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Fiduciary Considerations for Adding Liquid Alternative Investment Strategies to DC Plans and Target Date Funds

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Amy Pocino Kelly and Julie Stapel, both experienced ERISA attorneys and partners with law firm Morgan, Lewis and Bockius, LLP, recently sat down with Robert Capone, Head of Defined Contribution and Sub Advisory at AQR Capital Management, LLC, to discuss fiduciary due diligence considerations for defined contribution (DC) plans when including alternative asset classes and strategies into a DC plan.

1. What due diligence process does a plan fiduciary need to undertake when considering alternative strategies or asset classes? Is there an "enhanced" need for fiduciary due diligence in selecting alternative strategies and asset classes for inclusion in the DC plan?

Response: When considering any investment strategy for a plan governed by ERISA, a fiduciary must consider all of the facts and circumstances relevant to the investment and the role that the investment will play in the plan overall. This includes factors such as diversification, the liquidity of the investment, the anticipated cash needs of the plan and the projected return of the investment relative to the objectives of the plan. Also, Department of Labor guidance and case law has held that a fiduciary's duty of prudence may require the fiduciary to retain the assistance of experts when the fiduciary does not have the required expertise to conduct this evaluation itself. With respect to alternative investment strategies and asset classes, even if new to a plan sponsor's defined contribution plans, there may be existing expertise and resources with respect to the plan sponsor's defined benefit plans. We think it can make sense to leverage such expertise and resources as appropriate, while taking care to avoid fiduciary issues that can arise when acting on behalf of two separate plans (such as cross-subsidization of investment fees, for example).

In addition, to the extent that the alternative strategies or asset classes present additional or higher costs than more traditional strategies or asset classes, those costs would need to be evaluated for reasonableness, as ERISA generally requires plan expenses to be reasonable. Of course, this is true for all investment strategies and asset classes that a plan may adopt. Fees should also be taken into account in light of the specific reasons that the plan fiduciaries may have had for introducing alternatives into the portfolio. The role that alternatives play may justify a higher fee than other investment strategies that play different roles in the portfolio. We know from DOL guidance and court decisions in ERISA litigation that plans are not required to seek the lowest cost service in all circumstances. Other factors, including the quality of the service provider, the role of the investment strategy or asset class in the plan overall, investment returns, among others, go into the determination of reasonableness as well.

To summarize, we do not think ERISA imposes any "enhanced" duty when it comes to alternative strategies or asset classes. That said, if a plan is making its first foray into a particular strategy or asset class, it may find itself without the expertise to fully evaluate that strategy as required by its fiduciary duties and may, therefore, determine to retain outside expertise where it may not have for strategies with which the fiduciary is more familiar.

2. Do the fiduciary risks differ based on the investment strategy in question? What additional processes, if any, should a plan sponsor consider?

Response: The fiduciary duty of prudence under ERISA is very much focused on process. So there need not be different risks depending on the investment strategy in question. The fiduciary process, however, needs to take into account the investment strategy. For example, as noted above, if the investment strategy is new or unfamiliar to the fiduciaries, then consultation with outside experts may be part of the process. If the investment strategy is unusually complex for the plan, then additional levels and methods of monitoring may be warranted. But, make no mistake about it, all investment strategies in a plan require careful observance of a fiduciary process, not just alternative strategies or asset classes. So it's not a question of whether or not you have to monitor an investment strategy or asset class, just a question of what that monitoring will entail.

Certainly, some investments are riskier than others. So, to that extent, riskier investments may present greater fiduciary risk because the risk of investment loss (which may prompt a claim of breach of fiduciary duty) is greater.

3. What types of plan fiduciary structures have you seen for selecting an alternative investment strategy? Would it be typical to have a "separation of duties" when selecting an alternative investment strategy, where perhaps one entity focuses on investment due diligence and selection while another focuses on ongoing monitoring and benchmarking while another focuses on education and communication?

Response: There is no "one-size-fits-all" or "best" structure from an ERISA perspective. Also, we are reluctant to call anything "typical." These types of questions depend on the size of the plan, the plan's demographics, the plan's governance structure and its internal resources on investment matters. The key considerations when structuring the governance of any investment strategy include but are not limited to:

- Confirming and clarifying each party's fiduciary role and status
- Confirming who has responsibility for monitoring each service provider
- Identifying and avoiding (or managing, if feasible) conflicts of interest that may exist for the service providers

Also, not so much a legal issue but something we have seen anecdotally in our experience, it is helpful to make sure there is strong coordination and collaboration between the investment and HR functions within an organization. The investment team may develop a brilliant strategy but, without coordinating with HR on implementation and communication, it may not be successful.

4. Does the use of alternative investments create additional considerations when preparing participant communication?

Response: The objective of all participant communication should be to provide effective, comprehensive and accurate communications that also comply with regulatory requirements. (Of course, that is easier said than done!) The objectives are no different for alternative investment strategies or asset classes. Thus, the considerations are how to communicate these strategies and asset classes in that manner, particularly if the strategy or asset class is different than those previously offered by the plan and thus more unfamiliar to participants.

We also think communication is affected by what role the strategy or asset class plays in the plan. For example, we would expect more pressure around the communication if the strategy or asset class is a stand-alone investment option that a participant may elect than, for example, if the strategy or asset class is a "sleeve" of a custom investment structure. If a "sleeve," a professional asset manager has likely determined the role of that strategy or asset class in the custom investment structure overall. If a stand-alone investment option, the participant must make that determination of the role of this strategy or asset class in his or her participant account. That decision may require more and different communication than the communication of the custom investment structure.

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