Conflict of Interest?

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ERISA fiduciary rules and target-date funds

The DoL's designation of target-date funds as qualified default investment alternatives (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. 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.

A related conflict arises with respect to the mix of funds that underlie the target-date fund. Because equity funds typically pay 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 Securities and Exchange Commission (SEC) and Department of Labor (DoL) have acknowledged that additional rules are necessary to protect plan participants, and both agencies appear to favor enhanced disclosure. 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.

The Wagner Law Group believes that 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 exemption from ERISA fiduciary coverage for mutual fund investment advisers and managers has been roundly criticized. Senator Kohl’s response was to announce his intention to introduce 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-date 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. 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 likely will be required to fix the problem, because anticipated regulatory initiatives appear to be inadequate. The DoL also has 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 embedded in the statute.

Plan sponsors should be aware of the availability of 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.

Marcia S. Wagner is an expert in a variety of employee benefits issues and executive compensation matters, including qualified and nonqualified retirement plans, and welfare benefit arrangements. A summa cum laude graduate of Cornell University and Harvard Law School, she has practiced for 24 years. Wagner is a frequent lecturer and has authored several books and numerous articles.

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