THE RISE OF THE Defined Contribution Trustee

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As defined contribution (DC) retirement plans become the primary source of retirement income for a growing number of plan participants, DC plan trustees must recognize their responsibilities in helping participants meet their retirement savings goals.

benefits
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Over the last two decades, the number of defined contribution (DC) plans being offered by employers has increased dramatically. For fiduciaries accustomed to overseeing traditional defined benefit (DB) plans, many of the same tenets of good governance and fiduciary responsibility can be applied to DC plans.

However, recent cases have demonstrated that failing to recognize the differences between the two, and specifically adopting new best practices accordingly, can lead to material liabilities for trustees and plan sponsors.

This article will explore the complexities of a properly governed DC plan and offer guidance on how to succeed as a DC plan trustee.

Steady Growth

The last 25 years have seen steady and significant growth in DC plans, especially 401(k) plans, which make up the largest component of the DC universe.[1] The Investment Company Institute states that, as of March 31, 2019, 401(k) plans held roughly $5.7 trillion in assets on behalf of about 55 million active participants and millions of former employees and retirees.[2] Savings rolled over from 401(k) and other employer plans also make up about half of the $8.8 trillion held in individual retirement account (IRA) assets.[3]

At first, the 401(k) plan was added to the Internal Revenue Code as a way for organizations to offer additional remuneration to high-paid executives, beyond traditional pension plans or other ad hoc retirement or benefit programs. During the 401(k) plan's rapid growth, however, the purpose of DC plans has unconditionally evolved. Instead of a retirement platform that allowed participants to save their own money to supplement a traditional pension, DC plans are becoming the primary source of retirement dollars for more than 100 million current participants (Social Security being secondary).[4]

With this swing to a more participant-driven world, plan risks have undoubtedly increased. The longstanding promise of retirement is generally accepted as a collective commitment between both plan sponsor and participant. However, the shift from DB to DC plans generally comes at the expense of workers, who solely bear the brunt of market fluctuations and who, in 401(k) plans, are asked to manage more of their own financial affairs without the financial sophistication to do so. This necessity can result in a reduced benefit at retirement versus a traditional DB plan.[5] Their inability to reach certain retirement outcomes creates unyielding stress for participants. At this time, the stress appears to be manifesting itself as litigation.

A study by the Center for Retirement Research at Boston College shows 107 complaints related to 401(k) plans that were filed in 2016 and 2017, the most in a two-year period since 2008 and 2009 after the financial crisis.[6]

Expensive settlements have resulted from the torrent of forceful litigation, as well as reputational damage for the organizations implicated. As would be expected, countless hours have been spent by organizations and service providers (investment advisors, plan consultants, legal counsel and third-party administrators) in dealing with litigation.[7]

Common Allegations in 401(k) Litigation

Unlike DB plans, the amount of fees and/or the performance of the investments can have a direct and sometimes negative impact on a participant's benefit. Every dollar paid to administer the plan or pay for investments is a dollar less to the participant. This concept has sparked the growing list of complaints in DC lawsuits that allege that plan trustees acting in a fiduciary capacity:

- Should have offered equivalent but less costly investment options
- Did not obtain the best possible cost/expense from their plan service providers
- Failed to monitor the actual cost of investment and administrative expenses over time
- Failed to monitor or address poor investment performance or results
- Allowed prohibited transactions, since the Employee Retirement Income Security Act (ERISA) prohibits fiduciaries from making payments to parties in interest from plan assets.

What is the common theme? These suits appear to have their roots in the perceived departure by plan trustees from standard fiduciary responsibilities.

Fiduciary Responsibilities

Given these challenges, trustees need to embrace best practices and remain ahead of trends that impact plans and participants. The good news is that the general tenets of trustee responsibility under ERISA apply to DC plans:

1. Duty of loyalty
2. Duty to follow plan documents
3. Duty of care
4. Duty to diversify plan assets.

The following is a look at how trustees may apply their responsibilities under each duty to the governance of DC plans.

Duty of Loyalty

The duty of loyalty is one of the more well-known responsibilities of a DC plan trustee. It states that a plan fiduciary must discharge his or her duties with respect to a plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying reasonable expenses. In essence, a trustee must put participants and beneficiaries first in every decision made.

In a DC setting, trustees often find themselves wearing two hats: one as an employer, governmental or union official, and one as fiduciary. They may face a decision that is in the best interest of participants but against the interest of the sponsoring company, government organization or union. For example, a decision to audit participating employers every two years (to ensure compliance with DC plan contributions) is in the best interest of plan participants. But this audit will undoubtedly cost the employer time and money to comply.

Recent litigation has focused on corporate 401(k) plans that offer company stock as part of their investment lineup, alleging that trustees breach their duty of loyalty by failing to disclose nonpublic information that will negatively affect the stock price and the participant's account balance. After the 2014 Supreme Court decision in *Dudenhoeffer*[8] made it harder to prove imprudence in these types of cases, plaintiffs have shifted to this new duty-of-loyalty claim. It has not found traction yet with courts, but more cases are expected to attempt to make the argument.

There also have been cases against corporate administrators who select proprietary investment options. Whether those options were selected "on their merit" or just to provide additional revenue to the administrator is a duty-of-loyalty question that will arouse suspicion amongst plaintiffs' counsel.

Here are some ways DC plan trustees can best protect themselves related to the duty of loyalty:

- Create and maintain a list of individuals or companies that are fiduciaries to the plan.
- Educate themselves on the rules that affect the duty of loyalty (e.g. two-hat, prohibited transactions).
- Submit a written declaration (annually) that they have received no other direct or indirect compensation for services provided to the plan and have not taken any action that would be considered a prohibited transaction under ERISA.
- Require a written declaration that vendors have neither provided any direct or indirect compensation to trustees, nor has the vendor received direct or indirect compensation from outside parties related to the services they provide to the plan.

takeaways

- Defined contribution (DC) plans hold roughly $5.7 trillion in assets and have become the primary source of retirement dollars for more than 100 million current participants.
- A growing number of lawsuits have been filed against DC plan trustees, making allegations such as that the trustees failed to monitor actual cost of investment and administrative expense over time or failed to monitor or address poor investment performance or results.
- To avoid these challenges, trustees should pay attention to the general tenets of trustee responsibility under the Employee Retirement Income Security Act (ERISA) and how they apply to DC plans.
- Recent lawsuits against 401(k) plans have alleged that trustees have breached their duty of loyalty in failing to put a participant's interest first.

Duty to Follow Plan Documents

Although the plan settlor is responsible for creating, designing and documenting plan-specific rules and regulations, including the plan's investment policy statement (IPS), trustees must enforce accordance with those documents. Trustees need to read these documents and familiarize themselves with the plan's benefits, distribution methods, and relevant policies and procedures.

To administer a plan according to its plan document, trustees should ask:

- Is the benefit accurately calculated in accordance with the plan?
- Have the distribution options been communicated with the participant, and are they accurately being applied?
- Do the investments offered follow the IPS?

The importance of consistency in following plan documents should not be overlooked. When a plan finds itself involved in a lawsuit, plaintiff and defense attorneys will almost certainly request access to meeting minutes and all relevant plan documentation. This data request should be taken very seriously, because litigators will look to confirm that trustees documented that they followed plan rules and were systematic in governing the plan. Any noncompliance will be readily exposed by an experienced plaintiffs' attorney.

Duty of Care

Under the duty of care, a trustee is obligated to act with the care, skill, prudence and diligence then prevailing that a prudent person "acting in a like capacity and familiar with such matters would use in similar circumstances." With respect to DC plans, the duty of care can be broken down into two parts: "do your homework" and "mind the store."

Do Your Homework

Trustees must undergo routine fiduciary training and must document the training they receive. This can come in the form of presentations by outside experts or plan vendors, attendance at conferences or webinars, and subscriptions to industry periodicals.

Some questions trustees should ask about DC plans while educating themselves are:

- What types of fee structures are other plans using?
- Are other plans offering more high-cost (active) or low-cost (passive) options? What are the benefits/costs of each?
- How many investment options are other plans offering?
- Are comparable plans offering a self-directed brokerage or mutual fund window?
- What is the average per participant administration cost?
- What are the current trends in distribution or spend-down methods?

The types of fees involved in typical DC plans are generally hard-dollar fees (where each participant pays a set amount), percentage or revenue sharing (where each participant pays a percentage of his or her account balance), or a hybrid of the two. Most plans use these options, but trustees must periodically review the market for alternatives.

ERISA does not mandate (or prohibit) implementing any particular fee approach, investment lineup or choosing the cheapest option in any category. It merely requires trustees to educate themselves about the current environment and make decisions they believe are in the best interest of their plan participants.

However, DC litigation usually focuses on plans without unbundled cost structures (i.e., plans that rely on revenue-sharing arrangements) to pay for plan administration. Plaintiffs' attorneys have alleged that trustees failed to ensure the amount of fees paid directly relate to the actual cost of the plan and that these arrangements lead to sizable and growing expenses for plan participants. In addition, revenue-sharing collection methods can be variable in nature (i.e., not all investment options or funds capture the same percentage) and lead to questions about fairness.

Mind the Store

Once trustees are armed with information about what comparable plans are doing, they need to look at their own plan. Here is where a third-party investment consultant can provide advice and support on investments, plan design, fees and expense issues. But trustees should make sure the consultant agrees to serve as an ERISA Section 3(21) fiduciary in that role.

Questions trustees can consider on an ongoing basis are:

- What is the actual cost of administering their plan, and is that reasonable compared with the market? Many plan participants are paying far more than is necessary to run their plan. For reference, a reliable source is vendor 408(b)(2) service provider disclosures.
- Are there hidden fees? Trustees should ask plan advisors to simply showcase all costs.
- How are investments performing relative to benchmarks? Should they be replaced?
- What investment vehicles are being used (e.g., mutual funds, collective trusts, separate accounts)? What are the pros and cons of each vehicle?
- Is the plan in the best mutual fund share class or vehicle, given the assets of each individual investment? Can an alternative vehicle lower the cost?

Since plan fees have a direct impact on participant account balances and are at the center of many of the recent cases, understanding what the market offers and how a plan compares is an essential duty for a trustee.

Duty to Diversify Investments

Fiduciary oversight of plan investments may be a trustee's most significant obligation. As discussed already, the risk of loss and litigation is more significant with DC plans than DB plans because any drop in market value directly impacts the participant account balances and future benefits. Whereas the ultimate benefit for a traditional DB plan is already defined, drops in market value alone do not affect the eventual amount paid.

There are two types of investment design in DC plans: trustee-directed and participant-directed.

- In a trustee-directed plan, trustees select the investment lineup and invest the assets of the trust. At a set point each year, they deduct plan operational expenses and credit or debit each account balance based upon the plan's gain or loss.
- In a participant-directed plan, the investment fiduciary selects the investment lineup and the participant then determines the investment and amount to invest. This is typical of 401(k) and similar plans. Trustees are protected from liability from any loss sustained by the participant or beneficiary caused by the investment's drop in market value if the trustee satisfies certain requirements. ERISA

Three Key Steps for Good Governance

Good governance requires real-world best practices. There are three vital steps that can help protect defined contribution plan trustees from potential claims:

1. **Follow the money.** Ultimately, the fiduciary duty rules are in place to ensure the money trustees oversee is being used prudently and solely in the interests of plan participants. Trustees should take the time to study their plan and what it's paying its vendors (recordkeeper, administrator and investment managers) and compare that with what other plans are doing.
2. **Keep current on industry trends.** Trustees should look at trends as they affect participants, such as new investment options, methods to fund plan expenses and distribution rules, and determine whether implementing them would be a benefit to participants. They may not be a good choice, but the most important thing is to consider the issue and document the process.
3. **Document, document, document.** Trustees should create a thorough record of everything they have reviewed and studied as a trustee, even if no decisions or actions were taken.

Section 404(c) states that in order to qualify for these requirements, the plan should "permit participants to exercise control over the investments in their accounts" and "offer a broad range of investment options—at least three of which have different risk and return characteristics."

Investment Policy Statement

To satisfy the duty to diversify investments and comply with ERISA, trustees often work with their third-party investment consultant to adopt and follow an IPS. In crafting the IPS, trustees should review the marketplace, use what they know about other similarly situated DC plans and gather recommendations from their investment consultant.

The IPS should generally set forth ten to 20 well-diversified investment options that may include large, mid or small cap stock; growth or value stock; stable value investments; real estate; international stock; fixed income; and/or target-date funds (TDFs) (various age-based TDFs may count as one option). Active or lower cost passive (index) funds or a mixture of the two should be considered. The final structure also may include a self-directed brokerage window that allows participants to choose investments outside of the plan menu. Offering multiple investments in the same asset class or volatile investments, such as a company stock fund, should be avoided. The IPS also should include procedures for reviewing and replacing investment options, including placing poorly performing investments on a watch list to be monitored closely before being replaced.

Once the IPS is formalized, the trustees and their consultant should then interview potential investment managers, review the fee structure and contractual documents, and ultimately select a menu of investment options in line with the IPS.

Whatever lineup, mix or menu of investments trustees finally select, they must be diligent in understanding each investment's fee structure, costs, how and when the fees are collected, and how the fees compare to the actual cost of administering the plan. The sidebar offers three key steps for trustees to implement for good DC plan governance.

Conclusion

DC plan trustees hold a crucial role in the promise of retirement between plan sponsors and employees. While much of the investment risk is now borne by participants, succeeding as a DC plan trustee is critical in helping millions on their road to retirement.

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Endnotes

1. Investment Company Institute (ICI), 2019.
2. Ibid.
3. Ibid.
4. The U.S. Department of Labor Employee Benefits Security Administration Private Pension Bulletin: Abstract of 2016 Form 5500 Annual Reports, December 2018.
5. "EBRI Reassesses Whether DC or DB Plans Are Better for Participants," PLANSPONSOR, www.plansponsor.com/ebri-reassesses-outcomes-dc-vs-db-plans/.
6. *Investment News*, March 5, 2019.
7. Ibid.
8. The issue in *Dudenhoeffer* was the standard applicable in determining whether it is prudent for an employee stock ownership plan (ESOP) fiduciary to buy or hold employer stock. Among other issues, that Court said that plaintiffs who claim that fiduciaries imprudently failed to take action when they knew of nonpublic information that could negatively impact the stock, must "plausibly allege an alternative action that the . . . fiduciary could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." It was no longer sufficient for the plaintiffs to make general statements of fiduciary breaches in a complaint.