John Hancock INVESTMENTS

Advisor insight: fiduciary prudence in rising interest rates

C. Frederick (Fred) Reish, Esq.
Employee Benefits & Executive Compensation Practice Group partner
Drinker Biddle & Reath LLP

Key takeaways

- Retirement plan sponsors and advisors are concerned about the potential for rising interest rates and how that will impact the bond funds in their lineups.
- When a prudent decision is made to add a replacement fund that is reasonably similar to the removed fund, the new investment qualifies for continued 404(c) protection.
- A prudent process is not about satisfying a series of detailed conditions; instead, it is about considering the relevant factors and making informed decisions.

Executive summary

As the Federal Reserve Board's policies change and interest rates begin to rise, retirement plan sponsors and their advisors are likely to become increasingly concerned about increased interest rates and their impact on the bond funds in their 401(k) lineups.[1] What can be done to provide some protection for participants against unnecessary losses in their investments in those bond funds?

The practical answer is that plans can switch from bond portfolios that are more susceptible to losses due to increasing interest rates to bond funds that take into account the effect of rising interest rates. However, any changes raise two fiduciary questions. First, is it prudent for fiduciaries to exchange bond funds under those circumstances? Second, if fiduciaries make those changes, will they continue to receive 404(c) protection for the new bond fund?

Fortunately, both of those questions can be answered favorably. This paper explains the legal framework that supports those conclusions.

Is it prudent to replace a fund?

Let's look at the first question: Is it prudent to remove a bond fund and replace it with another, even when the existing bond fund may be a prudent choice?

The answer is yes. The Employee Retirement Income Security Act (ERISA) imposes almost no requirements about the types of investments to be included in participant-directed plans and almost no restrictions on the ability of fiduciaries to change investments. The truth is that fiduciaries have broad latitude in selecting, removing, and replacing investments. The main issue is that the mutual funds must be individually selected through a prudent process that applies prevailing investment industry practices.[2]

As further explanation, I am not aware of any litigation about the removal and replacement of a 401(k) investment by a plan fiduciary, except where other factors are present. Stated slightly differently, there is no provision in ERISA that would preclude that change. Instead, the litigation comes from self-imposed requirements in investment policy statements (IPS) and plan documents. For example, in one case, a plan committee was found to have breached its fiduciary duties because it removed and replaced mutual funds without

1 "Advisor Viewpoints 2014," Cogent Research, February 2014.
2 ERISA Section 404(a)(1)(B).

following the procedure in the IPS. Keep in mind that an IPS is considered to be a document governing the operation of the plan and, therefore, the fiduciaries must follow the terms of the IPS. However, those types of provisions are not required and those injuries were self-imposed by the committee members failing to follow—or amend—the IPS.[3]

While ERISA does not specify the types of investments that must be offered to participants, arguably prudence requires that a broad range of investments be included in a plan lineup that allows participants to create balanced portfolios in their accounts. However, ERISA does not impose any mandates, conditions, or restrictions on the types of investments to be included in those portfolios other than, perhaps, that the plan lineups include some component of equities, fixed income, and stable value or money market-type investments.

For example, the 404(c) regulation conditions its fiduciary protections on a plan offering a "broad range of investment alternatives."[4] The regulation defines broad range as at least three investments, each of which is diversified, and has materially different risk-and-return characteristics, which enable participants to assemble portfolios that balance their need for return with their tolerance for risk.[5] It is commonly accepted that the three building blocks are equities, fixed income, and a "safe," interest-bearing investment.

But within the category of fixed income, the only requirement is that the fixed-income alternative be of a type that allows participants to construct prudent risk-and-return portfolios.

That conclusion is consistent with the requirement that fiduciaries apply "generally accepted investment theories," and the most generally accepted is modern portfolio theory (MPT).[6] Simplistically stated, MPT requires that fiduciaries select investments from asset classes that are not highly correlated; for example, equities, fixed income, and money market (or stable value). But these are general categories, not specific investments. Within that framework, fiduciaries have considerable discretion.

As a practical matter, a common practice in the 401(k) community is for a participant-directed plan to have a bond fund, which often is an intermediate-term bond fund. Given the potential change in interest rates, multi-sector bond funds are being considered to replace intermediate bond funds given their ability to invest in less interest-sensitive bonds. The question that fiduciaries may wish to ask is, are these two types of bond funds generally considered to be similar primary bond funds for a retirement plan? In practice, both types have been selected as the basic bond offering in plans by fiduciaries who have engaged in prudent processes. As a result, plans can offer either or switch from one to the other without limitation, and without the change being considered significant so long as the fiduciaries prudently select the replacement fund. Investment fiduciaries have used both to represent the fixed-income asset class in participant-directed retirement plans.

A related question is whether fiduciaries can prudently consider the possibility of anticipated future events, such as interest-rate increases, and take that into account in selecting and/or replacing investment alternatives in a plan. ERISA requires that, in making investment decisions, fiduciaries must consider the "facts and circumstances" that a fiduciary "should know are relevant."[7] While it seems on the face of it that the direction of interest rates could be considered relevant for the selection and monitoring of bond investments, that is more of a question for advisors and knowledgeable investors than for lawyers. While the consideration of potential future increases in interest rates may or may not be required by ERISA, it is certainly permissible. In fact, those types of considerations may be viewed as best practices. By best practices, I mean that ERISA may not require the change, but a focus on participants would suggest that the change is anticipated to benefit the participants.

To conclude regarding the first question—can fiduciaries, based on the factors they reasonably deem appropriate (such as possible increases in interest rates) remove and replace investments—the answer is yes. ERISA does not restrict the ability of fiduciaries to exercise their discretion in making those decisions.

3 *Tussey v. ABB, Inc.*, No. 2:06-CV-04305-NKL, 2012 WL 1113291 (W.D. Mo. Mar. 31, 2012).
4 ERISA Section 404(c); DOL Reg. §2550.404c-1.
5 DOL Reg. §2550.404c-1(b)(3).
6 *Laborers Nat'l. Pension Fund v. Trust Quantitative Advisors, Inc.*, 173 F.3d 313 (5th Cir. 1999); and *Lanka v. O'Higgins*, 810 F.Supp. 379, 388 (N.D.N.Y. 1992).
7 DOL Reg. §2550.404a-1(b).

Do fiduciaries keep their 404(c) protection?

The second question is, if fiduciaries remove a primary bond fund (for example, one that is interest-rate sensitive) and replace it with another primary bond fund (one that is less interest-rate sensitive), would the fiduciaries continue to enjoy the protection of 404(c) as they did before the change? When I refer to primary bond for this purpose, I mean intermediate-term bond funds or multi-sector bond funds.

ERISA Section 404(c)(4) provides that if certain information and notice requirements are met, a plan's fiduciaries can replace one investment with another and retain the plan's 404(c) protections for the replacement investment, but only if the old and new investments are "reasonably similar."[8] As a result, the answer depends on whether the removed bond fund and the replacement bond fund are reasonably similar. Unfortunately, the U.S. Department of Labor (DOL) has not issued a regulation or other guidance defining reasonably similar. As a result, the language should be given its ordinary meaning.

Keep in mind, though, that the regulation does not say "identical" or even "substantially similar." In other words, it doesn't require that the removed and replacement funds closely parallel each other or even be close to that. Instead, it requires that they be more "reasonably similar." In other words, could the two funds have reasonably similar roles in a participant's asset allocation? In that regard, note that one of 404(c)'s key concepts is that participants will construct multi-asset class portfolios in their accounts.[9]

As discussed above, the 401(k) community has largely viewed multi-sector bond funds and intermediate-term bond funds as appropriate primary funds and as being interchangeable for that purpose. While some bond funds might not be similar to those primary funds—for example, a U.S. Treasury fund, a high-yield fund, or an emerging-market bond fund—there seems to be little fundamental distinction between the two types of primary bond funds.[10] It appears that the investment community has treated them as reasonably similar for participant-directed plans. To place that in context, the DOL and the courts will not, on their own, decide whether two funds are reasonably similar. Instead, they will turn to the investment community and the treatment of investments in participant-directed plans.[11]

To conclude regarding the second question, and based on that analysis, advisors and fiduciaries can be comfortable that the selection of a high-quality primary bond fund to replace another primary bond fund will be considered prudent and the fiduciaries will not be considered to have breached their duties in making the change.

The importance of prudent decision making

While ERISA'S fiduciary duties can seem daunting, those responsibilities are, for the most part, principle-based. A prudent process is not about satisfying a series of detailed conditions.[12] Instead, it is about considering the relevant factors and making informed decisions. In that context, there is nothing in the law that prohibits fiduciaries from removing and replacing an investment when they decide to; that can be done prudently. Where the replacement fund is reasonably similar to the removed fund, the new investment should qualify for continued 404(c) protection.

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About the author

C. Frederick Reish, Esq. Fred is a partner in Drinker Biddle & Reath LLP's Employee Benefits & Executive Compensation Practice Group, chair of the Financial Services ERISA Team, and chair of the Retirement Income Team. His practice focuses on fiduciary issues, prohibited transactions, tax qualification, and retirement income. Fred has written four books and over 350 articles on fiduciary responsibility, prohibited transactions, IRS and DOL audits, and pension plan disputes. He is a nationally known speaker on fiduciary responsibility, technical compliance matters, and litigation issues. He has spoken at the annual conferences of the American Bar Association, the American Society of Pension Professionals and Actuaries, the Western Pension and Benefits Conference, the Enrolled Actuaries Conference, the International Foundation of Employee Benefit Plans, and the National Institute of Pension Administrators. Fred received a J.D. from the University of Arizona James E. Rogers College of Law and a B.S. from Arizona State University.

8 ERISA Section 404(c)(4)(B)(ii).

9 DOL Reg. §2550.404c-1(b)(3).

10 Theoretically, a multi-sector bond fund could be invested in a manner that was different than the norm, and that could change the conclusion. However, based on observations, that would be the exception rather than the rule.

11 DOL Interpretive Bulletin 96-1; *Laborer's Nat. Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313 (5th Cir. 1999); and *Chao v. Moore*, 2001 WL 743204 (D Md.).

12 DOL Reg. §2550.404a-1(b)(1).

John Hancock Funds, LLC ■ Member FINRA, SIPC
601 Congress Street ■ Boston, MA 02210-2805 ■ 800-225-5291 ■ jhinvestments.com

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