2016 DEFINED CONTRIBUTION OUTLOOK

Redesign of DC plans focuses on building the right oversight process moving forward.

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NOVEMBER 2016

This summary is part three of a three-part plan sponsor research series on the design and oversight of defined contribution plans.

PART THREE OF THREE

EXECUTIVE SUMMARY

It’s never been a more difficult or challenging time to be a trustee of a company’s defined contribution (DC) plan. Plan sponsors readily acknowledge that they are concerned their participants will not have the necessary savings to retire at retirement age. DC plans were not initially built to be the primary retirement income vehicle and plan sponsors know a redesign is inevitable. They also know the need to change will only continue as the investment world evolves and new products are available. These changes are broadening the layers of complexity when it comes to oversight and governance of plan investments.

While trying to make changes and manage plans to meet goals moving forward, the threat of lawsuits is a primary concern for committees overseeing these plans. Plan trustees need to be especially aware of their fiduciary liability in managing the company’s retirement plan and the scrutiny for that plan only continues to grow. Retirement committees need to have the best possible processes in place for ongoing management and oversight of their company’s plan.

As plan trustees seek to offer the best possible investment approach, more are decoupling asset management from recordkeeping, virtually ending the bundled experience of “all things in one place.” From a governance perspective, those were simpler times, but the need for more effective plans requires more accountability and oversight. This requires a thorough process for monitoring the plan and making timely decisions about changes to the plan and investments. As committees overseeing DC plans look for best practices, the answers are not always clear. The results of this survey outline three high-level observations for the current state of governance and oversight of DC plan investments:

1. Fund lineup decisions are being made by retirement committees and the highest representation on committees is coming from human resources.
2. Committees are trying to improve investment options, but with limited resources this is challenging to implement.
3. Outside providers will play an increased and critical role in investment oversight and governance moving forward.

Plan sponsors are putting a broader oversight process in place. Formal processes are being documented. Now, more frequently, quarterly meetings are including ERISA attorneys or internal counsel. Outside investment advisors are also being included. The need for improvement continues and with that comes change. From an investment lineup perspective, determining the best process for ongoing oversight and the implementation of change with as little disruption to participants as possible is an important piece.

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AS RETIREMENT COMMITTEES DRIVE CHANGES, MANY FACTORS INFLUENCE THOSE DECISIONS

Of those surveyed, nearly nine out of 10 (86%) said the retirement committee ultimately drives changes to the fund lineup.

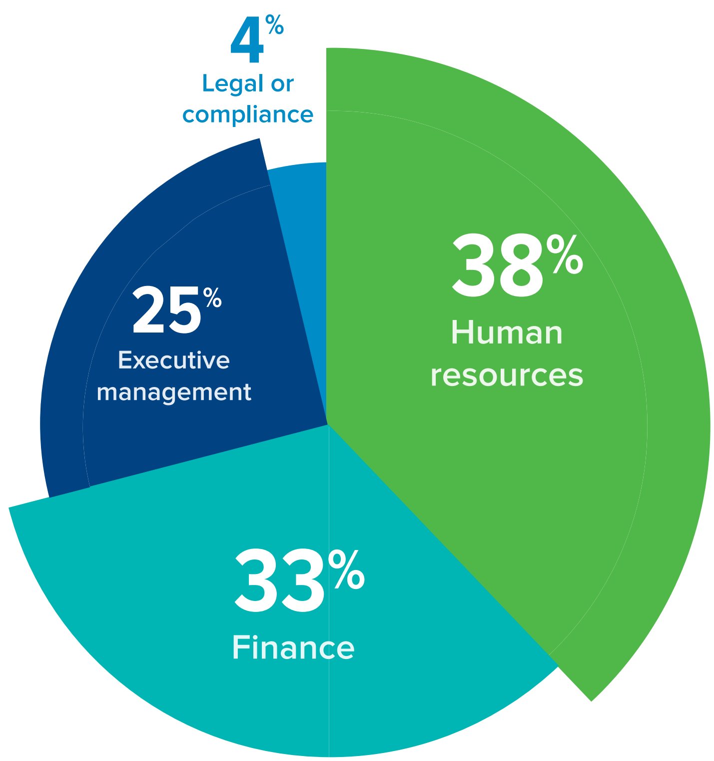
The Employee Retirement Income Security Act (ERISA) requires that a DC plan must have at least one fiduciary (a person or entity) named in the written plan. For many plans, that named entity is the retirement committee charged with overseeing the operations of the plan. The individual members of this committee are trustees of the DC plan and could have personal liability in that capacity. As a result, their oversight responsibilities are significant and they maintain authority in controlling and managing the administration of the plan.

A notable percentage (12%) of those surveyed said fund lineup changes are driven by the finance or treasury department within their organization and not the committee. These organizations tended to have larger plans (56% with $1 billion or more in assets) and offer defined benefit (DB) plans (77%). For the vast majority of organizations (86%), the retirement committee ultimately drives investment decisions for the DC plan lineup. It's important to understand the makeup and focus of those committees.

The makeup of retirement committees

The retirement committees overseeing DC plans are mostly made up of existing employees with other full-time responsibilities. Of the poll respondents, nearly three-quarters (73%) were on the committee responsible for overseeing the DC plan. The poll looked to gain insight into representation on committees based on functions or departments. Human resources had the highest level of representation followed closely by finance.

Retirement committee representation by department or function



Did you know: Of those plan sponsors offering both a DB and DC plan, less than a fifth (19%) have separate committees focused on each plan, instead opting for one committee overseeing both plans.

Committees have a lot on their plate

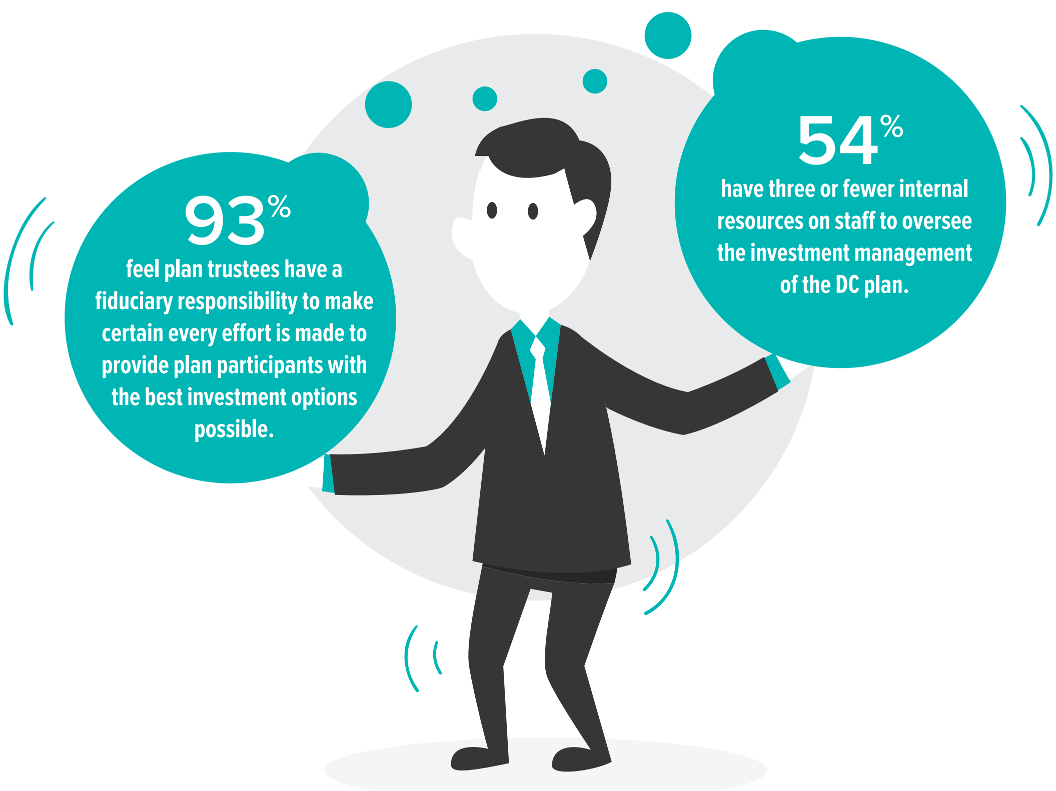
As members of the retirement committee, plan trustees appear to understand their roles and responsibilities. When it comes to issues and challenges being faced by these committees, the survey results showed:

- **Committees don't feel participants will be able to retire at retirement age.**
  While the retirement committees influence changes to the fund lineup, they are not currently confident the DC plan is helping participants accomplish their goals. A vast majority (84%) of committee members are not very confident their plan's participants will have the needed amount of income to retire at retirement age 62 to 65.
- **Design of DC plans needs to change.**
  More than half (52%) of the committee members feel DC plans were not initially built to act as the primary retirement vehicle, and therefore, need to be redesigned in order to accomplish this goal/objective.
- **Committees believe their fiduciary responsibility is to offer the best investment options possible.**
  Almost all (92%) of the responding committee members believe that plan trustees have a fiduciary responsibility to make certain every effort is made to provide the plan participants with the best investment options possible. Nearly half (46%) of the committee members surveyed said that the "quality of investment options" is the most important priority to the organization when making investment decisions for the DC plan. This was a greater priority than "performance of funds" or "fees."
- **Litigation concerns are impacting decisions.**
  At a time when committees need to focus on designing a plan that best supports participants' needs, litigation concerns loom large. More than half (52%) of the committee members surveyed conceded that avoiding litigation is a primary concern of their retirement committee. Nearly one in five (17%) said it was the first or second priority when making investment decisions for the DC plan, ranking it above "quality of investment options" and "performance of funds."

Committees challenged to balance needs of plan and resources

As plan sponsors embark on a redesign, accountability is high and resources are scarce. This creates challenges as fiduciary risk for potential litigation depends just as much on the oversight process as it does on the outcomes. Retirement plan committees are focusing on that process and ensuring that they are making prudent decisions based on diligent investigation of all options.

The expectation is committees are conducting significant levels of research and understanding about the investment options they are offering to participants. The reasonable question is: Do they have the expertise, time and resources to do so? Plan sponsors must balance prioritizing responsibilities and allocating the time and resources to fully performing those management duties.



SECTION II:

COMMITTEES TRYING TO GET PARTICIPANTS MORE ACTIVE IN A FAST-CHANGING ENVIRONMENT

DC plan management is requiring significant oversight

As part of an effort to best meet fiduciary standards, committees are focusing more on truly understanding potential conflicts and issues when it comes to the investment lineup. This includes scrutinizing recordkeeper and money manager compensation, how investment managers or funds are being selected, relationships between consultants and money managers and overall plan design. Furthermore, trustees overseeing the plans are trying to find ways to get participants better educated about their choices, contributing more and taking advantage of options guided by external expertise.

Plan sponsors are attempting to improve investment lineups as more than three-quarters (76%) made a change in the past year to the investment menus of their DC plans.

There is a high volume of activity taking place and with that comes high levels of accountability and oversight.

Consider, in the next 12 months:

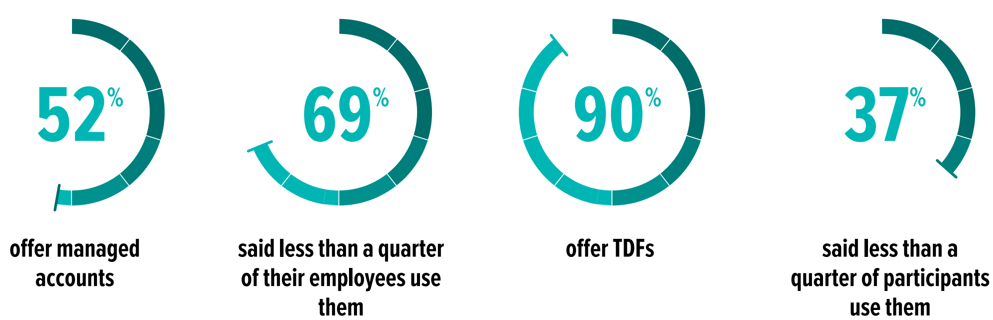
- 25% plan to consolidate number of funds in the core lineup
- 42% plan on adding new asset classes to the menu
- 37% plan to conduct a participant re-enrollment
- 43% plan to add funds to the lineup that are designed to reduce investment volatility

Clearly, committees are very active in trying to design plans that increase participation and improve the overall quality. However, as these changes take place, the oversight process will also need to change. As committees make changes, it is important they implement a sustainable management process that will ensure sound plan and investment management into the future.

Many participants not using professionally managed options

An additional challenge for plan sponsors is that professionally managed options within the DC plans are being underused. This includes target date funds (TDFs), where asset allocations and subsequent changes are designed by outside professionals, and managed accounts, which create custom portfolios for individual participants. In recent years, TDFs and managed accounts caught the attention of regulatory bodies including the Government Accountability Office (GAO) and the Department of Labor (DOL). The GAO and DOL scrutinized a plan sponsor's fiduciary responsibility for conducting ample due diligence when those sponsors chose and oversaw providers of professionally managed options as well as which of those options were best for their plans.

This heightened sensitivity created additional expectations and oversight responsibilities for plan sponsors who choose to offer TDFs or managed accounts in their lineups. Beyond the due diligence requirements, if plan sponsors believe these are the best options for participants, they feel it is their responsibility to get participants to use them. Participation rates for these options are low, and plan sponsors are investing additional time and resources toward attracting more participants to both of these professionally managed options.



The poll responses suggest possible confusion among plan sponsors in thinking their consultant is acting in a full discretionary capacity, like a true ERISA 3(38) investment manager, when in reality they may only be making recommendations for final approval or implementation by another plan fiduciary (like a plan committee or the plan sponsor).

SECTION III:

COMMITTEES DEPENDENT ON OUTSIDE PARTNERS IN HELPING WITH OVERSIGHT AND GOVERNANCE

Plan sponsors believe ERISA 3(38) providers are common

Many plan sponsors do not have the necessary expertise or resources in-house and partner with outside investment experts. For the majority of respondents (87%), their primary source for investment guidance is an investment consultant or advisor. Over the past few years, litigation risk, increased scrutiny and investment management complexity has created a challenging environment for committees. This has led many sponsor to explore options for delegating decision-making authority about investments, and ultimately, sharing fiduciary responsibilities with an outside partner.

The terms 3(21) and 3(38) reference the definition of the term “fiduciary” and “investment manager” as found in the Employee Retirement Income Security Act (ERISA), but are more generally and colloquially been used publicly to describe the levels of fiduciary responsibility these outside providers accept. According to ERISA section 3(21)(A)(ii), a non-discretionary investment advisor to a qualified retirement plan does not have specific investment discretion over plan assets directly, but provides investment advice to another plan fiduciary (a plan committee or plan employee or officer, for example) for a fee. The plan sponsor retains the responsibility to appoint and monitor the investment advisor, and ultimately, exercises the final investment discretion over the plan. In contrast, according to ERISA section 3(38), an investment manager to a qualified retirement plan has discretionary control to, among other things, hire and fire other investment service providers relevant to its scope of responsibility. The plan sponsor retains the responsibility to appoint and monitor the 3(38) fiduciary, but does not ultimately exercise investment discretion over plan assets or implement the final investment decisions. Of those using a consultant or advisor, the question was asked if that provider acts in an ERISA 3(38) capacity:

69% YES **31% NO**

While many providers are offering some services that would be included in the ERISA description of a 3(38) "investment manager", by definition, an ERISA 3(38) investment manager should, among other things, accept fiduciary authority for managing the investment portfolio in writing (i.e., in their contact with the client). A true ERISA 3(38) discretionary investment manager accepts full discretion for making changes to the portfolio on an ongoing basis. The above response suggests possible confusion among plan sponsors in thinking their consultant is acting in a full discretionary capacity, like a true ERISA 3(38) investment manager, when in reality they may only be making recommendations for final approval or implementation by another plan fiduciary (like a plan committee or the plan sponsor). At a time when fiduciary risk is of great concern to plan sponsors, they might be at greater fiduciary risk if they do not fully understand the actual liability their provider is accepting. According to an article on this topic, "ERISA 3(38), and the allocation of liability that comes with using an investment manager to manage an investment portfolio, is a very, very, dubious provision for a fiduciary committee to use if the consultant/manager is not actually managing an investment portfolio."[1]

Committees want an ERISA 3(38) to act as a discretionary investment manager to mitigate risk and improve process

As nearly three-quarters of those polled use a partner who serves in a 3(38) capacity, it could become the expectation or norm that providers take on that responsibility. However, to better address growing investment management challenges, more plan sponsors are looking for a provider who is willing to take on more accountability by taking on greater discretionary responsibilities within that 3(38) capacity. This type of provider is often referred to as a discretionary investment manager. A discretionary provider takes on decision-making responsibilities for the management of the investment menu.

Nearly two-thirds (63%) of all survey respondents said they would or currently do use a discretionary investment management provider.

The appeal of the discretionary manager is the ease of investment management changes in the plan moving forward. If plan sponsors use a discretionary manager for white-label or multi-manager funds, they can reduce fiduciary risks while implementing a process that is handled by the provider and is seamless for participants. The discretionary manager can provide complete fee transparency while building a better investment lineup for participants. Of those who currently do or would use a discretionary investment manager, they were asked which areas of discretion they would expect that partner to provide.

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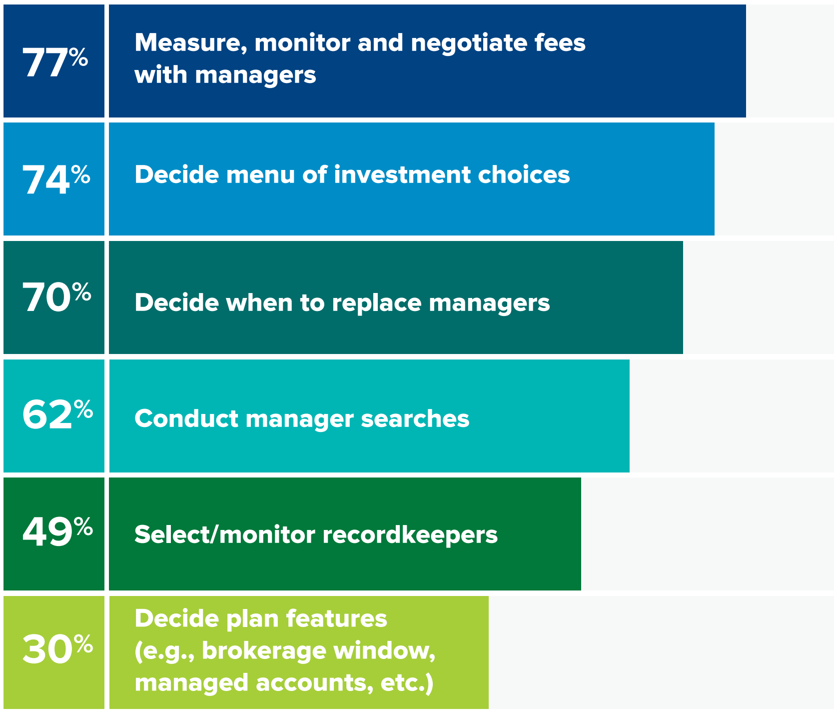
[1]Whitehouse, Herbert A,"The Use of ERISA 3(38) Investment Managers in Defined Contribution Plans," *401khelpcenter.com.*

Below is a breakdown of the percentage of plan sponsors who feel it is important that discretionary investment managers take on full responsibility for these services:



The above expectations suggest a need for providers to take on full responsibility for a lot of changes moving forward. This enables the retirement committee to focus on overseeing the discretionary manager and spend more time on other aspects of the plan.

Fast fact: 40% of those who feel it is a good idea to separate asset management from recordkeeping also work with a consultant/advisor who **does not** act in an ERISA 3(38) capacity.

CONCLUSION

The makeup of DC plans is changing from where they were decades ago. Liability issues continue to surface for fee transparency and the performance of funds versus associated fees. Bundled providers are being challenged from a transparency and independence perspective as plan sponsors look to decouple asset management from recordkeeping. TDFs, are becoming an increasingly important part of DC plans as the overall percentage of DC assets in TDFs tripled from 2006 to 2013.[2] Plan sponsors need to pay careful attention to how TDFs are constructed, monitored and improved through time to ensure participants meet their retirement needs. As a whole, the management of DC plans continues to grow in complexity and many plan sponsors don't have the necessary expertise or resources in-house; therefore, plan sponsors partner with outside investment resources.

The level of discretion those providers accept needs to increase when it comes to the plan's investments. Committees are interested in discretionary providers to ensure fee transparency, build a better investment lineup and implement a sustainable process for future changes that don't cause interruption for participants. Plan sponsors want external experts to take on those critical decisions as it will improve the overall experience for their participants.

This is the final part in our three-part series detailing the results of our survey. If you would like copies of the other parts of the series, visit seic.com/dcpoll2016 or email seiresearch@seic.com.

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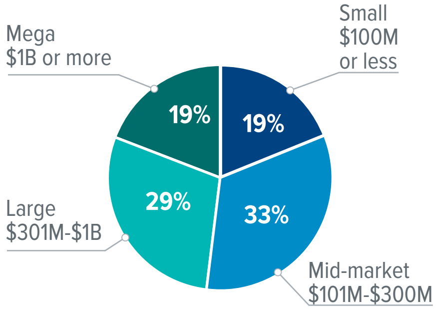
[2] 2015 Investment Company Fact Book, "A Review of Trends and Activities in the U.S. Investment Company Industry," Investment Company Institute, 2015.

Participant demographics and survey information

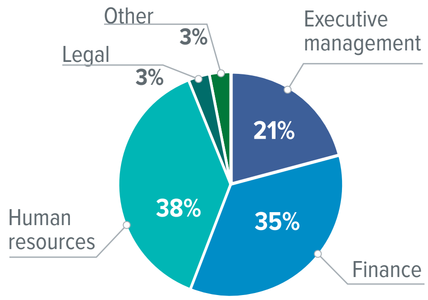
SEI's Defined Contribution Research Panel completed a comprehensive survey of executives from defined contribution (DC) plan sponsors in the U.S. to gauge their views on a number of areas of plan management. The poll was completed by 231 executives, representing DC plans ranging in size from $25 million to more than $5 billion. Of the respondents, 47 are current clients of SEI. The poll was conducted in November/December 2015.

The accompanying charts show some demographic breakdowns of the participants:

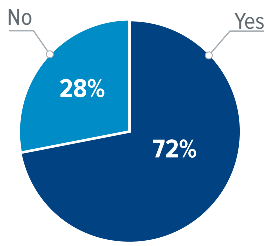
Size of participating plan sponsor's DC plan assets



Role or department within organization



Are you a member of the investment committee for your organization's DC plan?



DEFINED CONTRIBUTION
Research Panel

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