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Fiduciary Fact or Fiction

The rules that govern the behavior of retirement plan fiduciaries are quite complex. Any time we are required to deal with complicated subject matter, things can get confusing, potentially leading to decisions based on a misunderstanding.

In this issue, we will try to clear up some common misconceptions that we hear from time to time regarding fiduciary responsibility. (Cue the music and flashing lights…) This is Fiduciary Fact or Fiction!

Fidelity Bond

Statement: The fidelity bond that all plans must have that is reported on the Form 5500 each year insures the plan itself and does not protect plan fiduciaries from liability.

Fact or Fiction: Fact

An ERISA fidelity bond must list the plan, not the plan fiduciaries, as the named insured and protects against losses due to fraud or dishonesty by plan officials. The bond does not provide any protection to plan fiduciaries who might face legal claims due to such losses. Only certain insurance companies are authorized to issue fidelity bonds. A list of these approved companies is available on the IRS website at www.fms.treas.gov/c570/c570.html.

Fiduciaries can obtain fiduciary liability insurance that provides coverage for expenses such as legal defense or monetary judgments. Like many other types of insurance, these policies differ based on features such as deductibles, exclusions, etc., so it is important to work with a property and casualty agent who understands the nuances of ERISA fiduciary liability.

Qualified Default Investment Alternatives (QDIAs)

Statement: All 401(k) plans are required to choose a QDIA into which they direct contributions for participants who have not made investment elections.

Fact or Fiction: Fiction

Ever since participant-directed investments came on the retirement plan scene, there have been instances in which contributions are allocated to the account of a participant who has not made an investment election. How are those dollars invested?

The Pension Protection Act of 2006 (PPA) tried to provide an easy answer to that question by creating the QDIA. Those rules basically say that plan fiduciaries who follow the PPA guidelines in selecting and monitoring a plan's default investment are deemed to have made a prudent decision. However, there are other appropriate choices that don't fit within the QDIA rules. For example, money market funds do not fall within the definition of a QDIA; however, many investment professionals believe that in a volatile economy, a money market fund is a prudent default. Just because it isn't a QDIA does not make it imprudent.

Some plans choose not to designate a default at all. Rather, they make sure they have one-on-one meetings with each employee eligible for the plan to ensure investment elections are made. If all participants make elections, there is no need for a default investment.

Co-Fiduciaries

Statement: A plan sponsor who appoints other fiduciaries or hires a "co-fiduciary" service provider such as an investment professional can be held liable for the actions of those other fiduciaries.

Fact or Fiction: Fact

Being a fiduciary is somewhat like being a parent. A mother is not any less of a parent simply because the father is a "co-parent." Both are parents in their own right, regardless of whether there is another parent involved.

So it is with plan fiduciaries, which makes the term "co-fiduciary" somewhat of a misnomer. If Jane Doe is a fiduciary, the fact that another plan sponsor representative or a service provider is also a fiduciary does not make Jane any less of one. When there are multiple fiduciaries, their liability is said to be "joint and several." This concept is best explained by a quick example. Assume a plan has four fiduciaries, and there is a fiduciary breach claim that results in $1 million in damages. Each fiduciary is responsible for the full $1 million, not $250,000 ¼ of the total) or some other pro rated amount.

There are several reasons this is important. First, it highlights the importance of using caution when selecting those who will serve on plan committees. While the idea of involving rank and file employees in plan management decisions might engender positive relations, an employee who doesn't understand all that is required of a plan fiduciary could create liability for other committee members, trustees, etc.

Second, it emphasizes the importance of hiring service providers who are truly experts in the field and are focused on acting in the best interest of plan participants.

Participant Investment Direction and 404(c) Compliance

Statement: Compliance with ERISA section 404(c) is mandatory and ensures that plan fiduciaries will not get sued.

Fact or Fiction: Fiction

As a quick recap, ERISA section 404(c) says that if plan sponsors meet certain requirements related to the number of investment options available, frequency of participant access and disclosure of information, the fiduciaries are not responsible for any losses that result from participants directing the investment of their own accounts.

Compliance with 404(c) is completely optional, and it does not guarantee a fiduciary will not get sued. It simply says that in the event of a lawsuit, fiduciaries use a different method to demonstrate they are not responsible for the losses in question. The lawyers still get involved, and the fiduciaries still have to defend themselves.

One of the core principles of fiduciary duty is to always act in the best interest of plan participants. Some sponsors believe that allowing participants with no investment experience to move their investments any given day among 20 different options is definitely not in participants' best interests. Anecdotal evidence suggests that more limited access such as allowing participants to choose once each year from three professionally managed, risk-based portfolios can lead to more favorable performance over time.

Daily access with 20 funds is 404(c) compliant (assuming all the disclosure requirements are satisfied) while annual access with three portfolios, by definition, does not qualify for 404(c) protection. However, one could certainly argue that the latter alternative is in the best interest of a participant population with no investment expertise.

Service Providers

Statement: Fiduciaries have an obligation to monitor their service providers on an ongoing basis to ensure they continue to be prudent choices.

Fact or Fiction: Fact

Many articles focus on the due diligence that should go into selecting those people or companies that provide services to a plan. What is sometimes overlooked, however, is the requirement that plan fiduciaries monitor the performance of those providers on an ongoing basis to make sure that all the factors supporting the original selection continue to be present and relevant. If circumstances change either with the plan or the provider, fiduciaries must assess the impact on the provider relationships.

Consider a large institution that comes under new management that does not share the previous commitment to servicing retirement plans. Fiduciaries must decide whether it is prudent (in the best interest of plan participants) to continue working with that institution. Sometimes, the plan, rather than the provider, experiences a change that warrants looking elsewhere. Any number of factors such as company growth or a recent acquisition could suggest that it is prudent to consider other providers.

This is not to suggest that a provider change is a foregone conclusion every time there is some extraordinary event. Maybe, a plan's growth makes it eligible for slightly lower fees at a larger institution, but the current investment advisor's familiarity with the company's culture, goals and employees allows him or her to provide very personalized service. The fiduciaries could very well determine that it is prudent to pay the higher fee in order to retain the personal service and trust they have with their current advisor.

The point is that fiduciaries should regularly assess their providers in light of the relevant facts and circumstances and document their decisions regardless of what that decision happens to be.

Fees

Statement: Fiduciaries must take steps to minimize the expenses related to maintaining the plan.

Fact or Fiction: Fiction

With all the regulatory focus on fee disclosure over the last five years, it would be easy to believe that every fiduciary's primary goal should be to control costs. It is never a good idea to overpay for a good or service, but there are two critical elements when it comes to retirement plan fees: reasonableness and value.

A Department of Labor Advisory Opinion from the late 1990s indicates, "…it is the view of the Department that a plan fiduciary's failure to take quality of service into account in the selection process would constitute a breach of the fiduciary's duties under ERISA…"

You would not want to save a few dollars by hiring the family's general practitioner to perform your knee replacement surgery. Similarly, you do not want to sacrifice quality and expertise to save a few dollars in plan expenses.

Consider a plan that has more than 100 participants and is required to hire a CPA to audit the financial statements each year. The CPA that prepares the sponsor's tax return has done other types of company audits and offers to do the ERISA audit for one price, while several other firms specializing in plan audits quote a fee that is three times higher. ERISA plan audits have very specific requirements that call for unique expertise. While the specialty firms' fees are higher, their expertise likely makes them the more prudent option.

Summary

Articles that attempt to simplify the complex regulatory framework that applies to plan fiduciaries are written on a regular basis. Marketing materials can make it challenging to understand where "suggested" ends and "obligatory" begins.

Fiduciary duty can be distilled into always acting in the best interest of plan participants, but the devil, as they say, is in the details. That is why it is important to work with experts who can help you separate Fiduciary Fact from Fiduciary Fiction.

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