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Consultants and Actuaries

Testimony of
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Procedurally Prudent Investment Process

Thank you for allowing me the opportunity to appear before you today and to provide our input on such an important issue. My name is Rhonda Migdail and I am Director of the Employee Benefits Research Group and a Principal at Milliman, Inc.

Milliman, Inc. is a global actuarial and consulting firm that has provided services to clients for almost 60 years. Besides actuarial consulting, Milliman offers defined benefit and defined contribution plan administration services as well as a variety of investment consulting services including the formation and review of investment policy statements, asset liability modeling, and assistance in monitoring investment results.

The issues that are currently being explored by the Advisory Council of ensuring a procedurally prudent investment process for both defined benefit and defined contribution plans are of vital importance to forwarding the basic tenets of fiduciary responsibility under ERISA. The basic rules currently governing the manner in which plan fiduciaries satisfy their obligations in this regard have been in place for over 20 years. So much has changed in the intervening years. The avalanche of technological advances such as the Internet and other forms of electronic communication has dramatically increased the ability to convey “real-time” information to participants. The availability of many different and new types of investments justify revisiting the types of investments that may be suitable for retirement funds. And finally, the recent enactment of the Pension Protection Act of 2006 which provides additional guidance on the application of ERISA section 404(c) with respect to default investments and mapping decisions deserves our immediate attention.

I believe that the Working Group appropriately provides a separate focus on procedurally prudent investment processes for defined benefit pension plans and ERISA section 404(c) defined contribution savings plans.

With respect to the questions regarding defined benefit plans, we are focusing on the *plan fiduciaries* discharging their duties under ERISA section 404(a) of “providing benefits to participants and their beneficiaries; and... defraying reasonable expenses of administering the plan... with the care, skill, prudence and diligence under the circumstances then prevailing that a *prudent man acting in a like capacity and familiar with such matters would use in the conduct*



of an enterprise of a like character” and “by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.” Specifically, Department of Labor (“DOL”) Regulation section 2550.404a-1(b)(2) provides that a fiduciary acting in this capacity must consider such factors as: (1) the diversification of the portfolio; (2) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and (3) the projected return of the portfolio relative to the funding objectives of the plan. Accordingly, the questions raised by the Working Group for such plans focus on the investment policy statement, the elements used to evaluate investment performance and the potential use of “alternative investments.” There is an underlying assumption that the individuals who undertake to make these decisions possess the requisite sophistication and knowledge to act as prudent experts.

On the other hand, when we are discussing ERISA section 404(c), we are dealing with an *exception* to the general fiduciary rules where a participant or beneficiary in a pension plan with individual accounts is permitted to exercise control over the assets in that account and they are *deemed not to be fiduciaries by reason of exercising this control* and *“no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant’s or beneficiary’s exercise of control”* where certain conditions are satisfied. These conditions include: (1) ensuring that participants and beneficiaries have a broad range of investment alternatives to choose from; (2) that they have been provided adequate information to be able to choose among those various alternatives; and (3) that they have been provided an adequate opportunity to make those decisions. I think it is important to point out that generally these individuals will have far less sophistication in matters of evaluating various investment options than the fiduciaries who are involved in the defined benefit plan investment process. This fact should be taken into account when evaluating the process and determining appropriate standards and investments. Accordingly, the Working Group’s questions focus on ensuring that such participants and beneficiaries have been provided the required notices and information (and revisiting what those should be), examining issues that may arise where plan fiduciaries provide for default investments and examining whether “alternative investments” are appropriate in this context. Additionally, we believe that this is an appropriate time to consider the impact of certain provisions recently enacted as part of the Pension Protection Act of 2006.

I believe it is important to maintain this distinction in focus as we discuss the specific questions posed.

I will now proceed to address the particular questions raised:

Defined Benefit Pension Plans

What is the definition and function of an investment policy statement for a defined benefit pension plan?

As indicated in DOL Regulation section 2509.94-2(2), a “statement of investment policy” is:



[A] written statement that provides the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories of investment management decisions...

A named fiduciary of the plan responsible for the appointment of an investment manager may condition such an appointment on the acceptance of an investment policy statement and the investment manager would be required to comply with such a statement as long as it is consistent with Titles I and IV of ERISA. However, maintenance of such a statement does not relieve the named fiduciary of its obligations with respect to the appointment and monitoring of an investment manager. And DOL has expressed its opinion in that regulation that such statements may need to include such factors as the plan's funding policy and its liquidity needs as well as issues of prudence, diversification and other fiduciary requirements of ERISA.

In other words, the investment policy statement functions as a "roadmap" for the investment committee, plan fiduciaries and investment managers to follow. If the members of the investment committee make decisions based on the investment policy statement (as long as it satisfies the applicable requirements), they have some predefined direction to refer to and justify their actions.

Accordingly, in developing such an investment policy statement, the following elements are generally included:

- An outline of the investment goals and objectives of the pension plan (i.e., the goal is to ensure adequate funding to pay the retirement, and other, benefits provided for under the plan);
- Delegation of specific responsibilities among the plan's decisionmakers including the Board, staff, investment managers and outside consultants;
- Establishment of investment and manager selection criteria as well as ongoing performance expectations;
- Definition of a target asset allocation policy for the plan (i.e., where the money is going to be invested) based on plan-specific cash flow assumptions and the level of risk acceptable to the plan;
- Definition of benchmarks to which the portfolio or particular asset classes within the portfolio will be measured against, such as a target rate of return;
- Proxy voting policy; and
- Rebalancing policy.

Taking into consideration the accrued benefit obligation and the actuarial present value of the benefits, what time horizon should be used in evaluation of investment performance? Number of years? Market cycles? Long-term/short-term needs to provide benefits?

Of course, always keeping in mind the prudent man standard of ERISA and the factors contained in DOL Regulation section 2550.404a-1(b)(2), generally, if the investment of the plan assets is



tied to the expected emerging liabilities of the plan either through duration matching or some other method of aligning the assets and liabilities, then measuring performance based on the ability to provide for the long-term/short-term needs is most appropriate. If the assets are simply invested in a manner to generate the highest possible returns to the plan consistent with the articulated investment policy, then the investments should be measured over various time periods (for example, 1,3,5 years).

Should investment returns be stated in absolute terms, i.e. minimum target to match actuarial investment return assumption? Should it be stated in relative terms, i.e. relative to other accounts having similar objectives managed by the manager or relative to indexes? How are investment returns reconciled with the assumptions to determine funding levels? Should it track the pension cost under U.S. GAAP?

Investment returns should be stated both in absolute and relative terms. In order to measure how a plan's assets are performing in relation to the return assumption (i.e., it is reflective of the impact on the pension funded status) an absolute measure needs to be used.

However, although a plan's absolute return may indicate that the investments are performing well (vis-à-vis the return assumption), this may simply be the result of a poor return assumption. Providing a comparison against other portfolios with similar objectives provides valuable insight on how the investments (or their managers) performed on a relative basis and could be used as a tool to flag those that are lagging. In pension funding, investment returns are reconciled with the assumptions used to determine funding levels through asset gains and losses. If investments outperform what was expected, there is an investment gain to the plan. If investments underperform however, a loss is generated. Over time, all gains and losses are either amortized directly within the plan or become a part of the ongoing normal cost.

Should performance be calculated including the management fee? Excluding the management fee, custodial fees?

There are only two reasons to be concerned about performance: first, to measure the growth in plan assets versus the growth in liabilities; and second, to measure the effectiveness of a given manager's performance.

With these considerations in mind, investment returns used to measure the change in assets versus the change in liabilities should be calculated net of all fees, i.e. management, custodial, trustee, actuarial, and other advisor and consulting fees, assuming the fees are paid by the plan. Gross of fee returns at the plan level can be unrealistic if fees continue to erode plan balances even though the "return" is positive. Plan returns should measure the effectiveness of the asset's ability to grow with the growth in liabilities. Returns used to measure manager performance should be calculated net of the management fee of that particular manager. These should not include trustee, custodian or consulting fees as these are a function of the plan and not a function of the manager's ability.



Additionally, calculating performance net of all fees provides a determination of the amount of money that is actually available to make benefit payments.

Are ‘alternative investments’ appropriate for defined benefit pension plans? By alternative investments we allude to, but are not limited by the following: private equity fund, venture, distressed debt, hedge funds, real estate, timber, oil & gas, LBOs and commodities. Which ‘alternative investments’ are acceptable ERISA investments and why? Are there existing compliance controls for such alternative investments?

In certain circumstances, we believe that alternative assets may provide an efficient mechanism to diversify systemic risk, or what has been known as non-diversifiable risk. The alternative investment universe includes asset classes that are non-correlated with the stock or bond markets. Portfolio efficiency and volatility reduction are dependent on low correlated assets.

Many alternative asset classes can be effectively utilized in an ongoing pension plan portfolio. Pension plans are ideally suited for the use of certain alternative assets where both the investment asset and plan have similar long-term goals. The pension plan goal is the payment of benefits over the long term. Complete and transparent valuation should not be a criterion for the adequacy of investment. Most alternative investments are designed for long-term appreciation or income. In addition, alternative investments are less susceptible to the whims of a public influenced market than are stocks and bonds.

Real estate, a long standing holding of many pension plans, frequently has an opaque value such that when the real estate holdings are marked to market, a pension plan’s ability to obtain that value in a sale is highly dependent on the current phase of the market cycle and the urgency of the need to sell.

REITs, real estate mutual funds, and Exchange Traded Funds (“ETF’s”) are other types of investments that provide inflation protection without the liquidity risk of holding ‘real property.’ They also benefit from diversification and are subject to certain regulatory requirements. Similarly, timber and or oil and gas interests can be beneficial pension plan investments. The use of Exchange Traded Funds (ETFs) and mutual funds provide an increase in liquidity and follow the appropriate regulatory controls.

What steps (due diligence, portfolio diversification and liquidity analysis, bargaining for audit and control rights) should be undertaken in evaluating alternative investments? Are such controls and steps adequate and do they provide complete and transparent valuation?

In evaluating the use of alternative investments, portfolio investment diversification might better be managed by staging the pension portfolio based on liability duration. The degree to which the plan’s short term liabilities (3 to 5 to 7 years for example) are covered by either cash flow or liquid assets can help determine the percentage of longer term liabilities that can be invested in less liquid or more risky alternative assets.



However, plans should be cautious about the use of such alternative investments. Some investments may not be appropriate for a defined benefit plan based on their regulatory status, liquidity, transparency, and jeopardy posed to the principal invested. Such investments may not be appropriate for frozen plans that do not have a long-term duration. If used, they should not comprise a sizable portion of the total plan portfolio and extensive due diligence should be done both in the initial acquisition of such investments and in subsequent monitoring of their performance.

Defined Contribution Savings Plans under ERISA section 404(c)

As a preliminary note, in responding to the questions raised concerning the ERISA section 404(c) investment process, I believe that the most important aspect to keep in mind is the general level of sophistication of the plan participant in self-directed defined contribution accounts. Unlike the defined benefit plan scenario where investment management professionals are involved in the decisionmaking process, individual participants and beneficiaries in self-directed individual account plans generally will not have the same level of sophistication as the plan fiduciaries responsible for making investment decisions in defined benefit plans. Accordingly, the rules under ERISA section 404(c) were designed with the intent of providing sufficient information and opportunity for participants to make informed investment decisions.

However, the current guidance under ERISA section 404(c) imposes many conditions on plan sponsors who want to take advantage of its protection and a failure of any one condition, even if it is a mere “housekeeping” type of item (such as failure to provide participants with the latest prospectus for their investment funds in a timely manner) can eliminate the protection otherwise afforded by this provision. In light of technological developments and the recent enactment of pension legislation, this is an appropriate time to revisit those requirements to determine whether they have adequately served their purpose and to determine whether there are other simpler alternatives available that would enhance and better fulfill the underlying purpose of this provision.

Whether in-house or out-sourced what due diligence can be done by a plan fiduciary to assure administration of notification and prospectus delivery is compliant?

Plan sponsors who wish to claim section 404(c) safe harbor protection should develop procedures such as random checks of transactions to ensure that participants and beneficiaries have received adequate notification, information and prospectus delivery. Random selection of participants electing fund changes into investments not previously selected via electronic confirmations should be verified. Electronic due diligence may be the least intrusive and least expensive means of ensuring compliance.

However, verifying that participants have been given an opportunity to read a delivered prospectus may not be indicative of the satisfaction of the underlying purpose of the section 404(c) rules, which is to ensure that participants and beneficiaries are provided sufficient



information to make informed investment decisions. Mandating prospectuses to be delivered every time a participant changes to a new fund does not ensure that participants make good choices. It is expensive and to the extent that the participant or beneficiary does not actually make use of the information provided, it is not an effective nor an efficient use of resources. Accordingly, as further discussed in these comments, we believe that DOL should reconsider the type of materials that should be provided or made available to participants and beneficiaries and the manner in which they are transmitted.

What practices satisfy the §404(c) “sufficient information” requirement and would it be useful for the DOL to issue safe-harbor procedures?

For plan sponsors to obtain the benefit of the ERISA section 404(c) safe harbor, it is important to ensure that the individual has sufficient and understandable information on a timely basis on which to make appropriate investment decisions. However, under current standards, the regulations require that each participant or beneficiary be provided with a multitude of detailed and technical information including (but not limited to) the following:

- An explanation that the plan is intended to constitute an ERISA section 404(c) plan and that the fiduciaries may be relieved of responsibility;
- A description of the investment alternatives available, and with respect to each investment alternative, a general description of the investment objectives and risk and return characteristics;
- Identification of any designated investment managers;
- An explanation of the circumstances under which participants and beneficiaries may give investment instructions and an explanation of any specified limitations;
- A description of any transaction fees and expenses affecting the participant’s or beneficiary’s account balance in connection with purchases or sales or interests in investment alternatives;
- The name, address and phone number of the plan fiduciary (or designee) responsible for providing information to participants or beneficiaries upon request and a description of the information which may be obtained;
- Information relating to the procedures established to provide for confidentiality of information relating to the purchase, holding, and sale of employer securities and the exercise of voting, tender and similar rights;
- In the case of an investment alternative subject to the Securities Act of 1933, and in which the participant or beneficiary has no assets invested, immediately following the participant’s or beneficiary’s initial investment, a copy of the most recent prospectus; and
- Subsequent to an investment in an alternative, generally, any materials provided to the plan relating to the exercise of voting, tender, or similar rights.

The following information is to be provided to a participant or beneficiary either directly or upon request by the individual:



- A description of the annual operating expenses of each designated investment alternative which reduce the rate of return to participants and beneficiaries and the aggregate amount of such expenses expressed as a percentage of the average net assets of the designated investment alternative;
- Copies of any prospectuses, financial statements and reports and any other materials relating to the investment alternatives available under the plan to the extent such information is provided to the plan; and
- A list of the assets comprising the portfolio of each designated investment alternative which constitute plan assets.

One of the questions that needs to be addressed here is whether this is too little, too much or an adequate amount of information and whether the type of information being provided is useful to the participant or beneficiary.

We believe that providing a more simple summary communication that contains the key information related to each investment alternative to a participant that is easy to understand, that can be easily mass produced and electronically delivered within the context of participant education would be much more effective in helping each participant to make wise investment decisions, rather than, for example, requiring the rote delivery of a legal prospectus. Of course, the ability for the participant to obtain the more detailed information upon request would be maintained.

We believe that the “sufficient information” standard could be satisfied by providing a brief, one- or two- page summary of fund characteristics, highlighting information such as asset class, fund objective, return history, expense, contact information (for those wishing a full prospectus), etc. It would be very helpful if the DOL were to issue a safe harbor on this because many people within the industry strongly believe it is impossible to satisfy 404(c) in its current form. As more defined contribution plans begin to use investment options that are Collective Trust funds or separate accounts, the prospectus requirement will become harder and harder to comply with as these investments are not NASD registered and do not require prospectuses. Perhaps, the Department of Labor could modify its regulations permitting the use of such a summary document and could issue a model document. Advisory Opinion 2003-11A (September 8, 2003) contemplates the use of such a summary prospectus or profile approach.

Is it practical to use electronic media for §404(c) notifications and prospectus delivery?

Yes, and we would encourage the DOL to pursue this approach.

In fact, with the use of the Internet as a means of viewing and managing a participant’s account, an electronic control could be put into place that would force the participant to view a particular investment’s prospectus (or other investment information) before the participant can transfer money into the investment.



Discuss self-directed brokerage accounts in light of the prudent man standards of fiduciary compliance. How should the standards take into account participant demographics such as participant account size, participant investment sophistication and other participant investments?

Although it is possible to limit the type of investments in a self-directed brokerage account, in light of the general lack of investment sophistication of participants and beneficiaries in such plans, it may be difficult to justify offering a brokerage account to a plan and claiming it was a prudent “offering.” In effect, instead of putting a focused lineup of high quality investments selected by fiduciaries utilizing high quality tools and benchmarking metrics, the whole investment world is opened up without any real controls to educate participants to the danger of investing in funds that may not be prudent for a qualified retirement plan. There is a high probability that some participants will invest in inappropriate investments. Such an approach would also require the plan sponsor to judge the relative sophistication of each participant and beneficiary, a very difficult task.

While plan sponsors are not obligated to ensure positive returns for all participant accounts, they may be held liable for losses in the self-directed brokerage account because they are unable to effectively provide “sufficient information” on all of the options that might be available.

How can plan fiduciaries mitigate risk for default investments or mapping from discontinued investment and other investments made at the direction of the plan fiduciary?

With the enactment of section 621 of the Pension Protection Act of 2006 (PPA 2006), generally effective for plan years beginning in or after 2008, ERISA section 404(c) protection to fiduciaries is extended to situations where there is a “qualified change in investment options” (i.e., where the participant’s account is reallocated among one or more new investment options and the characteristics of the new options including risk and rate of return are reasonably similar to those investment options previously offered). Certain notice, information and other requirements must be satisfied by the plan.

Additionally, section 624 of PPA 2006 amends ERISA section 404(c) for plan years beginning in or after 2007 to treat participants as exercising control over their accounts (and thereby relieving plan fiduciaries of their responsibility) where the participant does not make an affirmative investment election and instead, those amounts are invested in a default arrangement established by the plan sponsor in accordance with the requirements of the provision and regulations to be issued by the DOL on the “appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.” The use of model portfolios, lifestyle funds, or target maturity funds would appear to be among the types of investments that would satisfy this requirement.

We believe that with adequate guidance, the introduction of these new provisions will provide plan fiduciaries needed relief in these situations.



It would seem prudent for the plan fiduciaries to hire an experienced, independent, “fee for service” investment professional to evaluate appropriate risk/return characteristics of each investment within the plan’s fund lineup. In addition to this, it would be prudent for the plan fiduciary to establish a concise, easy to understand “road map” of the mapping schedule for participant communication purposes. There are already ERISA rules in place for monitoring investment options of participant directed retirement plans. The key to mitigating risk is in the process used to make the decision of where to place default or mapped assets. No investment manager guarantees positive returns; therefore no plan sponsor can guarantee positive returns for a default option or a mapped fund. Legislating mapping scenarios seems cumbersome and overbearing. All that ERISA requires for any investment option is that a prudent process is undertaken in the selection and monitoring of the plan’s investment options.

Additionally, advanced communication with the participants is essential since it provides both a foundation for the decisions that were made and a framework for the fiduciary in making such decisions in the future.

Are “alternative investments” appropriate for ERISA section 404(c) plans?

Although they may be appropriate if part of a *managed* account properly allocated by an investment professional and dynamically managed, we believe they are generally not advisable for a self-directed account for basically the same reasons noted in our response to alternative investments.

Many participants have an extremely tough time just understanding “typical” asset classes and the implications of how various economic factors affect the most basic equity/bond portfolios. Stand-alone alternative investments requiring decisions dependent upon proper participant allocation could be disastrous in terms of long-term retirement performance. It could be said that if we allow self-directed brokerage accounts then we should also allow alternative investments. Both of these options can be high risk and high return investments, and both are mostly misunderstood and ill used by unsophisticated investors. Even the securities laws impose requirements on investors who wish to participate in certain non-public offerings. Under section 4(2) of the Securities Act of 1933, an investor must satisfy certain net worth (\$500,000 in net worth) and other requirements to be deemed a “sophisticated investor” eligible to participate in certain non-public offerings.

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Again, I would like to take the opportunity to thank you for permitting me to speak to you about these important issues. I am available to respond to any questions you may have now or in the future on these important issues.