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ERISA Fiduciary Rules and Target Date Funds

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In a Dec. 4, 2009, response to questions from Avatar Associates regarding conflicts of interest in target date funds, the U. S. Department of Labor clarified that plan sponsors, rather than the managers of target date funds, are solely responsible as fiduciaries under the Employee Retirement Income Security Act for losses occurring in such funds due to imprudent investments.

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Nine days later, in an anticipated reaction, Senator Herb Kohl (D-Wis.) stated his intent to close this loophole, which allows managers of proprietary funds to circumvent ERISA fiduciary rules in Pension Protection Act-compliant plans (239 PBD, 12/17/09; 36 BPR 2915, 12/29/09).

In a further blow, related class action lawsuits, such as *Tussey v. ABB* (W.D. Mo., No. 06-cv-4305), are progressing, thereby potentially exposing plan sponsors, who saw proprietary target date funds as a prudent and safe choice, to personal liabilities.

While the easy solution is to switch to non-conflicted, low fee target date strategies, the mutual fund industry and its trade organizations are encouraging sponsors to stay put, as they aggressively lobby against attempts to close the mutual fund loophole.

For those betting they will succeed, some background might be helpful.

Congress and regulators have voiced deep concerns regarding the design of target date funds, especially funds with near-term target dates. The average investment loss for funds with a target date of 2010 was roughly negative 25 percent due to the market turmoil in 2008, with individual fund losses running as high as negative 41 percent, according to an analysis by the U.S. Securities and Exchange Commission. Target date funds in general have drawn considerable attention because of their widespread use as qualified default investment alternatives (QDIAs) in tax code Section 401(k) plans.

Concerns of Senate Committee

On Oct. 28, 2009, the Senate Special Committee on Aging released a report highlighted by several concerns relating to the effectiveness of target date funds, includ-

ing the lack of disclosure, excessive hidden fees, and conflicts of interest.

The DOL's designation of target date funds as QDIAs provides a certain measure of protection for plan sponsors by effectively making participants responsible for their passive decision to invest in QDIAs. However, from a public policy perspective, these rules mask a structural flaw that places retirement savings at risk and may subject plan sponsors to liability.

The problem lies in the fund-of-funds structure of target date funds and the use of affiliated underlying funds, creating inherent conflicts of interest. Technically, a target date fund is a separate legal entity, typically a corporation or business trust, with its own board of directors or trustees charged with protecting the interests of the fund's shareholders, including retirement plans and their participants.

Conflicts of Interest. The mutual fund industry, as voiced through its trade organizations, asserts that independent boards prevent a fund manager's interests from taking precedence over the interests of plan participants and other fund shareholders. In practice, however, product design is driven by business considerations, and target date funds are not created ''solely in the interest of participants'' or in accordance with any other fiduciary standard under ERISA.

In creating a target date fund, the fund family has a financial incentive to include as many affiliated underlying funds as possible in the fund-of-funds product, increasing its aggregate compensation through the fees paid to the underlying fund managers.

Such compensation would be in addition to any wrap-fee that is charged directly by the manager of the target date fund. In the report prepared by the Senate Special Committee on Aging, it was revealed that target date funds have ''higher expense ratios than the rest of the core portfolio in 401(k) plans.''

A related conflict arises with respect to the mix of funds that underlie the target date fund. Because equity funds typically charge higher fees than other funds, the fund family has an incentive to design the target date fund so that it has a higher exposure to equity, increasing its aggregate fees at the expense of plan participants and also increasing the product's likely volatility.

This conflict arises at the product design stage and persists to the extent the fund manager has the discretion to increase allocations to underlying equity funds. The Senate Special Committee on Aging, as well as the DOL, have observed that target date funds have what appears to be an over-concentration in equity investments. Thus, even in funds with a target date of 2010, underlying equity funds constituted up to 68 percent of assets, which in turn contributed to recent volatility and investment losses.

Call for Additional Rules

The SEC and DOL have acknowledged that additional rules are necessary to protect plan participants, and both agencies appear to favor enhanced disclosure. For example, the DOL and SEC have jointly issued guidance describing the basic features of target date funds, and ways to evaluate them (207 PBD, 10/29/09; 36 BPR 2466, 11/3/09).

In addition, the SEC is said to be interested in issuing rules ensuring that target date fund shareholders understand the risk profile of such an investment. For its part, the DOL plans to amend its QDIA regulations to require greater specificity as to the information to be disclosed in order for an investment to qualify as a QDIA.

However, by reason of their nature as default investments for participants who may not even read the fund's prospectus, enhanced disclosure will not mitigate the conflicts embedded in target date funds. Moreover, the burden of the additional disclosure will likely fall on plan sponsors that, by and large, do not have the ability to evaluate the inner workings of target date funds.

Fiduciary Status of Target Date Managers

The Wagner Law Group believes the managers of target date funds can as a matter of law be held responsible for their conduct as ERISA plan fiduciaries in certain instances. Section 3(21) of ERISA provides that a plan's investment in a mutual fund

> ''shall not *by itself* cause such [fund] or such [fund's] investment adviser or principal underwriter to be deemed to be a fiduciary (emphasis added).''

This wording demonstrates that the exception which allows target date fund advisers to escape fiduciary status does not apply in all instances and is not absolute. The firm recently requested advice from the DOL that the exception does not apply to target date funds investing in other affiliated mutual funds. The DOL declined to rule that the investment advisers to such funds should be viewed as fiduciaries to investing plans.

The implications of the DOL ruling are starkly clear and could be considered revolutionary in the eyes of plan sponsors. Phyllis Borzi, Assistant Secretary for the DOL's Employee Benefits Security Administration, in her testimony regarding QDIAs before the Senate Special Committee on Aging stated that

> ''[the plan sponsor] continues to have the obligation to prudently evaluate, select, and monitor any investment option that will be made available to the plan's participants and beneficiaries.''

Thus, in its selection of target date funds as default investment options, plan sponsors alone are responsible for monitoring target date funds and the construction, management, and oversight of their portfolios of underlying funds. Why is this revolutionary? Because most plan sponsors when questioned about this responsibility believed they were protected by the fund company providing the target date fund and were not exposed to such liability.

Criticism of Exemption. The exemption from ERISA fiduciary coverage for mutual fund investment advisers and managers has been roundly criticized. As noted, Senator Kohl's response was to announce his intention of introducing legislation that would require target date fund managers to accept fiduciary responsibility in order for the product to qualify as a QDIA.

If implemented, this proposal would subject the allocation of assets in target dated funds operated by mutual fund families to ERISA's fiduciary standards. This, in turn, would force fund families to reform their current self-dealing practices or withdraw their involvement in the management of target date funds.

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Plan sponsors would benefit from the greater transparency that this would bring about, making it easier to meet their own fiduciary responsibilities. Nevertheless, Congressional support for such legislation is uncertain.

Legislative change will likely be required to fix the problem, because anticipated regulatory initiatives appear to be inadequate. As discussed above, the burden of additional disclosure tends to fall on the plan sponsor.

The DOL has also indicated that it will expand the definition of an investment advice ''fiduciary,'' but this change will be aimed at those advisers who render investment advice for a fee, and according to the DOL's regulatory agenda, would take into consideration the expectations of plan sponsors and participants.

This apparently means that plan sponsors and participants would have to place reasonable reliance on a direct communication from the mutual fund before fiduciary status attaches. It is doubtful that this would be useful in overcoming the mutual fund exemption that is embedded in the statute.

Use of Alternative Managers Urged

When seeking an investment provider offering a target date investment alternative, plan sponsors should be looking for providers that do not have the conflicts found in most target date funds. In contrast to mutual fund managers, sponsors should also seek out providers that formally acknowledge their fiduciary status under ERISA.

In addition, sponsors could pay lower costs for such investments by investing in funds that have their underlying investments in exchange-traded funds, which typically offer costs that are lower than that of the average target date fund investing in underlying funds actively managed by affiliates.

Although self-dealing may have no consequences for the managers of target date funds, plan sponsors who bear fiduciary responsibility under ERISA would be well advised to seek target date investment alternatives. Plan sponsors should be aware of the availability of such default investment vehicles, which are more transparent and have lower fees, unconflicted managers, and investment services delivered in accordance with the fiduciary standards of ERISA.