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The Absentee Fiduciary

By Alison J. Cohen, Esq.

Eleanor Shellstrop has operated her fledgling business, The Good Place, for about seven years now. She established a 401(k) Profit Sharing Plan (the “Plan”) somewhere around year two at the recommendation of her CPA. The CPA set up the plan for her with a bundled service provider. Whatever the CPA put on the paperwork (without ever discussing it with Eleanor), was how the Plan was established and how it remains. Relying on her payroll manager, Janet, to just keep the contributions flowing, Eleanor was very pleased with herself.

The Good Place gets randomly chosen by the Department of Labor (“DOL”) for a fun-filled investigation. In reading over the DOL letter from Investigator Chidi, Eleanor is baffled by half of the requested items and calls her CPA.

“Michael, they seem to keep asking about minutes and procedures and investment monitoring. What’s that all about?”

“Eleanor, you were responsible for making sure the Plan was running properly and monitoring the investments. Haven’t you been doing that?”

“When did you tell me that?”

This investigation is going to be a bumpy ride.

What is a Fiduciary Required to Do?

The Employee Retirement Income Security Act of 1974, as amended (“ERISA”) requires all persons who exercise discretionary control or authority over plan management or plan assets must do so with prudence and solely in the best interest of the participants. Where Eleanor first went wrong was establishing a Plan without taking time to understand what she was required to do and allowing some random salesperson to make all of the decisions. Further, ERISA comes with a fiduciary duty to monitor the service providers and the investments.

ERISA section 404(c) requires a plan that permits participants to direct the investment of their accounts must provide a “broad range of investment alternatives.” This means that Eleanor should have made sure that her retirement plan offered at least three investment alternatives:

1. Each of which is diversified;
2. Each of which has materially different risk and return characteristics; and
3. Which, in the aggregate, enable participants to select investment options that match his/her risk and return needs.

One of the key legal lessons learned comes from the U.S. Supreme Court decision, *Tibble v. Edison International* [575 U.S. 523 (2015)]. The lesson is that a prudent plan fiduciary needs to swiftly take action to replace a fund that is not performing at the level it should. To be able to take that action, and know that the fund is not performing well, the plan sponsor should be monitoring the funds on a regular basis.

So, what has Eleanor done wrong? She hasn't done any monitoring since Day One, when her broker set up the plan. Basically, she went with the "set it and forget it" mindset. After five years, the odds that all of the initial funds selected are still performing above the benchmark are pretty slim.

Which brings up the next key question – what is the benchmark that should be used by Eleanor?

How Do You Monitor Investments?

Eleanor has a few choices. She can learn about how to monitor the investments herself or she can engage a financial professional to help her. One option is to hire a 3(21) financial advisor to help her monitor the investments, provide her with reports, and give her recommendations. She will still need to make all of the decisions, but she'll at least get guidance. Option two is for Eleanor to engage a 3(38) investment manager. This professional will monitor the investments for Eleanor, report back to her, and actually make all of the investment decisions for her. (Interesting observation: after talking to several ERISA litigation attorneys, collectively, we can't think of a single prominent lawsuit where the plan sponsor used a 3(38) investment manager.)

Eleanor decides that she wants to become a prudent fiduciary and starts to read and learn about how to properly monitor the investments in her plan. To begin with, she goes online to get the current fund-line up and the respective fund performance information. Just in this initial action, she is surprised to see that there are a few funds that have had negative performance for a considerable period of time.

Development of a written investment policy statement ("IPS") is a much-debated fiduciary tool. There is no requirement in ERISA to have a written, formal IPS. The purpose of the IPS is to provide the plan's investment fiduciary with the guideposts and standards for how investments are chosen, how they should be measured, and when they should be replaced. The IPS, like the investments themselves, should not be written and forgotten. It is an evolving document that will need to be reviewed periodically and modified as necessary. (For example, Eleanor may want to add statements about whether cryptocurrency should be offered in the plan and if not, why?)

On the other hand, the concern some legal parties have is that, if Eleanor has such a written IPS and fails to follow it, she'll be in violation of ERISA (which requires to act in accordance with the plan document and procedures). This could open Eleanor up to a lawsuit. But even if she chooses not to have a formal, written IPS, Eleanor still needs to have some structure as to how she intends to monitor and deal with her plan's investments.

Part of the monitoring process must include writing things down. That means that any formal reporting that she receives from her service provider or investment professional should be retained in her files. This does not necessarily mean it has to be paper, but it does require she establish a governance folder with this historical information to support the decisions she makes. The decisions themselves and the basis on which they were made need to be documented somewhere so that there is proof the proper procedures were followed. This is tough for small employers. Investigator Chidi has asked Eleanor for her minutes. If she is the only member of her company's management team, why does she need to have minutes? The answer is simple – absent some documentation (it doesn't need to be formal minutes, an internal memo will do), there is no proof of the decision process. Also, over time, Eleanor's memory will fade. It happens to even the best of us. So, when Investigator Chidi asks her why she elected one investment over another three years ago, she can whip out her handy minutes/notes that discuss the decision and its process.

The purpose of a retirement plan is long-term investing, rather than focusing only on quarterly results. Therefore, when Eleanor starts her quarterly reviews of the plan investments, she should be looking at performance over a longer period, such as three years. There are a number of tools available that can help Eleanor with the review by providing a report that compares the funds in the plan against benchmark funds. These benchmark funds can be an index fund, such as the Standard & Poor's 500 Index or bond index, depending on the asset class being measured. A bond fund would be compared against a bond index. Because there are lots of criteria to determine which is the best benchmark, this may be when Eleanor leans on the professionals to determine what the best comparison is.

Why Do Fees Matter So Much?

A good benchmark system, and a good plan investment portfolio, should consider and compare the fees associated with the investments. Over time, a participant with $100,000 invested in funds with the same annual rate of return but with a .25% expense ratio versus a 1% fee will end up with $30,000 more at retirement. (See the Investor Bulletin by the SEC for additional reading and examples.) There are certainly more dramatic scenarios published, claiming as much as $590,000 could be lost over time due to even a 1% fee differential. The point is that Eleanor has to be careful that she does not just jump on a fund that has the highest rate of return because it could also have the highest fees, which will eat at the true value of that fund.

For example, Fund A has a one-year rate of return of 15%, which is above Fund B's rate of return of only 10%. But, Fund A has really high fees and will cost 8% per year. Fund B has very low fees of only 2%. Suddenly, in the aggregate, Fund A really only performs at 7%, but Fund B performs at 8%. So, Fund B is looking like a better choice.

Plan-related fees are also the reason for the numerous lawsuits by participants in regard to their retirement plans. Roughly 150 fee-based lawsuits have been filed in federal court in the past two years and there seems to be no end in sight, given the US Supreme Court decision in Hughes v. Northwestern University [595 U. S. ____ (2022)]. [https://news.bloomberglaw.com/us-law-week/explosion-of-401k-fee-litigation-gets-boost-from-supreme-court)] If The Good Place 401(k) Plan has a menu of the most expensive funds available to Eleanor, there is a chance she will be accused of not acting in the most prudent manner, and certainly not in the plan participants best interests.

While a plan is not required to always offer the cheapest funds available, the fiduciary has to articulate why a particular fund is still in the line-up despite the fees. Perhaps the participants requested availability of a real estate or tech fund that has the possibility of amazing performance, but has the highest fees. Those minutes and/or memos can outline the decision-making process and justify why such a fund was appropriate.

Conclusion

It's not too late for Eleanor just because she was put on notice that the DOL is coming for a visit. She can still show Investigator Chidi she is on the right path and has turned a corner in her fiduciary oversight responsibilities. As a participant, Eleanor herself can benefit from a leaner, stronger fund menu. It all starts with a solid understanding of her fiduciary duties and a strong investment selection and monitoring program. If you have questions about fiduciary duties or plan governance, let us know. Remember: We are your ERISA Solution!

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BENEFITS LAW CENTER
We are your ERISA solution

Ilene Ferenczy • ilene@ferenczylaw.com | Alison Cohen • acohen@ferenczylaw.com
Adrienne Moore • amoore@ferenczylaw.com | Adriana Starr • astarr@ferenczylaw.com
Tia Thornton • tthornton@ferenczylaw.com | Leah Dean • ldean@ferenczylaw.com

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2635 Century Parkway, Suite 200 | Atlanta, GA 30345
T - 404.320.1100 | F - 404.320.1105 | www.ferenczylaw.com