

Capital Preservation Product Selection and Monitoring: Prudent Process Considerations

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Breach of fiduciary duty allegations related to the selection of capital preservation investment options feature prominently in a series of recent putative class action lawsuits.¹ Those cases generally allege that defined contribution plan investment fiduciaries imprudently selected money market funds as investment options for the plan's capital preservation asset class even though higher yielding stable value investment options were available. The cases are in the early stages of being litigated and it is too soon to tell whether courts will accept the plaintiffs' theories of liability. But the very fact that these lawsuits are being brought, serves to remind and warn defined contribution plan fiduciaries of the plaintiffs' bar's growing interest in the capital preservation asset class, the processes plan fiduciaries use when selecting and monitoring capital preservation investment options, and whether those processes sufficiently satisfy the fiduciary duty of prudence.

The sheer diversity of product types available in the capital preservation asset class, and how the investment returns on those products may be affected by how they are bundled together with or unbundled from the cost of plan recordkeeping and administration, is often overlooked. This article explores how to better take these considerations into account through procedural safeguards that plan fiduciaries, their advisors and consultants may wish to add to existing processes for selecting and monitoring capital preservation investment options. To better frame this discussion, below we briefly review selection and monitoring processes generally being used today by fiduciaries of 401(k) and other defined contribution plans. We then identify some of the unique characteristics of investment options that fall within the capital preservation asset class and discuss whether those may

merit renewed attention. Lastly, we offer some suggestions for potential overlays to existing selection and monitoring procedures with respect to capital preservation investment options.

ERISA's Duty of Prudence

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), imposes special duties and obligations on persons who act as "fiduciaries" with respect to ERISA plans. Section 404 of ERISA obligates fiduciaries to act "with the care, skill, prudence and diligence under the circumstances that a prudent [person] 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." Fiduciaries who breach their duties may be held personally liable for resulting losses to the plan. Importantly, courts have generally held that questions as to whether a plan fiduciary acted prudently are not to be measured in hindsight, but turn instead on whether the fiduciary engaged in a reasoned decision-making process.²

The Role of the Investment Policy Statement

Plan advisors and consultants have long appreciated that a well-drafted investment policy statement or "IPS" can be helpful to plan fiduciaries. The IPS describes, outlines and frames processes that plan fiduciaries intend to use to select, monitor and, as warranted, replace the plan's investment options. Experienced advisors and consultants realize that part of the value they are able to add involves assisting client plan fiduciaries in implementing prudent investment oversight processes. With that objective in mind advisors and consultants may furnish clients with a template or sample IPS and then engage with the plan's fiduciaries to build-out and tailor the IPS that is ultimately adopted.

While ERISA does not require the adoption of an investment policy statement, a properly crafted IPS can help guide and support the plan's investment fiduciaries in the discharge of their obligations



to prudently oversee and manage the selection and de-selection of plan investment options. The IPS frames the investment option selection and oversight process by clearly identifying the plan's investment objectives. A defined contribution plan's investment objective is often described in terms of affording participants an opportunity to construct investment portfolios consistent with their own personal risk and return objectives by making a range of investment options available within stated asset classes. In many cases, the IPS takes the additional step of identifying various asset classes to be made available, and the criteria that plan fiduciaries will consider in evaluating and selecting investment options to fill-out those asset classes.

Many IPS's tend to broadly apply the same evaluation and consideration criteria to the capital preservation category as are applied to every other plan asset category (e.g., fixed income, equities, balanced, target-date and international). The performance returns generated by the plans' funds are evaluated as part of a process that includes comparisons to appropriate benchmark and peer category funds. The competitiveness of investment option fees and expenses relative to similar funds, consistency of investment style, and tenure of fund management further exemplify consideration criteria that are often broadly applied to all of the plan's funds.

Comparison criteria of these types are fundamental and will undoubtedly remain an important part of the process many fiduciaries will continue to use to evaluate investment options within the capital preservation asset class. But might plan fiduciaries consider additional procedural steps that could be overlaid on an existing framework for capital preservation fund investment selection and monitoring?

On the following pages, we briefly discuss several unique attributes of the capital preservation investment category. We note at the outset that many investment policy statements in use today often devote scant attention to these issues. That lack of focus could provide opportunities for plaintiffs to bring cases based on theories that the selection and monitoring of capital preservation funds was somehow deficient or incomplete and therefore procedurally imprudent.

Some Often Overlooked Capital Preservation Asset Class Attributes

1. The Capital Preservation Asset Class is Multi-Dimensional

A much-overlooked characteristic of the capital preservation asset class is the tremendous diversity of available product types and structures available as investment options to fill-out that category. Each product type and structure has its own accompanying sets of advantages and *other considerations*. Commonly available products include:

- **Insurance Company General Account Products** (advantages include minimum credited rate guarantees and credited rates of return that typically exceed those currently available from competing money market fund and banking products; *other considerations* include the need to monitor insurer financial strength and claims paying ability and potential restrictions or financial adjustments applicable to non-benefit responsive withdrawal activity);
- **Collective Investment Trust Stable Value Funds** (advantages include presence of a professional asset manager that will typically accept appointment as an investment manager under section 3(38) of ERISA, low investment minimums that facilitate small plan access, potential diversification of benefit responsive guarantees across multiple insurance providers, transparency of underlying holdings; *other considerations* include restrictions on non-benefit responsive withdrawals including "12 or 24 month put" feature applicable for exiting the fund, absence of pre-declared credited rate, average duration of fixed income investment holdings tends to be shorter, and therefore lower-yielding, than those of competing insurance company stable value funds);
- **Life Insurance Company Separate Account or "Synthetic" Stable Value Funds** (advantages include periodically declared credited rates in effect for stated periods, transparency of investment holdings and credited rate setting process, typically longer duration fixed income holdings and investment yields than available under competing CIT products, "insulation" from general account financial strength concerns (separate account arrangements) or direct plan ownership of underlying fixed income assets (synthetic arrangements); *other considerations* include the degree of diversification among providers of insurance guarantee, presence of withdrawal restrictions and or adjustments for non-benefit responsive withdrawal activity);



- **Bank FDIC Pass-Through Products** (advantages include FDIC insurance coverage, rates of return that are generally higher than money market fund rates; *other considerations* include product complexity and costs associated with underlying banking institution selection, allocations of deposits across banks as required to maximize FDIC coverage, and FDIC insurance pass-through accounting records); and
- **Money Market Funds** (advantages include liquidity, simplicity relative to competing structures, registered under the federal securities laws; *other considerations* include extremely low rates of return relative to other available product structures (currently) and absence of insurance guarantees, recent changes in applicable securities regulations generally limit the availability of \$1.00 per share pricing to funds that invest in lower yielding government securities).
- Many investment policy statements overlook the diversity of product structures within the capital preservation asset class category. A particular product type, once chosen, tends to be evaluated in light of benchmark and peer group comparative information available for that particular sub-category (e.g., money market fund against peer money market funds). We would suggest that relevant considerations may also include whether or not the plan's interests would be served by remaining with or by changing the product type selected to populate the capital preservation asset class.

2. Recordkeeping and Administrative Service Fee Support

DC marketplace advisors and consultants are generally familiar with how various revenue streams generated by a plan's investment holdings may be applied to reduce or offset the level of direct recordkeeping charges that the plan would otherwise be obligated to pay directly. The intent behind the Department of Labor's 2012 fee disclosure regulations under section 408(b) (2) of ERISA largely involved making more transparent the degree to which the selection of investment products may affect plan recordkeeping charges.³

Depending on how they are constructed and offered, capital preservation investment options may be particularly correlated to the costs of recordkeeping. That result is neither inherently a good thing nor a bad thing. It is, however, something that likely merits consideration as part of a prudent process for determining whether that particular product and the accompanying inter-connect with plan recordkeeping costs makes sense for the plan. As part of a prudent process, a plan fiduciary may wish to consider and evaluate the degree to which capital preservation products available through their recordkeeping provider's investment platform involve trade-offs between investment returns and direct recordkeeping charges. As noted above, a procedurally prudent process is one that reflects a reasoned decision-making process following consideration of relevant factors.

Attached is a sample investment policy statement addendum that identifies several capital preservation product considerations and that may complement typical evaluation criteria already in place. Plan consultants and advisors may wish to consider using these additional metrics to help further encourage procedurally prudent processes on the part of client plan fiduciaries.

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Capital Preservation Investment Option Addendum to Plan IPS

Exhibit 1

Capital Preservation Asset Class:

- With respect to the selection and monitoring of the Plan's capital preservation investment option, the plan's fiduciaries may also consider, in addition to the investment option evaluation criteria generally specified by this IPS, the following—
- Whether and the extent to which alternative capital preservation investment product structures may advance the plan's risk and return objectives for this investment category. Alternative structures include:
 - Insurance Company General Account Products
 - Collective Investment Trust Stable Value Products
 - Life Insurance Company Separate Account Stable Value Products
 - Bank FDIC Pass-Through Products
 - Money Market Funds
- The potential advantages and *other considerations* associated with competing structures, including relative safety, liquidity, the presence or absence of a pre-declared credited rate, relevant fees and expenses, asset duration, long-term performance and financial strength backing insurance company guarantees.
- The degree to which, if at all, the selection of a capital preservation product affects the levels of direct recordkeeping expenses charged to the plan and, conversely, whether and the degree to which the levels of direct recordkeeping charges may affect the rates of return achieved by the capital preservation product.

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The U.S. Department of Labor has adopted new fiduciary regulations (the "DOL Rule") that apply to plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA") on and after June 9, 2017. Brokers, consultants, stable value managers, plan platform providers and recordkeepers, and any other third party intermediaries should consult with their own tax and legal advisors regarding the impact of the DOL Rule. Please understand that New York Life, its subsidiaries, agents and employees do not provide legal, tax, investment or ERISA advice.

¹See, e.g., McDonald v. Edward D. Hone & Co., L.P., No. 4-16-cv-01346-NAB (E.D. Missouri, filed Aug. 19, 2016); Cryer v. Franklin Resources, Inc. et al, No. 4:16-cv-04265-CW (N.D. California, filed July 28, 2016); White et al v. Chevron Corporation et al, No. 4:16-cv-00793 (N.D. Cal. filed on Feb. 17, 2016); Bell et al v. Pension Committee of Ath Holding Company, LLC et al, No. 1:15-cv-02062-TWP-MPB (S.D. Ind. filed Dec. 29, 2015); Bowers, et al. v. BB&T Corporation 1:15-CV-732 (M.D. North Carolina, filed Sept. 4, 2015).

²DiFelice v. U.S. Airways, Inc., 497 F.3d 410 (4th Cir. 2007)

³See 29 CFR §2550.408b-2(c)(1)(iv)(D)(2) ("If the covered service provider reasonably expects recordkeeping services to be provided, in whole or in part, without explicit compensation for such recordkeeping services, or when compensation for recordkeeping services is offset or rebated based on other compensation received by the covered service provider, an affiliate, or a subcontractor, a reasonable and good faith estimate of the cost to the covered plan of the such recordkeeping services, including an explanation of the methodology and assumptions used to prepare the estimate and a detailed explanation of the recordkeeping services that will be provided to the covered plan. The estimate shall take into account, as applicable, the rates that the covered service provider, an affiliate or a subcontractor would charge to, or be paid by, third parties, or the prevailing market rates charged, for similar recordkeeping services for a similar plan with a similar number of covered participants and beneficiaries.")



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