The Misperception of Fiduciary Risk and Active Management in DC Plans: A Legal Perspective

By **Alison V. Douglass, Esq.**

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Highlights

In the complex and litigation-prone world defined contribution plans occupy, it is important to underline what the real focal points for fiduciaries should be. Here are five guiding principles under ERISA that can aid fiduciaries in selecting and monitoring investment options and assessing active strategies within their plan lineups:

It's about the process.

In order to satisfy ERISA prudence standards, a fiduciary needs to make informed decisions. This means that fiduciaries should have a good decision-making process that they consistently follow.

Fiduciaries should focus on the value-for-cost proposition.

Plan fiduciaries are not required to scour the market for the cheapest possible investment options. Rather, fiduciaries should focus on the value-for-cost proposition. This means that fiduciaries have latitude to consider what different investment strategies provide to plan participants, and not just cost.

There is no one-size-fits-all approach to investment menus.

Making good decisions about investment menus requires a fiduciary to understand the available alternatives and know their audience.

Range of choice and strategies can be appropriate.

In choosing investment strategies, plan fiduciaries should consider the particular attributes of their plans and may appropriately offer plan participants an array of choices across multiple investment styles and strategies.

Fear-based decisions fall short of prudence.

While litigation may be top of mind, it has no place in fiduciary decision-making. Instead, a well-rounded assessment of investments strategies and options that focuses on participant outcomes and plan objectives should supersede all other factors.

The fiduciary standards and guiding principles highlighted above, and discussed later in more detail, do not mandate any particular investment lineup and do not favor the use of either actively or passively managed strategies.

Introduction

Plan sponsors today have unprecedented options available to them when making investment selection decisions for their plans. Among those options is a wide array of actively managed investment strategies. These strategies provide participants a diversity of choice and the opportunity to benefit from excess returns above a benchmark, which can have a significant impact on portfolio value over longer time horizons due to the power of compounding. At the same time, plan sponsors face increasingly complex fiduciary requirements, as well as pressure to provide an optimal plan experience for participants at a reasonable cost. Making investment selection decisions under these conditions can prove challenging.

This white paper aims to help fiduciaries navigate the waters of plan investment selection and monitoring processes by:

- Decoding the legal standards that apply to fiduciaries who are responsible for choosing investment options for their plans.
- Identifying some guiding principles drawn from legal authorities that may assist fiduciaries assessing investment strategies such as active and passive as part of a plan lineup.
- Emphasizing the importance of process as the most important factor in fiduciary decision-making.

Decoding ERISA's Fiduciary Standards

ERISA holds plan fiduciaries to certain standards of care that the courts regard as the highest standards known to law, namely:

- Fiduciaries owe a ***duty of loyalty***[1] to plan participants and beneficiaries. This means that the fiduciaries must act solely in the interests of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and paying only reasonable plan expenses. This standard is often is referred to as the "exclusive benefit rule."
- Fiduciaries owe a ***duty of care***[2] to plan participants and beneficiaries. This means that when the fiduciaries act for the plan, they must act "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 a like character and with like aims." This standard is known as the "prudent person rule."
- Fiduciaries also must act ***consistent with the documents***[3] that govern the plan and must ***diversify***[4] the plan's investments so as to minimize the risk of investment losses.

When it comes to a plan's investments, most defined contribution plans are set up so that the participants themselves can decide how to invest their plan accounts. Even so, plan fiduciaries do have the responsibility to select and to monitor the investment options that will be made available to participants. Meeting these responsibilities requires an informed and thorough evaluation of both the needs of their plan and the options available in the marketplace. Here, the focus is on the *inputs* to the fiduciary's decision-making, and not on the investment *outcomes* achieved. In other words, employing a good investment selection and monitoring *process* is a key to meeting fiduciary obligations.

A good fiduciary investment selection process may include:

- Understanding the documents that govern the plan, which may set forth investment objectives or mandates for the plan. Remember, following the plan documents is a key fiduciary obligation.
- Meeting regularly to discuss and review the plan's investment options. Again, the focus here is on process. It is important to have a decision-making process that is thorough, consistently applied, and documented.
- Considering key attributes of the investment options (such as performance, expenses, and volatility) when considering available options and monitoring those investments chosen for the plan.

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[1] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A).

[2] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[3] ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D).

[4] ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C).

Basics of Active and Passive Investments

Because of the variety of options in the marketplace, there are several dimensions to an investment selection decision. One key dimension that plan fiduciaries often evaluate when selecting investments is *management strategy* or, more specifically, "passive" or "active" management strategies.

- Passive strategies aim to provide the return of an index that replicates the market and can be accomplished for a relatively low cost.
- Active strategies aim to outperform the return of a benchmark by utilizing different analyses and trading strategies.

It is essential for fiduciaries to consider the value-for-cost proposition when comparing the two strategies. Actively managed funds will likely have higher research and trading costs than passively managed funds, resulting in greater overall expenses. However, the active fund manager's objective is to produce superior returns, even after costs are taken into account.

In recent years, class action litigation has challenged many common features of employer-sponsored retirement plans, including the use of active management. It can be daunting for plan fiduciaries to read headlines about litigation trends and to keep apprised of developments in the law. In the following section, we identify five guiding principles for plan fiduciaries that have emerged from recent court cases addressing investment selection decisions for employer-sponsored retirement plans.

5 Guiding Principles for Fiduciary Investment Selection and Use of Active Management

Courts are frequently called upon to consider whether a fiduciary's selection of an investment for the plan was consistent with ERISA's standards. The cases have generated some guiding principles that may be helpful to plan sponsors as they consider the role that active management can play in their plan's investment lineup.

▶ Guiding Principle 1: Fiduciary prudence focuses on the process by which investments are selected and monitored for the plan and not on investment outcomes.

ERISA's prudent person standard is not concerned with results.[5] Time and again, courts have said that the test of prudence focuses on the fiduciary's decision-making process, not on investment outcomes. In particular, the fiduciary must give appropriate consideration to the facts and circumstances that are relevant to the particular investment under consideration, and act accordingly.[6] Relevant factors may include the sponsor's purpose in offering the plan, the risk of loss and the opportunity for gain (or other return) associated with the investment being considered, and the role the investment will play in the plan's investment lineup.

In short, ERISA's fiduciary standards are satisfied by an informed decision-making process. For this reason, courts are not inclined to hold liable a plan fiduciary who engaged in a reasoned decision-making process and took into account all relevant information in carrying out its fiduciary duties.[7] Because plan fiduciaries are judged largely based on the steps they took and the information they considered in making investment decisions, a decision to include actively managed funds in a plan lineup can be entirely consistent with fiduciary standards, provided that the fiduciary considered relevant information (such as performance and fees) and made a thoughtful decision.[8]

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[5] *Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915, 918 (8th Cir. 1994) (prudence is "a test of how the fiduciary acted viewed from the perspective of the time of the challenged decision rather than from the vantage point of hindsight").

[6] 29 C.F.R. § 2550.404a-1.

[7] *Bunch v. W.R. Grace & Co.*, 555 F.3d 1, 6 (1st Cir. 2009) (no liability for plan fiduciary who engaged in "thorough investigative and decisional process"); *DiFelice v. U.S. Airways*, 497 F.3d 410, 420 (4th Cir. 2007) (no liability for plan fiduciary whose decision-making process used "appropriate methods to investigate the merits" of the challenged investment).

[8] *Taylor v. United Technologies Corp.*, No. 06-1494, 2009 WL 535779 (D. Conn. Mar. 3, 2009), aff'd. No. 09-1343, 2009 WL 535779 (2d Cir. 2009) (rejecting attack on the use of actively managed funds in a large defined contribution plan where the fiduciaries' selection process included "appropriate consideration" of the fees and the returns of funds).

▶ Guiding Principle 2: Appropriate selection and monitoring of plan investments requires an understanding of the basis for comparison.

Plan investments cannot be evaluated in a vacuum. Part of a fiduciary's responsibility in evaluating investment options is to consider available alternatives. In evaluating the available options, the fiduciary needs to understand certain key dimensions of investments, such as investment type (e.g., mutual fund or collective or common trust), asset class, management strategy, and cost. While a broad range of options along each such dimension are available in the market, once an investment has been chosen for a plan, any evaluation of such plan investment should be subject to appropriate comparisons. For instance, critics of active management often base their after-the-fact critique on a comparison between the fees of active and passive investment products. But such comparisons are not apples to apples. Actively managed investment products are typically more expensive than passively managed investment products because they require different levels of services. There are costs associated with active trading strategies. The courts have recognized this and have rejected claims based exclusively on inapt fee comparisons.[9]

Moreover, courts have consistently recognized that fees are just one dimension to a plan's investments and should not alone be the basis upon which an investment selection decision is judged. For example, some courts have considered the availability of cheaper options to be "beside the point" because nothing in ERISA requires every fiduciary to "scour the market" for the cheapest possible funds.[10] Not only do plan fiduciaries have latitude to value investment features other than price, they are required to do so.[11] This is consistent with any common sense approach to purchasing. For instance, no professional would advise a person who is looking to buy a house or a car to only consider the listing or sticker price.

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▶ Guiding Principle 3: There is no one-size-fits-all approach to choosing investment options for a plan.

ERISA does not require fiduciaries to pick any particular mix of investments for their plans, much less preclude the use of particular options such as actively managed funds. To the contrary, the law gives plan fiduciaries leeway to choose the options that make the most sense for their particular plans. After all, every plan is different, and there is no one-size-fits-all approach to selecting plan investments. In fact, courts have said that plan fiduciaries are entitled to—and indeed should—consider their plan's unique attributes in selecting investments. For example, factors such as the age and level of sophistication of employees participating in the plan may bear on the fiduciary's evaluation of investment options available in the marketplace.[12] Based on these kinds of factors, a fiduciary may conclude that participants would benefit from a diversity of choice and the opportunity to seek excess returns above the benchmark that active management presents.

Plan fiduciaries are also entitled to consider the preferences of their participants in choosing investment strategies for their plan. Actively managed strategies are widely offered in defined contribution plans and are a common choice among many plan investors.[13] Plan fiduciaries may fairly consider whether including appropriate investments that are also preferred by participants will increase participation and investment levels among employees. After all, participation in an employer-sponsored retirement plan is entirely voluntary, and employers have often faced challenges incentivizing employees to save for retirement.

In choosing investment strategies for their particular plans, fiduciaries may also take into account that certain strategies are offered by other similar plans. Indeed, under ERISA's prudent person standard, fiduciary conduct is judged in part by what a fiduciary "acting in a like capacity" would do with a plan of "like character and with like aims." This means that the investment selection choices of similarly situated fiduciaries can provide a good frame of reference.

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[9] *Loomis v. Exelon*, 658 F.3d 667 (7th Cir. 2011) (rejecting challenge to inclusion of actively managed funds in plan lineup and noting costs associated with active strategies).

[10] *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009) (rejecting claims that cheaper alternatives were available).

[11] *White v. Chevron Corp.*, 2016 WL 4502808 (N.D. Cal. Aug. 29, 2016) (rejecting claims that cheaper alternatives were available).

[12] *See Hecker*, 556 F.3d at 586 ("nothing in [ERISA] requires plan fiduciaries to include any particular mix of investment vehicles in their plan"); *Whitfield v. Tomasso*, 682 F. Supp. 1287, 1304 (E.D.N.Y. 1988) (fiduciary obligation includes consideration of participant needs).

[13] *See Deloitte Annual Defined Contribution Benchmarking Survey (2015)* at 31 (88% of plans offering actively managed funds).

▶ Guiding Principle 4: Participant choice plays an important role in defined contribution plans and may favor a sponsor's decision to provide a variety of investment options, including active and passive strategies.

Nothing in ERISA "forbids plan sponsors to allow participants to make their own choice."[14] To the contrary, defined contribution plans are unique in that they are designed to allow participants to direct their own investments. Giving participants a sufficient variety of options can go a long way toward putting participants in the driver's seat of their retirement savings. Consistent with the role that participant choice plays in defined contribution plans, courts have acknowledged that fiduciaries may appropriately provide plan participants with an array of options, including actively managed funds. Indeed, courts have recognized that a plan that offers a variety of options "has left choice to the people who have the most interest in the outcome."[15]

As discussed above, participant choice plays an important role under ERISA's safe harbor provision in § 404(c), as the protections of the safe harbor are only available if a broad range of investment options are offered to participants, among other conditions. Courts have recognized that the safe harbor encourages sponsors to allow choice to participants in defined contribution plans.[16] Of course, plan fiduciaries should consider the unique attributes, needs, and preferences of their own participants in determining the right number of investment options for their plans.

> "...the protections of the safe harbor are only available if a broad range of investment options are offered to participants, among other conditions.

▶ Guiding Principle 5: Investment selection (and removal) decisions should not be motivated by self-interest or a fear of litigation risk.

ERISA's prudence and loyalty obligations go hand in hand. Fiduciaries should make informed choices, *and* do so for the right reasons. After all, ERISA's exclusive benefit rule requires plan fiduciaries to act with an "eye single" to the interests of the plan's participants and beneficiaries.[17] But the flip side of the duty to act exclusively in the interests of plan participants is that fiduciaries cannot make decisions motivated exclusively by *their own* self-interest. As a result, courts have said that a fiduciary who makes an investment decision purely out of concerns about its own liability can find itself in trouble.[18] The fiduciary duty to act solely in the interest of participants and beneficiaries means that it is improper for plan fiduciaries to consider their own potential exposure and act out of a fear of liability, and not out of concern for employees' best interests.

The lesson here is that knee-jerk reactions to litigation trends do not make for a sound fiduciary decision-making process. Of course, putting aside a fiduciary's obligation to refrain from acting out of self-interest, in any event there is no particular course of conduct that can immunize a plan sponsor against litigation risk. As 401(k) plan fee litigation proliferates, even low-cost, passive investment options have come under attack.[19]

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[14] *Loomis*, 658 F.3d at 673 (rejecting claims challenging a plan "that includes high-expense, high-risk, and potentially high-return funds, together with low-expense index funds that track the market").

[15] *Id.*

[16] *Loomis*, 658 F.3d at 673.

[17] The "eye single" standard for fiduciary conduct comes from one of the earliest cases to define fiduciary duties. In assessing the actions of plan trustees, the court stated: "Although officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation or, indeed, themselves, their decisions must be made with an eye single to the interests of the participants and beneficiaries." *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982), cert. denied, 459 U.S. 1069 (1982).

[18] *Tatum v. RJR Pension Investment Committee, et al.*, 761 F.3d 346, 358-61 (4th Cir. 2014) (fiduciaries breached their duties in making investment decision "with virtually no discussion or analysis" where "driving consideration" was their risk of fiduciary liability).

[19] *See* Complaint, *Bell, et al.*, v. Anthem, Inc., et al., No. 15-2062 (S.D. Ind.) (alleging breaches of duty in connection with plan's offering of index fund options with costs as low as 4 basis points).

Conclusion

To sum up, the fiduciary standards and guiding principles previously discussed do not mandate any particular investment lineup and do not favor the use of either actively or passively managed strategies. Indeed, courts have recognized the role that different management strategies can play in a plan lineup that provides participants with a broad range of choice. Rather than mandate certain types of investment options for plans, courts instead focus largely on the decision-making process in which the fiduciaries engaged when making investment selections for their plans, and the plan sponsor's purpose in offering the plan in the first place. The selection of active management or other common plan features based on a deliberative process and plan-specific considerations is entirely appropriate and consistent with ERISA's fiduciary standards.

Actively Managed Target Date Funds

Target date funds (TDFs) are a popular choice because of their growing prominence and size in defined contribution plans. If you are considering TDFs for your plan, and value the role that active management can play in your plan's investment lineup, you may have questions about some of the unique features of actively managed TDFs.

TDFs are often structured as funds of funds and utilize active investment management strategies. TDF managers have faced unfounded criticism not just for the use of active management, but for the common practice of investing in affiliated products. The potential for conflicts of interest in this context has been closely examined, and the Department of Labor (DOL) has specifically rejected the notion that investments in affiliated funds necessarily creates a conflict of interest concern for TDFs. This issue was the subject of a March 2009 advisory opinion request to the DOL, in which money manager Avatar Associates questioned whether an investment adviser to a TDF would be subject to ERISA's fiduciary rules by investing in affiliated funds. In response, the DOL issued an advisory opinion that cited the provisions of ERISA that expressly exempt mutual funds from the statute's purview and noted that Congress had clearly concluded that it did not need to apply ERISA's fiduciary rules to the operation of mutual funds.[20]

In its advisory opinion, the DOL further clarified that nothing in ERISA suggests that a mutual fund's investment in the shares of an affiliated fund would, by itself, change the analysis under the relevant provisions of the statute, and that there was no basis to conclude that a TDF manager's investment in affiliated funds should subject it to ERISA's fiduciary provisions. In short, according to the DOL, the investment of a TDF in affiliated mutual funds does not implicate any conflict of interest or self-dealing issues under ERISA.

More recently, in its 2013 publication, "Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries," the DOL discusses key considerations for plan fiduciaries in selecting TDFs, including the TDF's underlying investments. So while fiduciaries should consider a TDF's underlying investments, among other attributes of the fund, there is no principle under ERISA that says a TDF's investment in affiliated funds runs afoul of fiduciary standards.

Of course, in addition to the DOL's legal analysis, which dispels the allegation of self-dealing in this context, there are some practical reasons why a TDF provider might elect to invest the TDF fund in an underlying affiliated fund(s)—reasons that do not implicate any conflict of interest and may even provide a benefit to investors. For example, fund managers investing in affiliated funds may have the benefit of in-depth knowledge of the underlying fund, its fund managers, and its strategies. There also may be cost savings and risk management benefits associated with access to affiliated portfolio managers, which may allow the TDF manager to better assess the risks associated with underlying investments.

[20] Department of Labor Employee Benefits Security Administration, Advisory Opinion 2009-04A (December 4, 2009) (citing § 3(21)(B) of ERISA, which states that a plan's investment in a mutual fund does not, by itself, cause the fund's investment adviser to be deemed a fiduciary to the plan, and § 401(b)(1) of ERISA, which provides that, when a plan invests in securities issued by a mutual fund, the assets of the plan include such securities but do not include the assets of the mutual fund) (available at http://www.dol.gov/ebsa/regs/aos/ao2009-04a.html).

ALISON V. DOUGLASS

Partner, ERISA Litigation – Goodwin LLP

Alison Douglass is a partner in Goodwin's Financial Industry and ERISA Litigation practices. Ms. Douglass represents clients in a wide array of complex commercial litigation, with a focus on financial services and products and class action litigation. She has been named a "Rising Star" by *Law & Politics* and *Boston* magazine and has been recognized by *The Legal 500*. She has also been ranked by *Chambers USA: America's Leading Lawyers for Business* as a nationwide "Recognised Practitioner" in ERISA Litigation.

Ms. Douglass's work includes representation of numerous financial service providers regarding the discharge of ERISA and other fiduciary duties. Currently, she is representing some of the largest financial institutions in so-called excessive fee ERISA litigation. She also represents clients in all phases of litigation, including pre-litigation counseling and trial and appellate matters in federal courts across the country and in regulatory investigations and governmental proceedings, including before the U.S. Department of Labor and the SEC.

T.RowePrice

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