Selecting, Evaluating, and Monitoring Investments in DC Plans: A Legal Perspective

By
Alison V. Douglass, Esq.
Christina Hennecken, Esq.
Goodwin Procter LLP

GOODWIN

Highlights

In the complex and litigation-prone world defined contribution plans occupy, it is important to underline what the real focal points for fiduciaries should be. Here are three key takeaways derived from the body of legal decisions that have been rendered in this area that can aid fiduciaries in selecting and monitoring investment options and assessing active strategies within their plan lineup:

It's about the process.

In order to satisfy ERISA prudence standards, a fiduciary needs to make informed decisions. This means that fiduciaries should have a good decision-making process that they consistently follow.

Fiduciaries should focus on the value-for-cost proposition.

Plan fiduciaries are not required to scour the market for the cheapest possible investment options. Rather, fiduciaries should focus on the value-for-cost proposition. This means that fiduciaries have latitude to consider what different investment strategies provide to plan participants, not just cost.

Range of choice and strategies can be appropriate.

Providing building blocks for participants to build prudent and well-diversified portfolios plays an important role in defined contribution plans and may favor a sponsor's decision to provide a variety of investment options.

The fiduciary standards and takeaways highlighted above, and discussed later in more detail, help clarify that there is not an investment lineup or singular approach that is deemed a mandate. Rather, there are core principles that sponsors can use to inform their investment choices and oversight.

Introduction

Plan sponsors today have unprecedented options available to them when making investment selection decisions for their plans. At the same time, plan sponsors face increasingly complex fiduciary requirements, as well as pressure to provide an optimal plan experience for participants at a reasonable cost. Making investment selection decisions under these conditions can prove challenging.

These challenges are compounded by the fact that defined contribution plans are increasingly the target of class action litigation. Claims are often brought by current or former employee-participants who have been recruited by plaintiff law firms to assert claims on behalf of the plan. Alleged claims are often based on little more than publicly available information about a plan's investments, and lack the benefit of any insight into the fiduciaries' selection and oversight process. Nonetheless, the specter of a lawsuit has many fiduciaries reevaluating how they select and monitor their plan investments.

After more than a decade of litigation, a body of decisional law is emerging that can offer plan fiduciaries insights into how courts analyze claims concerning plan investments. This white paper aims to help fiduciaries navigate the waters of plan investment evaluation, selection, and monitoring processes by:

- Decoding the legal standards in recent court decisions that apply to fiduciaries who are responsible for choosing investment options for their plans.
- Identifying some key takeaways from legal authorities that may assist fiduciaries assessing investments for their plan lineup.
- Emphasizing the importance of process as the most important factor in fiduciary decision-making.

Decoding ERISA's Fiduciary Standards

ERISA holds plan fiduciaries to certain standards of care that the courts regard as the highest standards known to law. Namely:

- Fiduciaries owe a ***duty of loyalty***[1] to plan participants and beneficiaries. This means that the fiduciaries must act solely in the interests of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and paying only reasonable plan expenses. This standard is often is referred to as the "exclusive benefit rule." Fiduciary decisions must be made with an eye single to the interests of participants. Of course, when it comes to investment selection, ensuring that the plan pays only reasonable expenses can also take into account the total costs of participation to participants—inclusive of investments and plan administration, whether paid for separately or through revenue generated by plan investments.
- Fiduciaries owe a ***duty of care***[2] to plan participants and beneficiaries. This means that when the fiduciaries act for the plan, they must act "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 a like character and with like aims." This standard is known as the "prudent person rule."
- Fiduciaries also must act ***consistent with the documents***[3] that govern the plan and must ***diversify***[4] the plan's investments so as to minimize the risk of investment losses.

When it comes to a plan's investments, most defined contribution plans are set up so that the participants themselves can decide how to invest their plan accounts. Plans typically make available a range of options from which a participant can construct a diversified portfolio. These options can include a qualified default investment alternative into which a participant's account will be invested in the absence of participant direction.

Notwithstanding the role of participant-directed investing, plan fiduciaries do have the responsibility to select and to monitor the designated investment alternatives that will be made available to participants. Meeting these responsibilities requires an informed and thorough evaluation of both the needs of their plan and a clear understanding of the range of options available in the marketplace. Here, the focus is on the *inputs* to the fiduciary's decision-making, and not on the investment *outcomes* achieved. In other words, employing a good investment selection *process* is a key to meeting fiduciary obligations, while also acting with exclusively participants' interests in mind.

---

[1] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A).

[2] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[3] ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D).

[4] ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C).

A good fiduciary investment selection process may include:

- Understanding the documents that govern the plan, which may set forth investment objectives or mandates for the plan. Remember, following the plan documents is a key fiduciary obligation.
- Meeting regularly to discuss and review the plan's investment options. Again, the focus here is on process. It is important to have a decision-making process that is thorough, consistently applied, and documented.
- Considering key attributes of the investment options (such as performance, expenses, and the spectrum of risks and corresponding trade-offs) when considering available options and monitoring those investments chosen for the plan.
- Accounting for the interests of participants in their retirement income.

Three Key Takeaways Regarding Fiduciary Investment Evaluation, Selection, and Monitoring

Courts are frequently called upon to consider whether a fiduciary's selection of an investment for the plan was consistent with ERISA's standards. The cases reflect key takeaways that may be helpful to plan sponsors as they consider the role that active management can play in their plan's investment lineup.

▶ Key Takeaway 1: Fiduciary prudence focuses on the process by which investments are selected and monitored for the plan, and not on investment outcomes.

ERISA's prudent person standard is not concerned with results.[5] Time and again, courts have said that that test of prudence focuses on the fiduciary's decision-making process, not on investment outcomes.[6] In particular, the fiduciary must give appropriate consideration to the facts and circumstances that are relevant to the particular investment under consideration, and act accordingly.[7] Relevant factors may include the sponsor's purpose in offering the plan, the risk of loss and the opportunity for gain (or other return) associated with the investment being considered, and the role the investment will play in the plan's investment lineup.

In short, ERISA's fiduciary prudence standards are satisfied by an informed decision-making process. For this reason, courts are not inclined to hold liable a plan fiduciary who engaged in a reasoned decision-making process and took into account all relevant information in carrying out its fiduciary duties.[8] For example, one court recently determined fiduciaries had used appropriate methods of investigation and review of its investment options when they met quarterly and made reasoned decisions, balancing relevant factors such as "historic performance, short-term performance, interests of stability," and other information available.[9] Relevant information can also include the macroeconomic environment at the time of the decision and the long-term investment strategy utilized.[10] An informed decision-making process does not require removing investment options "at the first indication of underperformance"—instead, taking a longer-term view and evaluating investments over a "full market cycle" can be appropriate.[11] Finally, courts have also approved of plan fiduciaries considering information from third-party consultants when they evaluate and review such third-party recommendations before adopting them.[12]

---

5 *Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915, 918 (8th Cir. 1994) (prudence is "a test of how the fiduciary acted viewed from the perspective of the time of the challenged decision rather than from the vantage point of hindsight").

6 *Meiners v. Wells Fargo & Co.*, 2017 WL 2303968, at *2 (D. Minn. May 25, 2017), *aff'd*, 898 F.3d 820 (8th Cir. 2018) (stating that the "rate of return" of the challenged funds "are only relevant insofar as they suggest that [the fiduciaries'] decision making process was flawed").

7 29 C.F.R. § 2550.404a-1.

8 *Bunch v. W.R. Grace & Co.*, 555 F.3d 1, 7 (1st Cir. 2009) (no liability for plan fiduciary who engaged in "thorough investigative and decisional process"); *DiFelice v. U.S. Airways Inc.*, 497 F.3d 410, 420 (4th Cir. 2007) (no liability for plan fiduciary whose decision-making process used "appropriate methods to investigate the merits" of the challenged investment).

9 *Ramos v. Banner Health*, 461 F. Supp. 3d 1067, 1130 (D. Colo. 2020) (rejecting challenge to plan's inclusion of certain target date funds when fiduciaries "look[ed] at returns over a market cycle" and "regularly discussed the performance of the [TDFs] at its quarterly meetings").

10 *Wildman v. Am. Century Servs., LLC*, 362 F. Supp. 3d 685, 707 (W.D. Mo. 2019) (rejecting claims of imprudence when record showed the fiduciaries continually monitored the challenged funds and "came to a reasoned decision to allow them to remain in the Plan"); *Cunningham v. Cornell Univ.*, 2019 WL 4735876, at *14 (S.D.N.Y. Sept. 27, 2019) (rejecting imprudence claims based on underperformance when fiduciaries discussed and monitored the challenged funds: "Evidence of 'discussions about the pros and cons' of investment alternatives is 'fatal to' plaintiffs' claims."), *reconsideration denied*, 2020 WL 1165778 (S.D.N.Y. Mar. 11, 2020). *See also Taylor v. United Techs. Corp.*, 2009 WL 535779, at *10 (D. Conn. Mar. 3, 2009), aff'd 2009 WL 535779 (2d Cir. Dec. 1, 2009) (rejecting attack on the use of actively managed funds in a large defined contribution plan where the fiduciaries' selection process included "appropriate consideration" of the fees and the returns of funds).

11 *Ramos*, 461 F. Supp. 3d at 1098; *Davis v. Salesforce.com, Inc.*, 2020 WL 5893405, at *4 (N.D. Cal. Oct. 5, 2020) (rejecting allegations based on five-year returns as "not sufficiently long-term to state a plausible claim of imprudence"); *Dorman v. Charles Schwab Corp.*, 2019 WL 580785, at *6 (N.D. Cal. Feb. 8, 2019) (rejecting allegation of "persistent" underperformance based on only "three to five years [of returns], which are still considered relatively short periods of underperformance").

12 *Ramos*, 461 F. Supp. 3d at 1130 (observing that the fiduciaries "did not uncritically adopt Slocum's recommendations. Rather, the [committee] engaged with Slocum representatives at the [committee] meetings to understand Slocum's reports, and to make informed decisions about the plan's target date solutions."); *Cunningham*, 2019 WL 4735876, at *14 (noting that the defendants did not "passively accept" a third party's proposal, pointing to evidence that the defendants reviewed presentations, and asked relevant questions).

Key Takeaway 2: Appropriate evaluation, selection, and monitoring of plan investments requires an understanding of the basis for comparison.

Plan investments cannot be evaluated in a vacuum. Part of a fiduciary's responsibility in evaluating investment options is to consider reasonably available alternatives. In evaluating the available options, the fiduciary needs to understand certain key dimensions of investments, such as investment type (e.g., mutual fund or collective or common trust), asset class, management strategy, and cost. While a broad range of options along each such dimension are available in the market, once an investment has been chosen for a plan, any evaluation of such plan investment should be subject to appropriate comparisons. For instance, critics of active management often base their after-the-fact critique on a comparison between the fees of active and passive investment products. But such comparisons are not apples to apples. Actively managed investment products are typically more expensive than passively managed investment products because they require different levels of services. There are costs associated with active strategies. The courts have recognized this and have rejected claims based exclusively on inapt fee comparisons.[13]

Similarly, fiduciaries who choose mutual funds for their plans may have the option of selecting share classes that make available a portion of revenue that can be used to fund plan administration. Upon proper consideration, a fiduciary may determine that the fees associated with such share class are reasonable and in the best interest of participants in light of the total cost to participants. When evaluating such investments options, however, it would be inapt to compare the fees of such a share class with the fees of a share class that does not pay any revenue to fund plan administration.

Moreover, courts have consistently recognized that fees are just one dimension to a plan's investments and should not alone be the basis upon which an investment selection decision is judged. For example, some courts have considered the availability of cheaper options to be "beside the point" because nothing in ERISA requires every fiduciary to "scour the market" for the cheapest possible funds.[14] Not only do plan fiduciaries have latitude to value investment features other than price, they are required to do so.[15] This is consistent with any common sense approach to purchasing. For instance, no professional would advise a person who is looking to buy a house or a car to only consider the listing or sticker price.

"it is important to note that the selection of passive investments does not insulate a fiduciary from their duties of loyalty and care under ERISA."

Instead, courts have observed that assessing and evaluating investment options requires considering, in addition to fees, the investment strategy and risk of the investment options. For example, courts have rejected comparisons between investment options with "different aims, different risks, and different potential rewards" as apples and oranges and "not a way to show that one is better or worse than the other."[16] Similarly, while it is possible that an index fund could serve as a suitable comparison to an actively managed fund,[17] some courts have rejected comparisons between actively managed and passively managed funds as unsuitable because of their dissimilar investment strategies.[18] Lastly, it is important to note that the selection of passive investments does not insulate a fiduciary from their duties of loyalty and care under ERISA. Recent court cases alleging abuses in cases where passive investments were used affirm the importance of a fiduciary using the same level of diligence with respect to passive investments, and that ERISA does not take sides with respect to the use of active or passive strategies.[19] It is critical for fiduciaries to act in the best interest of their participants, which may take into consideration the profiles of their particular participant base, which can certainly vary from plan to plan. But it is equally critical that fiduciaries avoid actions designed only to avoid their own risk of exposure, as such actions that are not made with an eye single to the interests of participants.

---

[13] *Loomis v. Exelon Corp.*, 658 F.3d 667, 672 (7th Cir. 2011) (rejecting challenge to inclusion of actively managed funds in plan lineup and noting costs associated with active strategies).

[14] *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009) (rejecting claims that cheaper alternatives were available). The Department of Labor agrees, noting in its participant fee disclosure rule-making that "fees and expenses are only one of several factors" in making investment decisions. 29 C.F.R. § 2550.404a-5(d)(1)(iv)(A)(4). *See also* Meeting Your Fiduciary Responsibilities, September 2020, *available at* http://www.dol.gov/ebsa/pdf/meetingyourfiduciaryresponsibilities.pdf ("Fees are just one of several factors fiduciaries need to consider in deciding on service providers and plan investments.").

[15] *White v. Chevron Corp*., 2016 WL 4502808, at *11 (N.D. Cal. Aug. 29, 2016) (rejecting claims that cheaper alternatives were available).

[16] *Davis v. Washington Univ. in St. Louis*, 960 F.3d 478, 485 (8th Cir. 2020) (finding a REIT was not a proper benchmark to a real estate mutual fund because the actively managed mutual fund invested directly in real estate assets like office, industrial, retail, and multi-family properties, whereas the passive REIT invested in stocks of publicly traded equity real estate investment trusts); *Sacerdote v. New York Univ*., 328 F. Supp. 3d 273, 312 (S.D.N.Y. 2018) (rejecting comparison between actively managed real estate fund and passive REIT, and also rejecting comparison between investment options with different asset allocations); *Sulyma v. Intel Corp. Inv. Policy Comm.*, 2021 WL 229235, at *8 (N.D. Cal. Jan. 21, 2021) (rejecting allegations based on comparisons to funds that are not "adequate benchmarks").

[17] *Brotherston v. Putnam Invs., LLC*, 907 F.3d 17, 34 (1st Cir. 2018), cert. denied, 140 S. Ct. 911, 205 L. Ed. 2d 455 (2020) (recognizing possibility that active funds could be compared to passive funds if shown to be plausible and "suitable benchmarks").

[18] *Wildman*, 362 F. Supp. 3d at 710 (finding index funds unsuitable for comparison with challenged actively managed funds because "investment strategy was so dissimilar").

[19] *See, e.g., Andrus v. New York Life Ins. Co., et al.*, No. 16-05698 (S.D.N.Y. filed July 18, 2016) (challenging retention of an S&P 500 Index fund); *Garcia v. Alticor, Inc.*, No. 20-01078 (W.D. Mich. filed Nov. 9, 2020) (challenging fees associated with plan's small-cap growth index funds).

Evaluation of Target Date Strategies

Target date strategies are the most widely used default offering in defined contribution plans. As noted above, the test of prudence focuses on the fiduciary's decision-making process, and the same applies for selection of a target date strategy. For example, the Department of Labor (DOL) has stated that plan fiduciaries should establish a process for comparing and selecting target date strategies and should consider how well the target date strategies' "characteristics align with eligible employees' ages and likely retirement dates" as well as the underlying investments.[20]

If you currently offer or are considering target date strategies for your plan, you may have questions about some of the unique features of those that contain underlying active investment management. Target date strategies are often structured as funds of funds and utilize active investment management underlying components in part or in whole. Similar to the assessment and evaluation of other investment options, fiduciaries can and should consider differences in strategy, asset allocation, and glide path when comparing different suites of target date strategies. Target date strategy managers have faced unfounded criticism for the use of active management because of their fees compared to passively managed target date strategies, but courts have recognized in the context of target date strategies that "fees, like performance, cannot be analyzed in a vacuum."[21] Indeed, courts have rejected criticisms of target date strategies that are based on performance comparisons to benchmarks that are not "meaningful" because the benchmarks reflected different investment strategies and/or asset allocations.[22] In addition, in choosing investment strategies for their particular plans, fiduciaries may also take into account that certain strategies are offered by other similar plans. Indeed, under ERISA's prudent person standard, fiduciary conduct is judged in part by what a fiduciary "acting in a like capacity" would do with a plan of "like character and with like aims." Accordingly, courts have considered the wide use of certain target date strategies among similarly sized plans a relevant factor in determining whether such funds were prudent investment options.[23]

▶ **Key Takeaway 3: Providing building blocks for participants to build prudent and well-diversified portfolios plays an important role in defined contribution plans and may favor a sponsor's decision to provide a variety of investment options, including active and passive strategies.**

> "fiduciaries may appropriately provide plan participants with an array of options, including actively managed funds."

ERISA does not require fiduciaries to pick any particular mix of investments for their plans. To the contrary, the law gives plan fiduciaries leeway to choose the options that make the most sense for their particular plans.[24] After all, every plan is different, and there is no one-size-fits-all approach to selecting plan investments. In fact, courts have said that plan fiduciaries are entitled to—and indeed should—consider their plan's unique attributes in selecting investments. For example, factors such as the age and level of sophistication of employees participating in the plan may bear on the fiduciary's evaluation of investment options available in the marketplace.[25]

---

[20] DOL, Feb. 2013, "Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries."

[21] *Meiners*, 2017 WL 2303968, at *3 (rejecting a comparison of target date strategies that invest in actively managed funds with those that invest in passive strategies when no showing that the suites offered similar services and funds had different investment strategies).

[22] *Meiners,* 898 F.3d at 822. Other cases challenging TDFs may face similar challenges in court if they fail to account for different glide paths or underlying allocation differences, if any, among the fund suites being compared.

[23] *Ramos*, 461 F. Supp. 3d at 1095 (rejecting argument that a prudent fiduciary would not have retained the plan's target date solutions when numerous other plans did just that during the same time period).

[24] *Id.* at 1129 ("ERISA does not require that a fiduciary make the best choice among numerous reasonable choices, only that the investment options that a fiduciary selects are prudent.").

[25] *See Hecker*, 556 F.3d at 586 ("nothing in [ERISA] requires plan fiduciaries to include any particular mix of investment vehicles in their plan"); *Whitfield v. Tomasso*, 682 F. Supp. 1287, 1304 (E.D.N.Y. 1988) (fiduciary obligation includes consideration of participant needs).

However, nothing in ERISA "forbids plan sponsors to allow participants to make their own choice."[26] Defined contribution plans are unique in that they are designed to allow participants to direct their own investments. Giving participants sufficient variety of options can go a long way toward putting participants in the driver's seat of their retirement savings. Consistent with the role that participant choice plays in defined contribution plans, courts have acknowledged that fiduciaries may appropriately provide plan participants with an array of options, including actively managed funds. Indeed, courts have recognized that "plans may generally offer a wide range of investment options and fees without breaching any fiduciary duty"[27] and a plan that offers a variety of options "has left choice to the people who have the most interest in the outcome."[28]

Participant choice plays an important role under ERISA's safe harbor provision in § 404(c), as the protections of the safe harbor are only available if a broad range of investment options are offered to participants, among other conditions. Courts have recognized that the safe harbor encourages sponsors to allow choice to participants in defined contribution plans.[29]

Conclusion

To sum up, the fiduciary standards and key takeaways previously discussed do not mandate any particular investment lineup. Indeed, courts have recognized the role that different management strategies can play in a plan lineup that provides participants with a broad range of choice. Rather than mandate certain types of investment options for plans, courts instead focus largely on the decision-making process in which the fiduciaries engaged when making and monitoring investment selections for their plans, and whether the fiduciaries were focused on the best interests of participants. The selection of certain investment strategies or plan features based on a deliberative process and participant-centric considerations is entirely appropriate and consistent with ERISA's fiduciary standards.

---

[26] *Loomis*, 658 F.3d at 673 (rejecting claims challenging a plan "that includes high-expense, high-risk, and potentially high-return funds, together with low-expense index funds that track the market").

[27] *Divane v. Nw. Univ*., 953 F.3d 980, 992 (7th Cir. 2020) (rejecting challenge to actively managed funds with high fees in a plan that also offered low-cost index funds).

[28] *Loomis*, 658 F.3d at 673-74.

[29] *Id*. at 673.

ALISON V. DOUGLASS, Esq.

Partner, ERISA Litigation — Goodwin Procter LLP

Alison Douglass is a partner in Goodwin's Financial Industry and ERISA Litigation practices. Ms. Douglass represents clients in a wide array of complex commercial litigation, with a focus on financial services and products and class action litigation. She has been named a "Rising Star" by *Law & Politics* and *Boston* magazine and has been recognized by *The Legal 500*. She has also been ranked by *Chambers USA: America's Leading Lawyers for Business* as a nationwide "Recognised Practitioner" in ERISA Litigation.

Ms. Douglass's work includes representation of numerous financial service providers regarding the discharge of ERISA and other fiduciary duties. Currently, she is representing some of the largest financial institutions in so-called excessive fee ERISA litigation. She also represents clients in all phases of litigation, including pre-litigation counseling and trial and appellate matters in federal courts across the country and in regulatory investigations and governmental proceedings, including before the U.S. Department of Labor and the SEC.

CHRISTINA HENNECKEN, Esq.

Associate, Goodwin Procter LLP

Christina Hennecken is an associate in Goodwin Procter's Complex Litigation & Dispute Resolution, ERISA Litigation and Consumer Financial Services Litigation practices. Ms. Hennecken represents financial institutions in class actions, government enforcement proceedings, and complex civil litigation in a wide range of areas, including the Employee Retirement Income Security Act, the Consumer Financial Protection Act, the Telephone Consumer Protection Act, and the Servicemembers Civil Relief Act.

T. Rowe Price

This paper is sponsored by T. Rowe Price Investment Services, Inc. Contents of this paper are for informational purposes only and not for the purpose of providing legal advice. The analysis and conclusions are solely those of the authors.