Chapter 2

The Duty of Care

By stipulating three Qualified Default Investment Alternatives (QDIAs), the Pension Protection Act of 2006 has established certain forms of safe harbors, but the substance, i.e., the selection of a specific QDIA, remains a fiduciary responsibility. Under the duty of care, fiduciaries must decide which form is most appropriate for their plan and they must strive to select the best they can find. They can't just simply throw darts at the QDIA dartboard.

Most fiduciaries have selected target date funds (TDFs) as their preferred form, but they have not done their utmost to find the best TDF. TDFs have not been vetted. For the most part, assets have been entrusted to the Big 3 bundled service providers – T. Rowe Price, Vanguard and Fidelity. These are fine firms, but the duty of care requires selection on the basis of superiority, rather than on convenience and familiarity.

Fiduciaries Set Objectives That Fulfill the Duty of Care

To select the best, fiduciaries need to establish objectives. What should the TDF achieve? Fiduciaries are duty-bound to seek solutions rather than settling for products. The word "solution" really needs to be taken seriously. The good news is that a universal objective can be achieved with reasonable confidence. This is the objective that fiduciaries should embrace.

Capital preservation is the universal objective of TDFs, the "perfect fit" for this "one-size-fits-all." The Hippocratic Oath of TDFs should be "lose no money." It's the one objective that we all have in common. Of course we all want to earn as much as we can, but we are most impacted by loss as we near retirement. Accordingly, the presumption for target date fund design near the target date should be that participants have saved enough to support a lifestyle that is acceptable to them. Some may plan for a humble lifestyle while others see yachts in their future. It's all the same. A plan is a plan.

Prior to the Pension Protection Act of 2006, the most common investment default was cash, but now the risk pendulum has swung too far for those nearing retirement. 2008 is all the proof we need.

The Center for Due Diligence surveyed investment advisors in 2012 and found that the majority want no risk of loss for those nearing retirement. There is a disconnect between this survey and advisor selections of TDFs with 40-60% in equities at the target date, which is the range for the Big 3.

Fiduciaries need to embrace the capital preservation objective and reject the hopes that are currently being sold. A hope is an objective without a reasonable course of action. Replacing pay and managing longevity risk are hopes because no glide path can realistically be expected to achieve these objectives; rather, saving enough is the right course of action. The main objective of TDFs should be to get the participant safely to the target date with accumulated savings intact. Not everyone agrees with this universal objective, which leads to "The Glide Path Debate" described in Chapter 6 on Current Practices.

Legal Guidance

What are the duties of a fiduciary?

The fiduciaries of a retirement plan have a legal responsibility to manage all aspects of the plan in the best interest of the plan's participants. This means adhering to four core fiduciary standards established by ERISA: to act prudently, and with loyalty to the plan participant, diversifying plan investments, and carrying out plan duties in accordance with plan documents and all relevant laws and regulations:

1. *Act Prudently*

All plan fiduciaries are expected to act as prudent experts. This means they are to be held to a higher standard of knowledge and informed experience than the average Joe off the street. A plan fiduciary has the responsibilities of a trained professional, and is

expected to have a knowledge and capacity in their field suitable for an expert. Fiduciaries have the duty of care while performing any acts that could foreseeably harm others. Good faith, or so-called "empty head and good heart," is not enough. The process that a fiduciary follows and the supporting documentation are critical. There are specific procedures for prudence.

2. *Act with Loyalty to the Plan Participants*

Fiduciaries must act solely in the interest of plan participants. Decisions for the purpose of corporate or personal gain are strictly prohibited.

3. *Diversify Plan Investments*

Each plan investment must be considered as part of the plan's entire portfolio. All parts of the whole should fit together in an integrated and well-balanced design.

4. *Carry Out Plan Duties in Accordance with Plan Documents and with ERISA*

Fiduciaries must be familiar with the plan's governing documents as well as with the standard ERISA requirements.

Once these core standards are understood, the specific issues of the plan can be addressed. Plans are unique. Some have similar characteristics, but each also has its own individual requirements and circumstances. For example, fiduciaries are duty-bound to mitigate investment and administrative expenses. As far as the Department of Labor (DOL) is concerned, if you pay more for a product or a service, it does not necessarily mean that product or service is better. As we said in Chapter 1, fees are a specific witch hunt of the DOL now.

Who are fiduciaries?

In simple terms, all parties with discretionary authority or control over the management of the plan are fiduciaries.

What can often be confusing about fiduciary status is that the same party frequently holds multiple roles. For example, in most plans, the sponsor is both the Named Fiduciary and the 3(16) Plan Administrator. All fiduciary liability for the plan originates with the Named Fiduciary. There is no reduction in the sponsor's liability by delegation to the 3(16) Administrator, because the Administrator is usually the sponsor.

Management and disposition of the assets is the area with the most exposure to liability, and is often delegated. If investment matters are delegated to a skilled professional such as a registered investment adviser who acknowledges its fiduciary responsibility, then the named fiduciary will not be responsible for the day-to-day portfolio management activities, PROVIDED that the delegation has been made with those same prudent standards.

What happens when duties are breached?

Liability for breach of fiduciary responsibility is harsh and personal. Under the statutes, "Any person who breaches any of the responsibilities, obligations or duties imposed upon fiduciaries shall be personally liable to make good to such plan any losses to the plan resulting from such breach." Personal liability can include fines, civil penalties, and other penalties. ERISA imposes a penalty of 20 percent of the amount recovered by the DOL from a fiduciary who breaches their fiduciary duty or commits another violation of ERISA, such as a prohibited transaction. A qualified plan is required to pay a 15 percent excise tax every year until it corrects the transaction.

Fiduciaries that do not follow the required standards of conduct are personally liable. If the plan lost money because of a breach of their duties, fiduciaries have to restore those losses, plus any profits received through their improper actions. For example, if an employer did not forward participants' 401(k) contributions to the plan, the employer would have to pay back the contributions to the plan as well as any lost earnings, and return any profits they improperly received.

Ethical Perspective

Many of the words found in the legal guidance above, such as prudence, loyalty and care, are also used in these ethical perspectives. That is because those who created ERISA recognized that neither a rule-based system of laws nor principle-based ethical theories were sufficient to protect the American worker's prospects of retiring with dignity.

For centuries, philosophers have debated the pros and cons of a rule vs. principle approach to ethical theory. Rules, like the letter of the law, can be inflexible and dogmatic, but we all know there are ways to weasel around every rule without necessarily breaking it. There are also many situations where the strict application of the law can result in consequences that are clearly counter to the intent of the law. Principles address the spirit of the law and drive us toward certain behaviors. However, principles can also be vague, lead to ambiguity and be difficult to enforce.

An example of a letter of the law, rule-based approach can be found in ERISA §406(a)(1)(c). This section prohibits plan assets from being used to pay ***any*** party for ***anything*** including, but not limited to, investment expenses, administrative expenses, or record keeping. There's certainly no ambiguity here, and the writers of ERISA waited to include an exception to this rule in an entirely different section.

This "exception to the rule" technique serves as an indication of how serious the authors were about safeguarding the retirement plan assets of participants. We find the following exemption in ERISA §408(b)(2) in order to provide services to the plan. It states that all three of the following criteria must be satisfied in order to qualify for the exemption: 1) The services must be necessary for the operation of the plan; 2) The services must be furnished under a contract or arrangement which is reasonable and; 3) No more than reasonable compensation is paid for the service.

Unfortunately, a philosopher was not among the men and women who wrote ERISA because they incorporated an ambiguous philosophical term with the word "reasonable." While the absolute, unambiguous nature of 406(a)(1)(c) serves as a valuable concrete rule, the ambiguity of the word "reasonable" in 408(b)(2) is far from concrete. This word has probably cost retirement plan participants billions of dollars since the first 401(k) was funded nearly 40 years ago.

An example of a spirit of the law, principle-based approach can be found in ERISA § 404(a)(1)(B). Often labeled the "prudent expert rule," this section mandates that plan sponsors discharge their duties "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Prudence is most often the focus of this clause, but prudence, skill, and diligence are all components of the ethical principle of due care.

The principle of due care is an act or a course of action that is required of one by position, social custom, law, or religion, and often as a moral obligation. While the notion of care is straightforward, the concept of "due" often is not. The word "due" is the root of the word "duty" and it implies an obligation to act. The relationship we have with our physician is a common example of the principle of due care.

If someone visits his physician because his elbow is sore, the physician doesn't just examine his elbow. The physician conducts an assessment of his overall condition. It is the physician's obligation to look at the big picture, not merely to treat the elbow. Similarly, it is the fiduciary's obligation to look at a participant's retirement health, and not merely at any given characteristic of their 401(k) plan.