Fiduciary Evaluation of Target-Date Conflicts of Interest

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INTRODUCTION

Target-date funds are immensely popular among defined contribution retirement plans for a good reason. They are designed to provide plan participants with a simple and convenient way to obtain a diversified portfolio of investments that automatically adjusts over time in a manner that is reasonably appropriate for individuals with a given target retirement date.

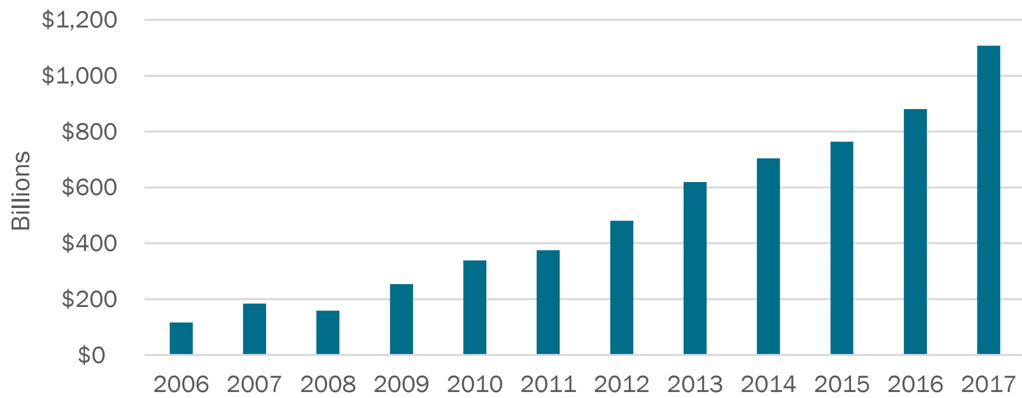
As simple as target-date funds are for plan participants to use, they are anything but simple for plan fiduciaries. In fact, their complex structures can present multiple areas of potential conflict of interest that are best avoided.

Fortunately, with a prudent evaluation process in place, plan fiduciaries are able to realize the considerable benefits of target-date solutions while addressing potential fiduciary concerns.

This paper will examine the potential conflicts of interest that can be present across different types of target-date solutions, and suggest a process that a prudent fiduciary might undertake to evaluate such conflicts in order to serve the best interests of plan participants.

Since the enactment of the Pension Protection Act of 2006 (PPA), target-date funds (TDFs) have become an immensely popular option for defined contribution ERISA plans. Today, over 85% of plans use TDFs as the default investment option.[1] Since 2006, TDF assets have risen nearly tenfold to well over $1 trillion in 2017 as shown in Figure 1 below.

Figure 1: Target-Date Mutual Fund Assets



Source: Morningstar Direct

LEGISLATIVE AND REGULATORY BACKGROUND

Since 1994, regulations under ERISA §404(c) have provided plan fiduciaries with relief from fiduciary liability for imprudent investment decisions made by sufficiently informed plan participants. The enactment of the PPA extended this relief to plan fiduciaries that select default investments for participants that have not made investment elections. This was the pivotal legislation that led to the widespread adoption of target-date funds.

The PPA ushered in a wave of plan design enhancements including automatic enrollment of eligible participants in 401(k) and 403(b) plans. Understanding that automatic enrollment would likely lead to an increase in plan contributions that were not accompanied by participant investment directions, congress incorporated "Qualified Default Investment Alternatives" ("QDIAs") within the PPA legislation. The U.S. Department of Labor (DOL) issued the final QDIA regulation[2] in October 2007 which outlined the requirements for relief of fiduciary liability associated with making appropriate default investments on behalf of plan participants who, given the opportunity, do not proactively make their own investment elections.

The date of the final QDIA regulation provided particularly timely relief for plan fiduciaries. Coincidentally, October 2007 also happened to be the month in which the U.S. equity market peaked before the financial crisis drew the market down nearly 58% by March 2009.[3]

In *Bidwell v. University Medical Center, Inc.*, a plaintiff sought to recover losses incurred after a plan sponsor exposed participants to increased market risk by introducing a QDIA amidst the financial crisis in 2008. The plan sponsor successfully defended the complaint by claiming protection under the QDIA regulation. The decision was later affirmed in federal appeals court.[4]

The final QDIA regulation identified three general types of QDIAs eligible for long-term investments:

1) TDFs designed to provide age-appropriate asset allocation adjustments over time
2) Balanced funds that consider the appropriate level of risk for the plan as a whole, or
3) Discretionary managed accounts that provide asset allocations based on a participant's individual circumstances.

[1] Callan 2018 Defined Contribution Trends Survey.
[2] 29 CFR 2550.404(c)(5).
[3] S&P 500 intraday peak occurred on October 11, 2007 at 1,576; intraday low on March 6, 2009 at 666.
[4] *Bidwell v. University Medical. Center., Inc.*, No. 11-5493 (6th Circuit, June 29, 2012).

For a variety of reasons, fiduciaries have overwhelmingly selected TDFs as the plan's QDIA, as opposed to either of the other choices. A government study in 2015 noted that more plan sponsors report using default investments that are *ineligible* for QDIA fiduciary relief such as stable value or money market funds, than the combined total of those that use either balanced funds or managed accounts.[5]

NORMAL FIDUCIARY DUTIES STILL APPLY

Although the use of TDFs is widely accepted, plan fiduciaries should not be complacent in evaluating and monitoring the specific TDFs selected for their plans. The ERISA fiduciary duties of loyalty, prudence, and diversification still apply, as well as the duty to avoid conflicts of interest.

It is important to recognize that managers of TDF mutual funds themselves are not generally considered fiduciaries under ERISA and are therefore not bound by the aforementioned duties. Mutual funds are organized as investment companies under the regulatory oversight of the SEC and are bound by the Investment Company Act of 1940 as well as the funds' prospectuses. Mutual fund directors and managers have fiduciary duties to fund shareholders, but they are not ERISA fiduciaries. This is directly addressed in the statute:

> "If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940, such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or party in interest…"[6]

There are common practices that are perfectly legal within a mutual fund, but would be considered prohibited transactions if the same practices were undertaken by an ERISA fiduciary. In order to examine how this might affect TDF's it is important to understand how TDF's are commonly structured.

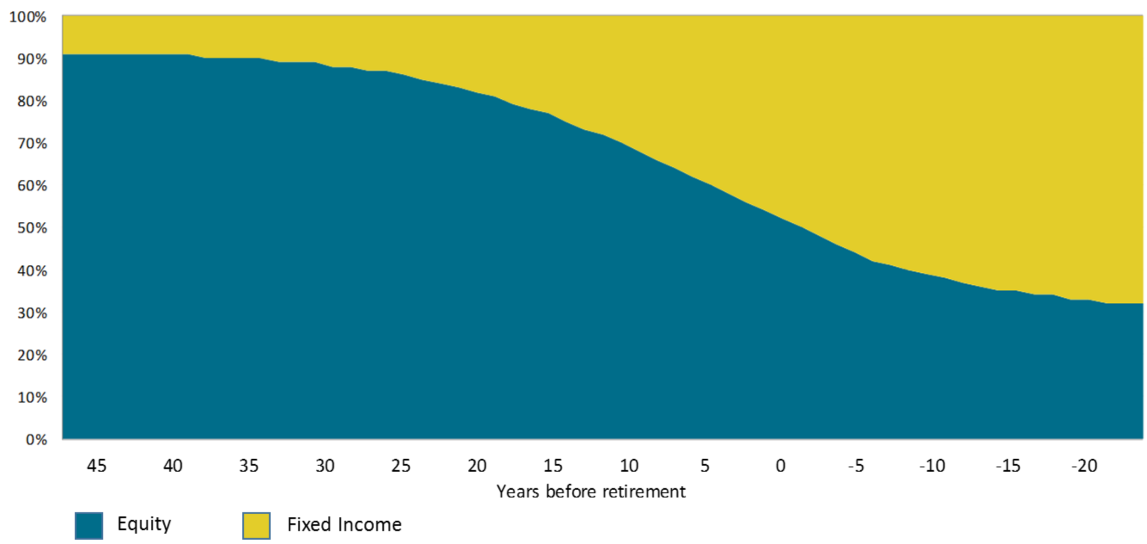
[5] GAO-15-578, *Clearer Regulations Could Help Plan Sponsors Choose Investments for Participants*, United States Government Accountability Office, August 2015.
[6] ERISA §3(21)(B).

ANATOMY OF A TARGET-DATE MUTUAL FUND

Since TDFs generally contain allocations to multiple underlying asset classes, most TDFs are structured as funds-of-funds. This means that TDFs typically hold shares of several underlying mutual funds that represent the various included asset classes. These underlying funds, referred to in the industry as "acquired funds", have their own internal fees and expenses. In cases where acquired fund expenses accrue to the benefit of the TDF manager, asset allocation decisions can easily become conflicted.

As illustrated in Figure 2, all TDFs have a "glide path" that represents the fund's intended strategic roll-down of equity exposure over time. The consensus among investment experts is that the appropriate equity allocation for a participant who is near retirement should be materially lower than the same participant's allocation at the beginning of his/her career. With that said, portfolio construction methods vary considerably across TDF providers, and meaningful differences exist with respect to the level of equity exposure at either end of the glide path, as well as, the slope of the equity rolldown.

Figure 2: Illustration of a target-date glide path



To illustrate how the shape of the glide path might present a conflict, let's consider a hypothetical scenario whereby all of the underlying acquired funds are from the same "proprietary" fund family as the TDF. We will call it the XYZ fund family for purposes of this illustration. Like most fund families XYZ, charges higher management fees for its proprietary equity funds than it does for its proprietary fixed income funds. And like most TDFs, the majority of XYZ's compensation for TDF management comes from fees on the underlying proprietary acquired funds. Under this scenario XYZ has a financial incentive to bias the TDF allocation towards equity over fixed income – while exposing participants to higher risks along the glide path.

To complicate matters further, if the XYZ TDF has an above-average equity allocation across the glide path it would likely have produced above-average performance relative to other TDFs that use a more cautious glide path – at least in a rising stock market. Plan fiduciaries that simply compare performance figures across TDF peer cohorts might not give due consideration to structural conflicts of interest and the relative prudence across TDF solutions.

These types of conflicts are deemed legally permissible because unlike ERISA fiduciaries, mutual fund managers have no explicit duty of loyalty in the selection or allocation of underlying acquired funds. Conflicts and multiple layers of fees are permitted, as long as they are described in the mutual funds' regulatory disclosures.

The XYZ hypothetical example is relatively simple. In practice, the conflicts can be harder to spot, especially when affiliated acquired funds have different brand names or when sub-advised funds are involved.

There are multiple layers of decisions involved in operating a TDF. Potential conflicts can exist at each level. Figure 3 below provides a partial list of such conflicts.

Figure 3: Potential conflicts within TDFs

LAYER	DECISIONS MADE	POTENTIAL CONFLICT
Acquired Fund Sub-Adviser	Select individual securities Select securities brokers	• Use of soft dollar commissions[7] • Trade allocations and rotations
Acquired Fund Adviser	Select sub-adviser(s)	• Selection influenced or driven by sub-adviser affiliation and/or business arrangement • Financial incentive to select lower cost sub advisers if sub adviser fees are paid by adviser
TDF Adviser	Select asset classes for inclusion	• Internal product availability and/or profitability influencing asset class inclusion
	Select acquired funds	• Acquired fund affiliation (i.e., “proprietary funds”) • Seeding unproven proprietary strategies • Revenue sharing payments from proprietary or non-proprietary funds • Financial incentive to select lower cost non-proprietary acquired funds in cases where a fixed management fee is charged and acquired fund expenses are offset by the TDF adviser.
	Strategic asset allocation (i.e., “glide path”)	• Financial incentive to design a glide path that favors allocation to acquired funds with higher management fees – and potentially higher risk
	Tactical asset allocation (i.e., short-term changes)	• Potential to make tactical changes that result in higher fees to adviser through acquired funds

While not universal to all TDFs, the conflicts outlined above are common in the industry. Some TDF managers earn fees at three or more levels, including:

- TDF management fees that are not offset by fees collected through acquired funds
- Revenue-sharing payments from non-affiliated constituent funds
- Adviser fees in proprietary acquired funds, whether sub-advised or not
- Adviser fees in acquired funds that are managed by affiliated companies

Although a TDF’s management fees are explicitly outlined in its prospectus, the TDF manager’s discretionary power to select and allocate across acquired funds gives the manager potential control over the total compensation it receives. Some TDF providers seek to mitigate these conflicts with fee offset arrangements, but others don’t.

ALTERNATIVE QDIA STRUCTURES PROVIDED BY ERISA FIDUCIARIES

Plan fiduciaries seeking to avoid the potential conflicts of interest associated with mutual fund TDFs might consider alternative delivery structures, where the portfolio manager serves as an ERISA fiduciary. As a fiduciary’s duties of loyalty and prudence are the “highest known to law”[8], self-dealing is prohibited.[9] These alternative delivery structures include Collective Investment Trusts (CITs), custom target date models, managed accounts and dual QDIA options. We consider the characteristics and attributes of each option below in greater detail.

Collective Investment Trusts (CITs). Offered through bank trust organizations, CITs are managed by ERISA fiduciaries who must comply with ERISA fiduciary standards. Although they are exempt from SEC oversight, CITs are regulated by the Office of the Comptroller of the Currency and the DOL, as well as, the bank’s state and federal regulators.

When a CIT manager selects proprietary acquired funds, the arrangement must satisfy specific requirements of a prohibited transaction exemption[10] issued by the DOL in 1977, less than 3 years after the enactment of ERISA. Among the

[7] Soft-dollars can be generated by fund managers through agreements with brokers that execute securities trades within the fund at commission rates that are above what would otherwise be charged solely for the trade execution. The excess commission represents soft-dollar credits that can be used by the fund manager to cover research expenses for which it might otherwise have to pay directly.
[8] *Donovan v. Bierwirth*, 680 F.2d 263, 272, n. 8 (2d Cir. 1982).
[9] ERISA §406(b) prohibited transaction rules.
[10] Prohibited Transaction Exemption 77-4 42 Fed. Reg. 18732 (April 8, 1977).

requirements of this exemption is a mechanism to offset multiple layers of fees, and for an independent fiduciary (i.e., plan committee or sponsor) to explicitly approve any changes in the CIT manager's total compensation.

Some investment management firms offer both mutual-fund and CIT versions of their target-date products. In such cases, the CIT generally operates under different fee arrangements from the mutual funds, to avoid the conflicts that are prohibited under ERISA.

However, the mere fact that conflicts of interest are prohibited does not necessarily mean they do not exist. A lawsuit filed in April 2018[11] against a major provider alleged a breach of the fiduciary duties of loyalty and prudence. The plaintiff's central allegation is that the investment manager was engaged in prohibited self-dealing by using relatively high cost proprietary index funds within its CIT product. At the time of this article's publication, this case is being vigorously contested by the defendants.

Custom Target-Date Models. If available through the plan's recordkeeper, another option may be to use custom target-date models that are managed in a discretionary capacity by an independent investment manager who serves as an ERISA fiduciary. The DOL has suggested that plan fiduciaries consider custom target-date models to avail themselves of two advantages[12]:

1. They provide the ability to incorporate the plan's existing core funds in the model allocations, and
2. They provide the ability to diversify participants' exposure beyond a single investment provider.

A third advantage of custom target-date models (that was not explicitly mentioned in the DOL publication) is the potential to separate the fund selection and allocation decisions from any revenue considerations of the underlying funds – thus eliminating a potential conflict of interest.

It is important to note that prudence and diligence is required in the selection and monitoring of a custom target-date manager. A relevant class-action lawsuit was filed in 2016. The original complaint alleged, among other things, that the defendant hired an inexperienced investment adviser and was imprudent in the design, implementation, and monitoring of its custom target-date models[13]. The lawsuit was settled by the plan sponsor for $14 million without admitting wrongdoing.

Managed Accounts. Although it was noted earlier that plan fiduciaries have not historically embraced managed accounts as QDIAs, this trend may be changing as managed account solutions continue to evolve. An industry survey of large DC plans[14] indicated that in 2017, over 5% of plans used managed accounts as the QDIA, compared to less than 1% in 2015.

Unlike prepackaged or custom target-date solutions, managed accounts are a form of technology-driven advisory solution that considers a variety of participant-specific inputs to arrive at a customized asset allocation decision. For example, these inputs may include retirement readiness scores, projected income replacement ratios, risk tolerance assessments, life expectancies, account balances, loans, contribution rates, and outside retirement resources. Since the advisor manages the participant accounts on a discretionary basis, the advisor is considered a fiduciary under ERISA and must avoid conflicts of interest.

The two main drawbacks to managed accounts are that 1) additional fees are typically involved, and 2) additional participant input is usually required in order to realize the full benefit of the service. If one thinks of the plan's QDIA as being the default investment for the plan's least engaged participants, it is easy to understand why some plan fiduciaries are reluctant to use managed accounts as the QDIA.

A class action complaint filed in April 2018[15] underscores the responsibility to ensure that any managed account solution used is reasonable and appropriate. The lawsuit alleged that the plan sponsor was imprudent and disloyal by allowing participants to pay unreasonable fees to its managed account provider Financial Engines, and "turned a blind eye to a kickback scheme between Financial Engines and the Plan recordkeeper Aon Hewitt." Notably, the complaint also alleges that the account management was not customized for each participant, but merely funneled each participant into a "cookie-cutter" portfolio based on the participant's age, self-reported investment strategy, and self-reported risk tolerance.

[11] *Nelson v. Principal Global Investors Trust Company*, S.D. Iowa, No. 4:18-cv-00115-SMR-SBJ.
[12] "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries", U.S. DOL EBSA, February 2013.
[13] Johnson et al. vs. Fujitsu Technology and Business of America Inc. et al, 5:16-cv-03698 NC.
[14] Callan 2018 Defined Contribution Trends Survey.
[15] Pizarro et al. vs. The Home Depot, Inc. et al, 1:18-mi-99999-UNA.

Managed account providers have continued to innovate in order to deliver more value by automatically incorporating more participant-specific information available to the recordkeeper and by expanding their deliverables to include advice on strategies for Social Security withdrawals in retirement.

Dual QDIA. An emerging trend in the retirement plan recordkeeping industry seeks to address the aforementioned drawbacks of managed accounts by introducing the concept of a dual QDIA, sometimes referred to as a "Dynamic QDIA", "Hybrid QDIA" or "Smart QDIA". The dual QDIA structure allows for plan sponsors to select one default investment for participants below a certain age threshold and another default investment for participants above that threshold. The setup is commonly used to steer participants into TDFs or custom target date models in their early savings years, but then to convert participants to managed accounts as they approach an age at which individual circumstances are likely to vary to a greater degree. Importantly, prior to the age threshold (for example, age 50), the QDIA avoids the extra cost of a managed account.

If one thinks of the plan's QDIA as the baseline option to accommodate a diverse range of participants, the dual QDIA concept may hold greater appeal.

APPROPRIATE DUE DILIGENCE

To be clear, we are not suggesting that TDFs engage in unethical practices or that proprietary TDF mutual funds should never be selected by responsible, diligent, and prudent ERISA fiduciaries. We are also not suggesting that all managers of a CITs, custom target-date models, and managed account solutions appropriately fulfill their fiduciary responsibilities under ERISA, or that these alternate structures represent a better fit than TDF mutual funds for all plans. As noted above, ERISA litigation has targeted TDFs organized as CITs and managed account structures when there were indications that these arrangements may have been imprudently managed or selected.

We do suggest that fiduciaries responsible for an ERISA plan's QDIA should follow diligent fund selection and monitoring processes. This is true of all plan investment decisions, but is especially important for QDIAs because of their use as a default investment for relatively disengaged participants. Further, due to their multi-asset class composition, glide path, and other factors, TDFs are typically among the most complex options offered in a plan, warranting an even deeper fiduciary analysis.

There are other relevant steps in the fiduciary assessment of a suite of TDFs that go beyond the normal process a fiduciary might use to evaluate single asset class options in the core investment lineup:

1. Determine eligibility for use as a QDIA. Among several other requirements, the investment must be "designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures"[16]. The common interpretation of this requirement among industry practitioners is that each TDF in the suite must have at least some fixed income and some equity exposure.
2. Consider how well the TDF's characteristics align with the presumed investment objective of the participant population. This should include an assessment of the appropriateness of the TDF glide path for the plan considering participant demographics and circumstances. The "MPI Target-Date Radar" tool from Markov Processes International, or SageView's "Best Fit Tool" are examples of analytical tools that facilitate such an assessment.
3. Assess the potential for conflicts of interest in the management of the TDF, and the reasonableness of the arrangement.

The Appendix at the end of this paper outlines a potential process that a prudent fiduciary might undertake as part of its evaluation and assessment of potential conflicts of interest in a TDF.

ASSESSING REASONABLENESS

There is no industrywide or statutory standard for determining the reasonableness of any arrangement for an ERISA plan. Unreasonable plan expenses are prohibited by ERISA, but the determination of reasonableness is ultimately based on specific facts and circumstances that inform whether or not the cost is competitive and appropriate for the value received.

The presence of conflicts and the range of potential compensation are important parts of the facts and circumstances that a prudent fiduciary should take into consideration in assessing reasonableness. Unfortunately, if a TDF manager has unrestricted ability to increase its total compensation without prior approval by the plan fiduciary, it may be quite difficult to conclude that the compensation is reasonable.

[16] 29 CFR 2550.404(c)(5)(e)(4)(i).

Although participants may commonly think of their TDF as a "set-it-and-forget-it" solution, plan fiduciaries must not have that mindset when it comes to selecting and monitoring plan investments. A TDF that was assessed by plan fiduciaries as prudent and reasonable upon initial selection for plan inclusion might not always be so. As individual TDF products and the broader industry continues to evolve ongoing diligence by plan fiduciaries is essential. This continuing fiduciary duty was affirmed by the U.S. Supreme Court[17].

As with all significant fiduciary decisions, it is important to document the assessment process that was undertaken and the rationale for the action (or inaction) taken.

CONCLUSION

The importance of target-date solutions within defined contribution plans, and the complexity of their structures, warrant a thorough fiduciary assessment. With appropriate care, diligence, and documentation, plan fiduciaries can make prudent decisions to utilize target-date solutions that are reasonably structured and managed in a way that is advantageous to plan participants.

[17] *Tibble v. Edison International,* 135 S. Ct 1823 (2015).

Appendix: Lines of Inquiry to Evaluate TDF Conflicts

SUBJECT	INQUIRY	FIDUCIARY ASSESSMENT
Asset class selection	• What is the basis for selecting underlying asset classes for inclusion? • Does the TDF manager consider asset classes that are not available through its own fund family?	• Does the process seem to be reasonable and prudent? • Is the inclusion rationale based on sound investment principles?
Strategic glidepath	• What is the rationale behind the shape of the TDF's glidepath?	• Is the process reasonable? • Does the stated rationale align with the actual glidepath? • Is the glidepath clear from apparent conflicts of interest?
Underlying fund selection	• What is the ongoing process to evaluate and replace underlying funds? • Are the acquired funds proprietary, unaffiliated, or a combination of both? • Would any of the acquired fund strategies be otherwise available to the plan at a lower cost?	• Is the process and rationale for selecting underlying funds reasonable? • Does the stated process align with the actual fund selection? • Do conflicts of interest appear to influence the selection of acquired funds?
Tactical allocation	• If tactical allocation is employed, is there a process to implement changes on a fee neutral basis? • What are the tactical allocation range limits?	• To what extent can the TDF manager's compensation be affected by tactical changes?
Total Compensation	• What compensation does the TDF manager earn from the TDF for adviser or administrative services? • What compensation does the TDF manager earn from acquired funds? • Are there fee waivers expiring or fee increases expected? • Are any TDF fees offset by compensation earned from acquired funds? • Is there a cap on total fees earned at all TDF levels? • Are the total fees the same for each target date along the glide path? • Is there any mechanism in place to ensure that the total compensation earned by the TDF manager is not affected by investment decisions?	• To what extent does the TDF manager have discretionary control over its total compensation? • Is there any evidence to suggest a pattern of self-serving investment decisions? • What is the range of potential total compensation at all levels? • Is the range of potential total compensation reasonable?