to participate on the committee to produce appropriate decisions for the benefit of the plan and its participants – not for the benefit of the executive themselves.

The other type of individual often considered for membership on the committee that needs to be discussed, are rank-and-file employees of the company. Many times companies will specifically reserve several spots on the committee for rank-and-file employees of the corporation, under the theory that by having representation by the rank-and-file it would be easier to "sell" the decisions to employee participants in the plan. As noted above, inclusion on the committee should be based upon the perspective, experience, and abilities, and not on the basis of position. The same is true for including rank-and-file members of an organization on such an important committee. This is not to say that they should be excluded, but the criteria for their inclusion should be their aptitude for the work at hand.

This raises another question about what to do when you have an individual who already is a member of an investment decision-making committee who hinders the committee's operations or consistently fails to add value in the process. The simple answer is that they should be removed, which may be another reason not to include high-ranking officers and others on the committee. Many committees will structure themselves with definitive terms that members will server, and at the expiration of that term, will be automatically removed and replace. While there is some value to this approach in removing certain low functioning members from the committee without the awkwardness of "firing them," it also tends to eliminate from the committee high functioning members who have simply reached the expiration of their terms. Removing some members also will result in the loss of "institutional memory" – recollections of why and how certain decisions were made, but for one reason or another not memorialized in the committee minutes. Many of the best functioning committees I have worked with use a hybrid approach – specifying terms, but allowing for continual reappointment of desirable members.

The bottom line is that the best members of the committee to function as a fiduciary or those who are enthusiastic about the role in which they are fulfilling, are willing to put forth the effort to do so appropriately, and are committed to making their plan a better plan for the benefit of the participants.

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II. Process, Process, Process - Have a Plan

Being a successful "prudent expert" means following a replicatable process that will reproduce decisions given the same or similar inputs. Prudent fiduciaries will strive to implement processes to remove discretion to the extent possible from everything they do. Investment committees actually have an easier time in developing processes for their decision-making than many other planned fiduciaries. This is simply because investment decision-making has been the subject of so much study and analysis, the wealth of resources exist with respect to not only the way in which investment decisions should be made, but also with respect to the nature and type of information that should be considered in making those decisions. In most cases, the criteria for investment decision-making, if not the process itself, is contained within an investment policy statement. Many samples exist that may be used as a foundation for developing a specific investment policy statement applicable to corporate retirement plan.

The investment policy statement will define all criteria applicable to the selection and retention of investment funds. Artfully crafted investment policy statements will provide guidance on investment decision-making but will not prescribe outcomes. An investment policy statement that provides very restrictive criteria for investment fund selection and retention will cause considerable frustration for the committee. For example, if an investment policy statement provides that an investment fund must be removed if it falls below the top decile of funds in its category in performance will require the committee to consider its replacement by almost continuous basis. An appropriate investment policy statement will allow for the normal variability of funds in their operation so that longer-term trends, permanent style drift, and other factors will become apparent and acted upon consistent with the longer-term nature of investments within retirement plans. On the contrary, an investment policy statement that doesn't provide sufficiently clear criteria will cause the committee to rely too much on personal discretion in making decisions.

Two things need to be kept in mind, however with respect to the process and investment policy statements. First, once the process is implemented, and the criteria established for decision-making, failure to abide by that process or apply the criteria is probably a *per se* violation of ERISA's mandates and a breach of fiduciary duties. That is, your investment policy statement and other processes become the standard against which you will be judged. Ignore them at your own peril. The worst scenario would be to adopt an investment policy statement or other process and then fail to follow it.

Second, "prudent experts" do not blindly follow previously established processes when circumstances warrant a change. Experts continually evaluate the processes they utilize, and the criteria applied in decision-making, and make changes to their processes are required criteria when necessary. As a corollary to this, when new information is uncovered, or a flaw in a process is discovered, a "prudent expert" will review past decisions in light of the new information or revised process to determine if a different outcome should have resulted. Where appropriate, retroactive changes to previous decisions should be made. In other words, one of the processes prudent experts always undertake is to continually review the appropriateness of all their other processes.

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III. Documentation - How Much is Enough, But Not Too Much

The content and amount of documentation that a successful investment committee should keep is always the subject of debate and warrants special treatment in this article. People naturally fear having documentation that might be perceived as damning those who participated in the discussions. The fear is somewhat justified. If the committee documents bad behavior, lack of diligence in process, failure to take their roles seriously, or breach of fiduciary duty, then of course the documentation will be the proof necessary to hang them. However total lack of documentation should be equally as scary as the only proof that the committee fulfilled its responsibilities appropriately will be the testimony of each of the members. Ask yourself this: as a committee member, are you willing to place your fate in the fuzzy recollections of your colleagues on the committee in the worst possible scenario, of being called to testify in a court of law concerning an alleged breach of fiduciary duties? The old adage, that if you put five people in a room and ask them to recall an event they all witnessed, you will receive seven different versions of that event, is often true.

The truth of the matter is that the amount of documentation the committee keeps is in itself a fiduciary decision. I generally recommend that committees at the least document three things with respect to each issue they deal with. First, they should document the nature of the issue and the information available that is salient to making a decision. Second, the committee should document the process they undertook in order to arrive at a conclusion. By defining the nature of the issue and the inputs used - that is the information and assumptions that are to be considered – and the process the committee undertook, the documentation is "proving" that the committee is functioning as a “prudent expert.” Prudent experts, as noted above, follow replicatable processes that produce identical or similar results given identical or similar inputs. Committees therefore should document what needs to be decided, what is considered in making that decision, and the process they undertook to make that decision. Some committees I've worked with have gone so far as to provide a synopsis of the discussion had and the talking points of individual committee members. Those minutes literally say things like “Mary raised the issue of…” and “John pointed out that….” This they believe shows that varying viewpoints were considered and that all interested parties had the opportunity with which to raise issues and voice opinions. Other committees will simply indicate that a discussion was had that addressed enumerated issues, without attributing those to specific committee members. Neither approach is right, or wrong, and there are merits to each of them. The question really becomes one of what level of detail the committee is comfortable with to demonstrate that it functioned as that prudent expert required by ERISA. Ask yourself, if called to testify independently as a witness in a court, following the testimony of all of your fellow committee members (without you having the benefit of watching them testify), what level of detail would you like in the committee minutes to refresh your memory sufficiently, so that your testimony is 100% consistent with the testimony of you fellow committee members.

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The third item a committee should document is the actual decision it has made. In many cases committees will reach an understanding of what it is that they intend to do, but unless it is actually written down, perceptions of the extent of that decision may vary. It's a simple task of documenting that "the committee decided to remove the XYZ fund and replace it with the ABC fund as soon as practicable", which leaves no doubt as to what the outcome is.

Conclusions

Having a high functioning committee was committed, passionate members, well-defined processes, and appropriate documentation is the best defense to the risks of being a fiduciary of a retirement plan. ERISA does not require that all decisions made be proven, in hindsight, to have been the absolute best decision that could have been made. A research choir is only the planned fiduciaries operate as prudent experts, following an appropriate process to arrive at their decisions. Appropriate processes are those that are well thought out, consider all appropriate information from all appropriate perspectives and then produce decisions that are replicatable given the same or similar inputs. While I have never seen a monument dedicated to the memory of a committee, in the case of ERISA covered plans, the use of a committee for fiduciary decision making accomplishes plan sponsor goals of reducing risks, truly arriving at appropriate results, and ensuring that the plan accomplishes its goals of providing benefits to participants effectively and efficiently.

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About the Author

Michael's practice as an employee benefit consultant spans all aspects of retirement plan design, documentation, administrative process and procedures, compliance testing, controversy resolution and fiduciary concerns. Michael's background as a practicing lawyer and internal consultant with several large retirement plan service providers and institutional trustees has provided a depth and breadth of experience that allows him to assist clients at all levels – from strategic planning and benefit designs that accomplish specific corporate goals through vendor selection and management, fee benchmarking and negotiation and fiduciary best practice analysis and implementation, to operational process improvement, error correction, root cause analysis, and loss mitigation. Michael's consulting philosophy and approach is to partner with several regional consulting practices that will provide additional support in areas including investment selection and monitoring and specialized educational analysis and support, and insurance based benefits to provide "best of breed" services in a cost effective manner.

Michael received his law degree from the University of Akron in 1985, and his LL.M. (Taxation/Benefits) from Case Western Reserve University in 1995, and has practiced ERISA/Benefits law in several law firms in Ohio and Virginia, as Trust Counsel for KeyCorp, a major "super regional" bank based in Cleveland, Ohio supporting it's institutional trust business involving both bundled and unbundled defined contribution plan services, and defined benefit master trust and custody services. Michael also functioned as a member of the senior management team, as a Vice President, ERISA Services, overseeing the organization's client consulting services and functioning as a consultant on ERISA matters with the bank's clientele. Michael subsequently became Director of ERISA Services for Strong Capital Management, Inc., a mid-sized mutual fund complex, building a client consulting group within the company's bundled defined contribution product, and functioning as a "relationship manager at large," dealing with issues affecting specific clients, resolving disputes, and rectifying errors. Most recently, Michael was a member of the client services team for Schwab Retirement Plan Services, Inc., and subsidiary of Charles Schwab & Co., Inc., functioning as a internal and external resource on ERISA, client management, and compliance issues.

Michael has spoken frequently at industry conferences, professional associations, and before client committees on maters pertaining to fiduciary best practices, industry trends and current legislative and regulatory matters, and has taught various courses in paralegal studies curricula on employee benefits and most of the course offered under the Certified Employee Benefits Specialist (CEBS) program offered jointly by the Wharton School of Business and the International Foundation of Employee Benefits. Michael has also authored and co-authored various articles and "white papers" on fiduciary responsibility, investment committee best practices, and employee benefits in mergers and acquisition.

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