

Through the ERISA Lens: Principles of DC Fund Selection

Prepared by The Wagner Law Group

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All investments involve risk, including possible loss of principal.

Important note: The Wagner Law Group has prepared this white paper on behalf of Legg Mason & Co., LLC. This paper includes suggested “best practices” that plan sponsors, and the financial professionals who work with plan sponsors, may wish to consider concerning the Employee Retirement Income Security Act of 1974 (ERISA) and the related rules governing the fiduciary standards for selecting a plan’s designated investment alternatives. These suggested practices include using a returns-based style analysis on a plan’s existing or prospective investment alternatives. With respect to any investment analysis based on performance returns, please note that past performance is no guarantee of future results.

It is important to note that the suggested “best practices” are not the exclusive means of complying with ERISA’s prudence requirements in selecting and monitoring Plan investments. Other combinations of practices also may be effective in meeting such requirements. Plan sponsors and other fiduciaries should consult with their own legal counsel concerning their responsibilities under ERISA in selecting and monitoring Plan investments.

Future legislative or regulatory developments may significantly impact these suggested practices and the related matters discussed in this paper. Please be sure to consult with your own legal counsel concerning the application of ERISA to the selection of plan investments and any related future developments.

This white paper is intended for general informational purposes only, and it does not constitute legal, tax or investment advice on the part of The Wagner Law Group or Legg Mason & Co., LLC and its affiliates. Plan sponsors and other fiduciaries should consult with their own legal counsel to understand the nature and scope of their responsibilities under ERISA and other applicable law.

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INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

Introduction

Mutual funds (“Funds”) have become popular investment vehicles for 401(k) plans and other types of retirement plans (collectively, “Plans”) that give participants (“Participants”) the responsibility for making investment allocation decisions for themselves.

The Plan sponsor is responsible for selecting an appropriate menu of investment alternatives for the Plan’s Participants. If the relevant requirements are met under Section 404(c) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), the Plan sponsor is not responsible for how Participants choose their investments from the Plan’s menu. Thus, by complying with ERISA Section 404(c), the Plan sponsor ensures that Participants alone are responsible for selecting an appropriate mix of investments for their individual accounts based on their personal circumstances and objectives.

There are numerous conditions imposed under ERISA Section 404(c), including certain investment diversification requirements that require the Plan sponsor to consider a Fund’s underlying investments. Unfortunately, many employers who sponsor Plans incorrectly assume that the underlying investments of a Fund are something that only the Fund’s investment advisor (the “Fund Advisor”) needs to worry about. The good news is that Plan sponsors and other responsible fiduciaries can take steps to protect themselves by becoming educated on how ERISA looks at and also “looks through” Funds to their underlying assets.

General requirements under the 404(c) regulations

ERISA Section 404(c) and the related regulations (the “404(c) Regulations”) issued by the U.S. Department of Labor (the “DOL”) have two basic conditions: the “Opportunity to Exercise Control” requirement and the “Broad Range of Investment Alternatives” requirement.

The DOL rules governing the Opportunity to Exercise Control requirement provide that Participants will have the necessary control over their accounts if they are able to make informed investment decisions. Thus, the 404(c) Regulations expressly require the Plan to disclose detailed information concerning the Plan’s investment menu and to explain how Participants may give investment allocation instructions to the Plan. The DOL rules have specific disclosure requirements and also incorporate the Participant-level disclosure rules that were recently implemented under Section 2550.404a-5 of the DOL regulations (the “404a-5 Regulations”)¹

Under the Broad Range of Investment Alternatives requirement, the 404(c) Regulations require the Plan to offer a menu of investment alternatives (the “Menu Options”) that gives Participants a reasonable opportunity to materially affect the potential return and risk profile for their accounts. The “Core Menu Requirements” and “Risk Minimization Requirements” described below must also be met.

¹ The Participant-level disclosures mandated under the relevant DOL regulations include annual disclosures concerning the Plan’s services, fees and investment menu, as well as quarterly fee disclosures. These annual disclosures were required to commence by August 30, 2012, and quarterly fee disclosures were required to commence by November 14, 2012 in the case of calendar-year Plans.

Core menu requirements

In order to satisfy the Broad Range of Investment Alternatives requirement under the 404(c) Regulations, at least three (3) of the Plan's Menu Options must serve as core investment alternatives (the "Core Options") in satisfaction of the following requirements (the "Core Menu Requirements"):

Each of the core options must:

- 1** itself be a diversified investment (e.g., Fund with a diversified portfolio of underlying assets).
- 2** have materially different risk-return characteristics.
- 3** give Participants the ability to construct different investment portfolios with different risk-return characteristics. Each Participant must be able to create portfolio combinations in such a way that they can generate a continuous range of risk-return characteristics that would be "normally appropriate" for such Participant.²

Risk minimization requirements

The Broad Range of Investment Alternatives requirement under the 404(c) Regulations imposes two separate but related investment diversification requirements on the Plan's menu (the "Risk Minimization Requirements"). First, investments in the Core Options, when combined, should tend to minimize the "overall risk" of the Participant's investments through diversification.³ Second, the Menu Options must give Participants a reasonable opportunity to diversify the investment of their accounts so as to minimize the "risk of large losses."⁴

Special rule for look-through investment alternatives

The Broad Range of Investment Alternatives requirement under the 404(c) Regulations has a special rule for any Plan that includes "Look-Through Investment Vehicles" in its investment menu. For purposes of determining compliance with both the Core Menu Requirements and the Risk Minimization Requirements, the underlying investments of the Look-Through Investment Vehicles must be considered.⁵

² Section 2550.404c-1(b)(3)(i)(B)(i), (ii) and (iii) of the DOL regulations.

³ Section 2550.404c-1(b)(3)(i)(B)(iv) of the DOL regulations.

⁴ Section 2550.404c-1(b)(3)(i)(C) of the DOL regulations.

⁵ Section 2550.404c-1(b)(3)(ii) of the DOL regulations.



Section 2550.404c-1(e) of the DOL regulations defines a Look-Through Investment Vehicle broadly to include various pooled investment vehicles, including an “investment company” or a “series investment company” under the Investment Company Act of 1940 (the “Company Act”). The Funds customarily utilized by Plans are in the legal form of open-end investment companies registered under the Company Act. Therefore, under these DOL rules, any Funds included in a Plan’s investment menu would clearly be viewed as Look-Through Investment Vehicles under the 404(c) Regulations.

Some Plan sponsors and fiduciaries may be unaware of the fact that the 404(c) Regulations view Funds as Look-Through Investment Vehicles. This may be due, in part, to the DOL’s separate regulation (the “Plan Assets Regulation”) governing how a Plan’s investment in an entity might cause

the entity’s underlying assets to be viewed as ERISA plan assets. However, the Plan Assets Regulation has a blanket exemption from its “look-through rule” that applies to all Funds. Therefore, a Plan’s investment in a Fund would never cause the Fund’s assets to be viewed as ERISA plan assets, which in turn means that the investment adviser managing the Fund (the “Fund Advisor”) would never be deemed a plan fiduciary managing ERISA plan assets.⁶

Because Funds are not viewed as “look-through” entities for purposes of the Plan Assets Regulation, some Plan fiduciaries may mistakenly assume that the Funds should not be viewed as Look-Through Investment Vehicles for purposes of the 404(c) Regulations. However, the Core Menu and Risk Minimization Requirements under the 404(c) Regulations expressly require Plan fiduciaries to take into account a Fund’s underlying investments.

⁶ Section 2510.3-101(a)(2) of the DOL regulations. For example, if one or more ERISA Plans were to acquire a significant interest in a private equity fund (i.e., at least a 25% equity interest), the underlying assets of the private fund would be deemed assets of each ERISA Plan investing in the fund. The net effect of this rule is that the private fund’s manager would be deemed a manager of ERISA plan assets, which in turn would make the fund manager an ERISA fiduciary to each such Plan.

Applying the core menu and risk minimization requirements

As discussed above, the Core Menu Requirements are composed of three separate conditions, and compliance with these conditions is only possible by examining each applicable Fund's underlying assets. The first condition merely requires the Fund's assets to be diversified, and there is no specific level of diversification that must be achieved. The second condition requires any Fund serving as a Core Option to be materially different from at least two other Funds serving as Core Options in terms of risk-return characteristics. Neither condition is particularly onerous and Plan fiduciaries should have little difficulty satisfying them.

The third condition of the Core Menu Requirements, however, is more challenging, and it typically requires Plan fiduciaries to take a closer look at each Fund's underlying investments. Under this third condition, Participants must be able to use the Core Options to construct investment portfolios that can generate a continuous and "normally appropriate" range of risks and returns for the Participant.

The Risk Minimization Requirements are similarly challenging, requiring any Funds which serve as the Plan's Core Options to tend to minimize the "overall risk" of the Participant's investments when combined. Furthermore, the Plan's Funds must give Participants a reasonable opportunity to minimize the "risk of large losses" through diversification.

To help Participants with their necessary ability to create portfolios that satisfy this "normally appropriate" standard and to help the Plan meet the Risk Minimization Requirements, the Plan fiduciary may want to consider selecting Funds that cover a broad spectrum of different asset classes and categories with different risk-return profiles. As the number and diversity of applicable

Funds increases, the number and diversity of possible portfolio combinations also increases. Thus, with a broader spectrum of diverse Funds, Participants should be more able to construct portfolios with a broader range of risk-return profiles, helping the Plan meet the "normally appropriate" requirement. Participants should also be more able to construct portfolios that minimize overall risk and the risk of large losses, helping the Plan meet the Risk Minimization Requirements.

Looking through the fund to its underlying investments

Demonstrating compliance with the Core Menu and Risk Minimization Requirements in accordance with the 404(c) Regulations is only possible by considering the underlying investments of the applicable Funds. It would likely be inadequate for Plan fiduciaries to rely exclusively on the asset class description stated in a Fund's marketing materials or prospectus. When selecting an appropriate number of diverse Funds for its menu, it is advisable that the Plan fiduciary confirm that each Fund's underlying investments are consistent with its stated asset class description.

A simple but effective way of confirming this information would be to review the Fund's fact card, which customarily includes the "top 10" holdings of the Fund or sector diversification (or sector allocation) information. More detailed information would be available in the Fund's portfolio holdings schedule (or summary portfolio schedule), which is typically included in the Fund's shareholder reports.⁷ The Fund's portfolio holdings schedule generally is also publicly available on certain quarterly filings with the U.S. Securities and Exchange Commission (the "SEC").⁸

⁷ Portfolio holdings schedules are not necessarily required for shareholder reports in the case of money market Funds, although they must be included semi-annually with such Funds' Form N-CSR filings with the SEC.

⁸ Portfolio holdings schedules are generally included in the Funds' Form N-CSR filings with the SEC for the Funds' second and fourth fiscal quarters, and Form N-Q filings with the SEC for the Funds' first and third fiscal quarters.



An alternative means for confirming that a Fund's underlying investments are consistent with the Fund's asset class categorization is to utilize investment performance tools or other similar investment analytics services ("Performance Analysis Tools"). Even though they do not rely on actual holdings information, Performance Analysis Tools are able to use the performance of a Fund's underlying portfolio to help reveal the Fund's actual investment style. This returns-based style analysis, which was first conceived by Nobel Laureate William F. Sharpe, could be an insightful method for Plan fiduciaries to learn about the true nature of a Fund's underlying investments and to identify the problem of "style drift" in a Fund, which may occur from time to time.

Style boxes generated by Performance Analysis Tools can also be used to perform a "gap analysis" to identify any asset classes or categories that are not covered by the Plan's menu of Funds. Style boxes are helpful visual aids in that they graphically map the applicable Funds to various areas of the style box based on the Fund's declared investment style. The supporting analysis used to determine a Fund's style is typically based on a returns-based style analysis, and style boxes are simply another tool that Plan fiduciaries may use to help them understand the nature of the Funds' underlying investments.



Applying procedural prudence to fiduciary reviews of fund assets

The Core Menu and Risk Minimization Requirements under the 404(c) Regulations should, of course, be considered when the Plan sponsor selects and monitors the Menu Options available to its Participants. The Plan sponsor and any other responsible fiduciaries are subject to a duty to prudently select and monitor the Plan's Menu Options, and the fiduciary relief available under ERISA Section 404(c) would not relieve fiduciaries from this duty.⁹ Thus, the selection of Menu Options also would need to be performed in accordance with the prudence standard of care under ERISA.¹⁰

This prudence standard, which applies to all fiduciary acts under ERISA, is both procedural and substantive in nature. Procedural prudence is generally satisfied if a Plan fiduciary performs an adequate investigation of the merits of any proposed investment action.¹¹ In addition to being made in accordance with procedural prudence, Plan investment decisions should also be made skillfully, and Plan fiduciaries have a duty to seek the advice of a qualified expert, such as a financial professional, whenever it is necessary.¹²

⁹ Section 2550.404c-1(d)(2)(iv) of the DOL regulations.

¹⁰ ERISA Section 404(a)(1)(B).

¹¹ See, e.g., *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983), cert. denied, 469 U.S. 1072 (1984).

¹² See, e.g., U.S. Department of Labor Interpretive Bulletin 95-1.



When selecting new Funds for the Plan or monitoring the Plan's Menu Options, the Plan sponsor may wish to consider gathering and maintaining a fiduciary file of all relevant information collected and reviewed. Because of the "look-through" nature of the Core Menu and Risk Minimization Requirements, the Plan sponsor should be sure to gather relevant information concerning the underlying investments of the Plan's Menu Options and any prospective Funds. If the Plan sponsor needs assistance gathering this information or understanding the nature of a Fund's underlying investments, it should consider seeking assistance from a qualified financial professional.

In many instances, a Fund's underlying investments will include options, futures and other derivatives. Certain derivatives can exhibit extreme price volatility and can offer a high degree of leverage for investors. The DOL has noted that "[w]hile derivatives may be a useful tool for managing

a variety of risks and for broadening investment alternatives" for an ERISA Plan, investments in derivatives may require "a higher degree of sophistication and understanding on the part of plan fiduciaries than other investments." Furthermore, if an ERISA Plan is investing in a pooled Fund managed by a third party, the ERISA Plan's fiduciary should obtain "sufficient information to determine the pooled fund's strategy with respect to use of derivatives in its portfolio, the extent of investment by the fund in derivatives, and such other information as would be appropriate under the circumstances."

Thus, ERISA does not prohibit a Plan's selection of, and investment in, Funds that utilize derivatives. However, when a Plan sponsor reviews the underlying assets of such Funds, it should gather sufficient information to understand the Fund Advisors' strategies for investing in derivatives as well as the nature and extent of the Fund's investments in them and related risks.

Conclusion

When selecting Funds for their Plans' Menu Options, Plan sponsors and other responsible fiduciaries should consider the requirements of ERISA Section 404(c) and the 404(c) Regulations. Because Funds are considered Look-Through Investment Vehicles under these rules, it is important for Plan fiduciaries to gather information about and understand each Fund's underlying investments as part of their fiduciary review process. If a Plan sponsor or any other responsible fiduciary has difficulty gathering the required information or understanding their significance, they should consider asking a financial professional for assistance.

This paper has mentioned a number of suggested "best practices" that Plan fiduciaries may wish to consider adopting, and they are listed on the attached Exhibit A. These practices are designed to help Plan fiduciaries make investment decisions prudently as they select and monitor the Plan's Menu Options in accordance with the fiduciary standard of care under ERISA.

Exhibit A

Suggested “Best Practices” for Considering a Fund’s Underlying Investments

By complying with the requirements of ERISA Section 404(c), Plan fiduciaries can seek to ensure that Participants (rather than the fiduciaries) are solely responsible for selecting an appropriate mix of investments using the Plan’s Menu Options. Because Funds are considered Look-Through Investment Vehicles under the DOL’s 404(c) Regulations, it is important to gather information about and understand each Fund’s underlying investments as part of a prudent fiduciary review process.

The following is a summary of suggested “best practices” to assist with the Plan fiduciary’s review of the Plan’s Menu Options and their underlying investments.

	Already executed	In progress	No action taken
<p>1. Gather information about Funds’ underlying investments. In addition to gathering other relevant information, when selecting new Funds or monitoring the Plan’s Menu Options, material information concerning the applicable Fund’s underlying assets should also be collected.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<p>2. Review Funds’ fact cards. Obtain and review each Fund’s fact card, which customarily includes the “top 10” holdings of the Fund or sector diversification / sector allocation information.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<p>3. Review Funds’ portfolio schedules. For more detailed portfolio holdings information, review a Fund’s portfolio holdings schedule (or summary portfolio schedule), which is typically included in the Fund’s shareholder reports. The Fund’s portfolio holdings schedule generally is also publicly available on certain quarterly filings with the SEC.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<p>4. Use performance analysis tools. Use Performance Analysis Tools that are able to use the performance of a Fund’s underlying portfolio to help reveal the Fund’s actual investment style. This returns-based style analysis may be used to identify the problem of “style drift” in a Fund, which may occur from time to time.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<p>5. Use style boxes for gap analysis. Perform a “gap analysis” using style boxes (generated by Performance Analysis Tools) to identify any asset classes or categories that are not covered by the Plan’s Menu Options. Style boxes are helpful visual aids in that they graphically map the applicable Funds to various areas of the style box based on each Fund’s investment style.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<p>6. Consider Funds’ use of derivatives. In the case of a Fund that utilizes derivatives, gather sufficient information to understand the Fund Advisor’s strategy for its investments in derivatives as well as the nature and extent of the Fund’s investment in them and related risks.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<p>7. Maintain fiduciary files. Maintain a fiduciary file of all information that has been collected and reviewed. These records can help demonstrate the prudence of the fiduciary reviews that have been conducted.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<p>8. Consider working with a financial professional. Consider asking a financial professional for assistance, as necessary, in gathering Fund information and understanding its significance.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<p>9. Review schedule. Establish a schedule for conducting regular, ongoing reviews of the Plan’s Menu Options.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Important note: It is important to note that the suggested “best practices” are not the exclusive means of complying with ERISA’s prudence requirements in selecting and monitoring Plan investments. Other combinations of practices also may be effective in meeting such requirements. Plan sponsors and other fiduciaries should consult with their own legal counsel concerning their responsibilities under ERISA in selecting and monitoring Plan investments.

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