Pension Protection Act of 2006

Chapter 1

History

Target date funds (TDFs) were first introduced in the early 1990s by Barclays Global Investors (BGI) and were originally used for college savings plans. The target date, for example the 2020 fund, is an event date. In the case of college savings plans, it's the year that a student intends to enroll in a college. Target date funds' asset allocation mix typically provides exposure to return-seeking assets, such as equities, in early years when risk capacity is higher, and becomes increasingly conservative as time progresses with exposure switched progressively toward capital-preservation assets, such as short-term bonds. This asset movement through time from more to less risk is called a "glide path." Eventually, target date funds began to be used for retirement savings plans, especially 401(k) plans. The event date in this application is the year in which an investor intends to retire.

Usage of TDFs remained minimal until 2006. Two major events brought TDFs to the forefront. First, behavioral scientists recommended that 401(k) plans use automatic enrollment to encourage participation. Employees would need to choose to be excluded from the plan, whereas they formerly needed to sign on for the plan. Behavioral scientists were right. 401(k) participation skyrocketed, but this created a new challenge. Many 401(k) participants were either unable or incapable of making an investment decision so they defaulted to their employers who, typically, placed their contributions in very safe assets, like cash. This led to the second major event: passage of the Pension Protection Act of 2006 (PPA).

Why is the Passage of the Pension Protection Act of 2006 Significant?

The PPA specifies three Qualified Default Investment Alternatives (QDIAs) that plan sponsors can use for participants who do not make an investment election: Target Date Funds, Balanced Funds, and Managed Accounts (accounts managed by outside professionals). By far the most popular QDIA has been TDFs. It's important to remember that most of the assets in TDFs are there by default, so these investments are employer-directed rather than participant-directed. Accordingly, there should be a separate statement of investment policy for each TDF.

Subsequent to the PPA, target date fund assets grew from $0 to about $150 billion in just two short years. This set the stage for serious disappointment in 2008 when the typical 2010 fund lost 25%. The market crash of 2008 exposed the fact that far too much risk was being taken, especially near the target date. Note that the 2010 fund is designed for those retiring between 2005 and 2015. Participants who defaulted their investment decision to their employers believed they were protected, especially near retirement, so they were devastated and shocked. As a consequence of this pathetic loss, the U.S. Securities and Exchange Commission (SEC) and the Department of Labor (DOL) held joint hearings in 2009, and subsequently threatened to regulate TDFs in a variety of ways, specifically by requiring more disclosures. At the time of this writing, these threats remain to be carried out. In the meantime, nothing of consequence has changed since 2008, other than some minor improvements in fees and diversification. The vulnerable participants remain in as much jeopardy today as they were in 2008.

The good news about 2008 is that not much was at stake, with $150 billion in TDFs, which was less than 10% of 401(k) assets. The next 2008 will be devastating by contrast, and it's not a matter of *if* – it's a matter of *when*. At the time of this writing, TDFs hold $1 trillion, which is about 25% of all 401(k) assets.

Legal Guidance

Should fiduciaries rely exclusively on the QDIA safe harbor?

The most severe problem facing plan sponsors is the denial of plausibility. Many believe that because they offer a variety of funds in their 401(k) and they state they wish to comply with 404(c), they're off the hook. The courts are daily proving this thought process wrong.

There have been 522 ERISA-related fiduciary breach cases since late 2013. The significant breaches include self-dealing, imprudent investments, failure to submit contributions, and failure to diversify. The good news for plans with TDFs is that a high percentage of lawsuits deal with excessive fees, so courts have not yet addressed the selection and monitoring of TDFs.

The bad news in the 401(k) world is that plan sponsors and their fiduciaries are liable for the funds that they select for their plan. Sure, following 404(c) can shift liability for selection of investments to participants if certain conditions are met, but default investments are employer-directed rather than participant-directed.

Fiduciaries were unscathed in 2008. Should they expect the same next time?

The only advice we can give plan sponsors is— **Don't be Complacent**. The sole fiduciary criterion in the 401(k) world is to strive for the best outcomes for your participants and their beneficiaries.

Remember that in Barker v. American Mobil Power Corp. 64 F.3d 1397, a court held that a fiduciary had an affirmative duty to inform participants about circumstances that could jeopardize benefits.

So while the class action lawyers are circling the 401(k) chum in the water, it becomes readily apparent that the regulator's traditional solution of "more disclosure" will be woefully inadequate.

Sponsors, be informed, stay educated, be prudent and, where necessary, hire professionals.

Ethical Perspective

Many plan sponsors fail to realize that fiduciary duties are not merely legal responsibilities, but ethical obligations as well. While the legal responsibilities have been described as "the highest known to the law," the ethical obligations affect the retirement income security of tens of millions of Americans. Donovan v. Bierwirth, 680 F.2d 263 (2nd Cir. 1982)

What is the ethical obligation? Plan sponsors have the fiduciary duty to ensure that participants are provided with a 401(k) product that provides a reasonable opportunity to achieve retirement income security. So while the legal motivation to fulfill one's fiduciary duties compare to the proverbial stick, the ethical motivation is the proverbial carrot.

Plato didn't have a 401(k), but in ***The Republic*** he did address the carrot and the stick. Plato tells the story of Gyges, a shepherd employed by the king. One day, there was an earthquake while Gyges was out in the fields, and he noticed that a cave had been uncovered on the side of a mountain. As he investigated, he discovered the tomb of an ancient king, and on the finger of the corpse was a gold ring. He took the ring and soon discovered that it allowed the wearer to become invisible. Gyges realized that if he was invisible, he could do whatever he desired with no fear of punishment. The next time he went to the palace to give the king a report about his sheep, he put the ring on, killed the king, seduced the queen, and ruled the land.

Plato intended this story as an argument for the necessity of laws; however, there's another moral to the story. During every philosophy class at West Point, I would ask my students what they would do today with the ring that they would not have done yesterday. The responses varied from things that would cause the cadet to be expelled from the Academy, to "nothing at all." The moral is that we often know what ethical course of action we should take to get the carrot, but sometimes a stick is necessary to keep us on track.