

Pension Protection Act and Fiduciary Responsibility: A Ticking Time Bomb for Plan Sponsors

Elliot N. Fineman
Compass Institute

Formulaic funds carry serious risks that may expose sponsors to liability.

Concerns over woefully inadequate retirement savings and underfunded pension plans spurred Congress to pass the Pension Protection Act (PPA) in 2006. This led, for the first time in 30 years, to widespread changes in laws intended to protect the way people accumulate funds for retirement. Along with these very good intentions, the government may have inadvertently set up a time bomb that could explode on two fronts: the law may backfire and put individuals into investment funds that will ultimately fail to produce anywhere near the money needed for a financially secure retirement; and simultaneously, it may leave plan sponsors open to an onslaught of legal claims down the road.

The PPA introduces several new alternatives to strengthen the federal pension insurance system, with the goal of helping U.S. workers safely build adequate nest eggs for their retirements. These include automatic enrollment in company-sponsored plans, automatic increases in participant contribution rates and designating new default options. In an October 2007 ruling, the Department of Labor (DOL) finalized that Qualified Default Investment Alternatives (QDIA) included lifecycle and target date funds, balanced funds, and professionally managed accounts.

As a result of QDIA, investments in lifecycle and target date funds will be the biggest beneficiaries of increased retirement plan investment. Overall participation rates are expected to increase to 80% or more from 73%. With the institutionalization of target date funds, a February 2007 report published by TowerGroup of Needham, Massachusetts, estimated that allocations to target date funds will

Keywords: *fiduciary; Pension Protection Act; retirement; section 601; Lifecycle funds; target date funds; LaRue; defined contribution plans*

DOI: 10.1177/0886368708317550

grow to 56% of all assets in Defined Contribution plans by 2011, up from 11% in 2007, which is more than five times the current allocation. In an April 6, 2008 *New York Times* article entitled, "New Rules May Help Target-Date Funds," Ted Benna of Malvern Benefits said that 75% of 401(k) assets would be held in target-date funds within five years.

Are QDIAs a Safe Harbor?

Contrary to what is claimed by the fund providers who lobbied for this legislation, it is exactly in these target date and lifecycle funds that the greatest risk for failure exists. A white paper issued by Compass Institute in August 2007, "The Paradox of Asset Allocation for Retirement Plan Participants: A Blessing or a Curse?," available at <http://ssrn.com/abstract=1087406>, proves that rather than protecting participants from risks as these funds claim, they expose them to the greatest risk of all: woefully inadequate retirement savings. And the threat to plan sponsor fiduciaries is that under PPA, they may be held legally liable in a court of law for having guided participants to these risky alternatives and not providing an alternative that eliminates these risks.

To understand why, consider the following: What if it was known that lifecycle and target date funds were not able to provide the typical plan participant with anywhere near the final Plan value needed for retirement income security? Furthermore, what if there existed a managed account solution with a proven asset allocation strategy—one that had never failed over all market cycles—that could be expected to provide the typical participant with a final Plan value that would provide realistic retirement income security? Two principal plan sponsor actions would most likely occur: (1) Only offering target date and lifecycle funds. (2) Offering both target date and lifecycle funds and the managed account solution referenced above. Note that there is a third option: only offering the managed account solution either as a stand alone or as a QDIA. In the first case, the plan sponsor would rely on the QDIA designations as a safe harbor—but can they do so?

PPA Section 601

There are a number of reasons to suggest that notwithstanding QDIA, plan sponsor fiduciaries might well be exposed to liability. There is ambiguity regarding the language contained in

Section 601 of the PPA. The Profit Sharing Council of America, in its executive report of February 2007, commenting on the DOL Field Assistance Bulletin 2007-1, notes the following:

The Bulletin provides only one example when monitoring specific advice is required—only to the extent needed to address a complaint [by a participant] about the quality of the advice [the participant received]. It should be noted that ultimately it is a court that will decide whether the monitoring is appropriate and plan fiduciaries may want to periodically sample the actual advice provided to the participants.

DOL references to quality have historically meant process, not performance. However, this wording suggests that the DOL has expanded the definition of *quality* to include performance.

Brooks Hamilton,¹ a leading Employment Retirement Income Security Act (ERISA) attorney, independent fiduciary and senior fellow at the National Center for Policy Analysis, recently pointed out that

Before the February 20th, 2008 LaRue decision by the United States Supreme Court, employee benefit plan participants who sued plan fiduciaries for investment losses faced near insurmountable legal hurdles. In LaRue the Court removed most of these hurdles, and may have opened floodgates of new 401(k) lawsuits! As fiduciaries of employee benefit plans governed by ERISA are personally liable for losses, this single decision represents the most significant expansion of potential liability faced by fiduciaries since ERISA became law in 1974.

Hamilton notes that prior to LaRue there was one exception when the individual could bring an action against the plan fiduciary:

In other words, an action brought under § 1132(a)(1)(B) of ERISA may only be enforced against the "plan" as an entity and may not be enforceable against any other person unless liability against such person is established in his individual capacity. (see § 1132(d)(2))

What would have constituted such a liability is unclear, but the wording of section 601 regarding the individual's right to bring an action to a court of law inferred that this was intended to come into play. The LaRue decision allowing an individual in a defined contribution plan to sue Plan

fiduciaries significantly expands the grounds an individual now has to bring an action to a court of law beyond 1132(a)(1)(B). These include among others: inadequate realized performance results i.e., the failure of final Plan value to grow to a level that will provide the individual with realistic retirement income security, fiduciaries allowing Fund providers to impose burdensome trading restrictions, in excess of 30 days, and the imposition of fee penalties for violation, fiduciaries having selected Advice Providers for the Plan but never having seen the Advice Provider's investment performance results (historical or current) because the selected Advice Provider does not report them.

It is important to note that fiduciaries of employee benefit plans governed by ERISA are personally liable for losses, and that LaRue represents the most significant expansion of potential liability faced by fiduciaries since ERISA became law in 1974.

Make Whole Relief, Deceptive Trade Practices

Hamilton suggests other avenues of potential fiduciary liability that might allow the participant to bring an action. He references a comment by Supreme Court Justice Ginsburg in a concurring opinion regarding *Aetna Health Inc v. Davila*, 542 U.S. 200, 223 (2004):

Justice Ginsburg referred to an argument in the Government's amicus brief mentioning a specific area of the law that may potentially provide monetary relief to ERISA plan members. In net effect, Justice Ginsburg pointed out that the Supreme Court had not yet precluded "make-whole relief" under a breach of fiduciary duty claim.

Such makewhole relief would be adjudicated under state law and would no longer be preempted by ERISA.

Additionally, in comments made by Hamilton outside the paper, he suggests that a suit could be brought by individuals against fiduciaries under state law involving Deceptive Trade Practices (relative to a service, not a product). The fiduciaries have represented to the participants that they are providing a service that looks after their well-being and best interests—indeed by law, they are mandated to. The operative question is whether a breach of this representation provides the

individual participant with grounds for a claim at the state level which, as a consequence of LaRue, can no longer be preempted by ERISA.

Paradox of Section 601

Prior to the LaRue decision, Section 601 gave rise to an interesting paradox. Section 601 gives the individual a right to a personal claim against plan fiduciaries that would ultimately be decided at the state level; ERISA, however, granted no such right under federal law (which preempts state law). Notwithstanding, the DOL has given that right and further, as Hamilton points out in his paper and in discussion, there are two grounds—make whole and deceptive trade practices—that may also give rise to a state claim that could not be preempted.

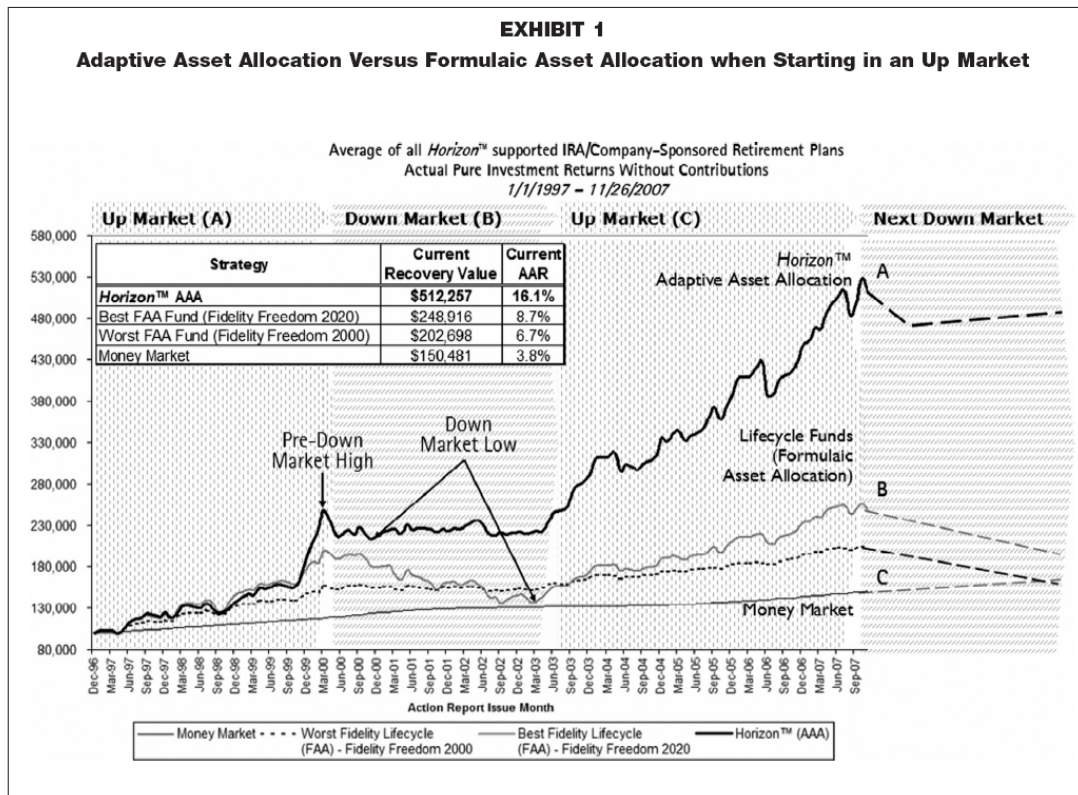
LaRue resolves this paradox. The individual has the right to bring a breach claim against a fiduciary that cannot be preempted by ERISA. If in fact it were known that that lifecycle and target date funds were not able to provide the typical plan participant with the funds needed for retirement income security, it would appear that relying on QDIA as a safe harbor was at best highly problematical.

In the final analysis, a fiduciary must ask the question: "Do I want to take a potentially devastating risk, for no gain whatsoever, when it could be readily eliminated by offering a default option—the aforementioned managed account solution discussed in the next section—that would eliminate this risk?"

Why Lifecycle and Target Date Funds Fail

To illustrate why lifecycle and target date funds cannot provide the participant with retirement income security and that there does exist a managed account solution that can be expected to do so, consider the following. (Note: balanced funds present the same issues discussed below; their formulaic solution is based on subjective risk.)

Lifecycle and target date funds can be categorized as formulaic asset allocation (FAA) funds because they use a preset formula, based on dates connected to anticipated retirement, to determine asset allocation. For nearly a decade, this approach to investing has earned widespread endorsement as the most logical way for workers to build their 401(k) retirement savings. In fact, they have achieved cult-like status because both individual



investors and plan sponsors are lured by their simplicity and straightforwardness.

In researching FAA fund behavior, Compass Institute used over 10 years of performance data, selecting for points of comparison the best performing Fidelity lifecycle fund, Fidelity Freedom 2020 over that period and the worst performing Fidelity Freedom 2000. Exhibit 1 show what happened when \$100,000 was invested in a plan during an up market of a market cycle, with no further contributions, over the nearly 11-year period from January 1, 1997 until November 26, 2007, which included a robust up market, a severe 3-year down market and a strong recovery market.

At the pre-down market high (March, 2000), the best FAA fund Fidelity Lifecycle 2020 (solid grey line) had grown to \$200,000. Over the 3-year down market, the FAA fund continuously falls, reaching a low of \$137,000 in March, 2003, the end of the down market. It approximated money market levels from August 2002 through April 2003.

After the down market ended, FAA's recovery was limited. Holdings in the fixed income portion held back the fund's growth during a rising

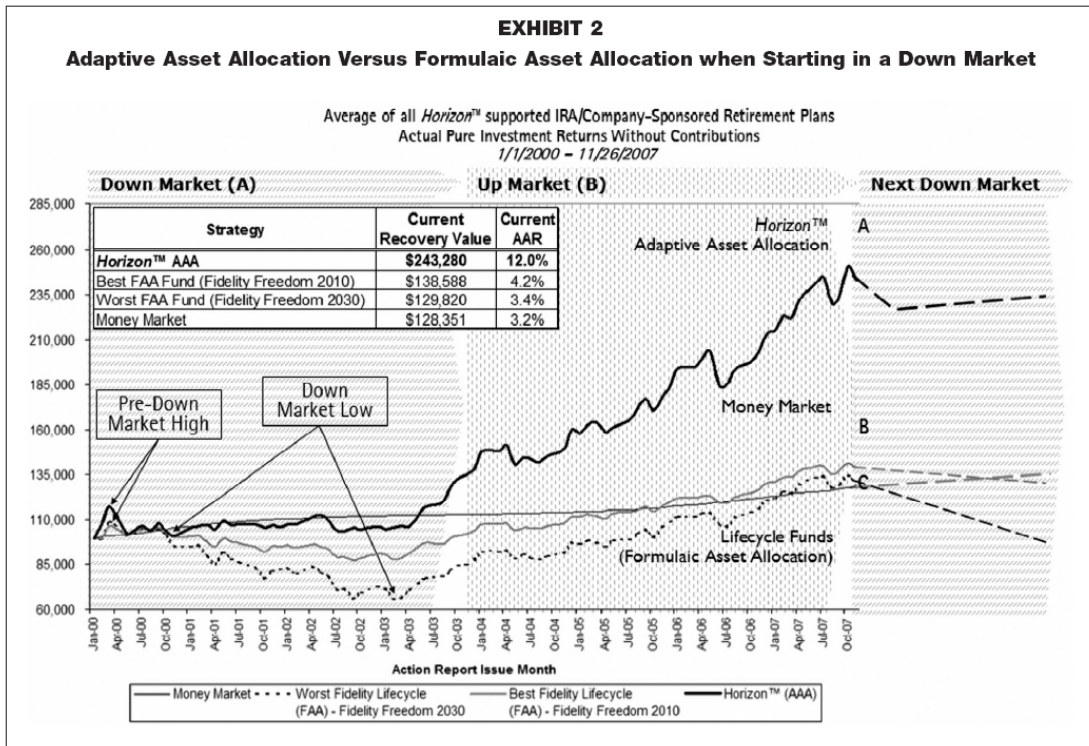
stock market. It took the best FAA fund more than 2 years (from March 2003 until August 2005) to recover to its pre-down market high.

As of November 26, 2007, the best FAA fund had grown to \$249,000, only 25% higher than its pre-down market high—made nearly 8 years earlier. The best and worst FAA funds will lead to a treadmill effect: Annual average return and plan value will once again trend to money market levels during the next down market.

Risk-Management Approach

Over the same 11-year period, Compass Institute tracked the performance of an unrestricted (no asset class rules) objective (does not try to forecast the future, has nothing to do with market timing and is not manager dependent) adaptive asset allocation approach (UO-AAA).

Reviewing Exhibit 1, under the UO-AAA strategy (solid dark line) at the end of the nearly 11-year period, the \$100,000 grew to \$512,000, more than two times higher than the \$249,000 value of the best FAA fund. From January 1, 1997, until March



2000—the pre-down market high—UO-AAA grew to \$240,000; 8 years later, it was \$512,000—113% higher than its pre-down market high.

Over the 3-year down market (March 2000 though March 2003) its low, \$215,000 was made in September 2000, over 27 months before the down market ended. After the down market ended in March 2003, UO-AAA quickly accelerated, taking only 90 days to recover to its pre-down market high. Unlike the FAA funds, it adapts and shifts from fixed income and cash into stock funds.

Over this nearly 11-year market cycle, the average annual return for the UO-AAA strategy was 16.1%, compared to 8.7% for the best FAA fund, 6.7% for the worst FAA fund and 3.8% for money market.

To show the impact of the time of start on obtainable performance, Exhibit 2 traces what happened when \$100,000 was invested in a plan starting during a down market of a market cycle, with no further contributions. The market cycle shown covers the nearly 8-year period from January 1, 2000, until November 26, 2007, which includes a severe 3-year down market and a strong recovery market.

Surviving a Down Market

Reviewing Exhibit 2, the performance of the UO-AAA strategy when the plan was started during the down market, we see that as of November 26, the \$100,000 managed by UO-AAA (solid dark line) had grown to \$243,000 (point A). The best performing FAA fund over this period, the Fidelity Freedom 2010 (light gray line), had grown to \$139,000 (point B), only 57% of UO-AAA; whereas the worst FAA fund, Fidelity Freedom 2030 (dotted line), had grown to \$130,000.

The best FAA fund (the one that would have been deemed a defensive risk avoidance holding for older participants) was only marginally better than money market (smooth light gray line; point C), \$128,000. After nearly 8 years, it had produced an average annual return of 4.2% compared to a money market return of 3.2% and UO-AAA of 12.0%. This defensive risk avoidance fund would have barely kept up with inflation over the 8-year period and would trend toward money market returns during the next down market. It would not provide comfort or safety to an older participant. In fact, it would doom the older participant to a seriously under-funded retirement. The

worst FAA fund performed the same as money market.

Over the 3-year severe down market (March 2000 through March 2003), UO-AAA and the best and worst FAA Lifecycle funds were below money market values. By the end (March 2003), UO-AAA was 8% below, the best FAA fund 20% below and the worst FAA fund 40% below.

After the down market ended in March 2003, UO-AAA reacted, and 180 days later (June 2003), it exceeded money market returns. Unlike FAA, the UO-AAA approach adapts and shifts from fixed income and cash into stock funds. The best FAA fund does not reach money market returns until June 2005—more than 2 years later. It keeps losing money on the bonds that must be held in the ensuing up market. The worst FAA fund does not reach money market returns until January 15, 2007—more than 2.5 years later. It takes 7 years (January 1, 2000, to January 25, 2007) to reach money market return.

Market Cycles

The two opposite market cycle extremes shown in Exhibits 1 and 2 represent average annual return (AAR) boundaries reflecting appropriate timeframes of nearly 11 years and 8 years. As individual participants will begin plans at different points of market cycles, their long-term AAR can be expected to fall at or between these extreme boundaries.

The AAR average of both market cycles for the aggressive Fidelity Freedom fund is 6.1% (8.7% Exhibit 1, and 3.4% Exhibit 2), for the conservative Fidelity Freedom fund is 5.5% (6.7% Exhibit 1, and 4.2% Exhibit 2) and for UO-AAA is 14.1% (16.1% Exhibit 1, and 12.0% Exhibit 2).

There is little difference in AAR over market cycles between the aggressive FAA fund (80% stock and 20% fixed income at inception) and the conservative FAA fund (40% stock and 60% fixed income at inception). Neither will produce anywhere near the needed plan values for retirement income security. However, looking at only ending values as is typically done by fund providers masks the fatal risks to plan participants that all FAA strategies must lead to once they encounter one severe down market. Furthermore, the Compass Institute white paper shows that increased contribution levels cannot overcome these fatal flaws.

By contrast, the UO-AAA approach, by being adaptive and not holding a fixed or formulaic

declining percent in equities at all times over market cycles, is not subject to these fatal flaws—it eliminates them.

The Jury's Position

With knowledge of these facts now in the public domain, a plan fiduciary would be hard pressed to credibly explain, in a court of law, to a Section 601 complaining participant's attorney, why the only available choices and advice alternatives were those unable to produce anywhere near what a typical participant would reasonably be expected to need for a financially secure retirement.

Plan sponsors who want to offer the best possible outcome for their employees must consider providing an investment strategy within its professional managed account selections that uses an unrestrictive, objective adaptive asset allocation strategy (i.e., UO-AAA). But plan sponsors must also consider doing this as a means of adding another layer of protection from future liability issues not only for the Plan sponsor but for the fiduciaries' themselves as fiduciaries of employee benefit plans governed by ERISA are personally liable for losses.

Under the PPA, combined with LaRue, plan participants are now allowed to seek redress in a court of law. Language in the PPA suggests that plan sponsor fiduciaries can be held responsible for monitoring the quality of advice given as it pertains to performance as well as adherence to process. The issue hinges on the definition of *quality*.

It is possible that quality could very well refer to performance rather than whether the plan sponsors followed proscribed processes and procedures. However, another way to think about this is to ask whether a jury of 12 people, many of whom are participants in their own employers' retirement plan, will think that quality refers to adherence to process and procedures or that quality refers to performance.

Note

1. Hamilton, Brooks. (2007, Dec. 27). *The inalienable rights of we the people*. Retrieved March 14, 2008, from <http://ssrn.com/abstract=1078913>.

PENSION PROTECTION

Elliot N. Fineman is senior vice president of the Compass Institute. For 25 years, he was a strategic marketing consultant to major U.S. corporations, including Accenture, KPMG and The Boston Consulting Group, where he developed and guided implementation of behavioral science-based, proactive marketing programs. He testified as an expert before the State of Illinois House Committee of Computer Technology regarding strategic operational and legal issues and is the author of an integrated theory to forecast relative positioning of publicly traded financial instruments. He holds a BS in civil engineering from MIT and upon graduation was awarded a research assistantship to do advanced studies in the field.

