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Sound Governance and Fiduciary Best Practices for State-Facilitated Retirement Savings Programs

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Elected and appointed state officials serving as fiduciaries are commonplace, and such responsibility should be assumed with the utmost seriousness. State board and committee members and program decision-makers typically are fiduciaries of programs that hold "other people's money," such as retirement plans for state employees and state-run college savings programs. A state-facilitated retirement savings program is one of the more recent new state programs with such fiduciary responsibilities. Being an unpaid fiduciary overseeing a savings program for (potentially) millions of participants can be intimidating, but it should not be feared.

Regardless of the type of program, a fiduciary should understand the rules and duties, and then design and follow a governance process that promotes the sound exchange of ideas and learns from the experience of other programs. A fiduciary also should not be paralyzed by "making perfect the enemy of good." In other words, a fiduciary should do what they think is best for participants after prudently considering the alternatives and bringing in expert guidance as needed.

This issue brief summarizes the basics of what it means to be a fiduciary and outlines the relevant laws, scope of duties and responsibilities, and lessons learned from existing public programs and private sector employer-sponsored plans and their applicability to the more recently established state-facilitated retirement savings programs. The objective is to provide information to help the board and staff of state programs create an operating framework for prudently fulfilling their mission of helping private sector workers save for retirement and strengthen their financial security.

Who is a Fiduciary? A fiduciary is someone who has authority (via statute, plan documents, or conduct) over program monies. This includes those responsible for safeguarding assets, setting fees, making investments, deciding claims for benefits, and interpreting program terms. Someone who hires a fiduciary or has the authority to fire/replace a fiduciary also is a fiduciary. When a board hires a money manager, both the manager (who handles program assets) and the appointing board are fiduciaries. However, ministerial tasks that do not involve choice or judgment, like most recordkeeping and administrative activity, are not considered fiduciary. This is also true for so-called "settlor" activities, such as deciding on program features, payment options, or contribution levels.

A person can wear several hats, such as being a fiduciary when selecting investment funds but a non-fiduciary when setting the rules for designating beneficiaries. A much higher standard of care is imposed on fiduciary activity.

What Are the Relevant Laws and Rules? A fiduciary must comply with all applicable law. Thus, with the help of inside or outside counsel, a fiduciary should be familiar with the applicable rules governing the program and their own conduct. Such laws typically include:

- *Enabling Legislation*. The starting place should be the enabling legislation that created the board and authorized it to launch and administer the program. The enabling legislation establishes the basic rules of program operations; acts as a mission statement of goals; allocates responsibility and authority; and provides for funding the board's activities, startup costs, and ongoing operations. Board members

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and senior staff should be familiar with the enabling legislation and raise any questions or concerns with state's attorneys or outside counsel.

- *ERISA*. The Employee Retirement Income Security Act (ERISA) regulates private sector employer-provided retirement plans. ERISA does not cover state auto-IRA programs because those are not considered *employer* plans. However, even for auto-IRAs, ERISA is instructive because it contains the wisdom and best practices developed over almost 50 years of regulating private sector 401(k)s, pensions, and other retirement plans.

- *State Fiduciary Rules*. State fiduciary rules, frequently found in trust and estate laws, must also be considered. These provide guidance about procurement, open meetings, conflicts of interest, disclosure, and the like. Each state is unique, and fiduciaries should be aware of these rules and make use of the office of their state attorney general or law department for guidance.

- *Federal and State Securities Laws.* Programs also are governed by certain federal and state securities laws. For example, auto-IRAs are generally considered "municipal securities" under federal law and are covered by certain disclosure, anti-self-dealing, and fiduciary rules. Further, the Internal Revenue Code imposes some basic fiduciary rules on the operation of IRAs and more robust requirements for 401(k)s, Multiple Employer Plans (MEPs), and other "tax-qualified" retirement plans.

- *Program Documents.* A fiduciary also must follow program documents unless the documents themselves contradict the law. These documents include the actual plan, trust and custodial agreements, and board rules. However, the tail should not wag the dog. Instead, boards should revise any out-of-date documents to conform to desired or required changes in program administration.

A fiduciary does not have to go to law school to conform to these rules. However, a fiduciary often finds it helpful to hire knowledgeable counsel to advise them about their legal obligations. Thus, while a fiduciary must be familiar with the applicable rules governing the program, they can — and often do — turn to outside experts to help them execute their duties and responsibilities.

What Are Fiduciary Duties and Standards for Programs? The quintessential fiduciary duty is to act for the exclusive benefit of plan participants and beneficiaries with the care and skill of a knowledgeable, prudent individual. The exclusive benefit rule means that the fiduciary must consider what is best for the program and its participants, disregarding the fiduciary's own interests or those of the state, taxpayers, and other board members. Similarly, board members appointed by virtue of their position in state government, expertise, or as representative of a particular group such as retirees should recognize that their fiduciary duties extend to the entire program and not simply their cohort. The board or committee should consider developing a charter or other rules of order and following these governance procedures, allowing each member to be heard and engaged. Of course, procedures should be reviewed periodically and adjusted as needed.

Crucially, while fiduciaries are held to the standard of a prudent expert, they do not have to be experts themselves. Instead, fiduciaries should hire experts — program and investment consultants, money managers, lawyers — to fill in their knowledge gaps. However, a fiduciary should not blindly follow the experts. Instead, they should understand and evaluate an expert's advice and make their own determination.

Several elements of program design and administration have important duties and responsibilities for a fiduciary.

1. *Investments.* Investments are an important — indeed, crucial — aspect of a savings program. While the board might be able to direct the investment of program assets on behalf of all participants, this rarely happens. Instead, the board will allow participants to direct the investment of their own accounts among a curated menu of investment funds selected by the board or designated committee (generally with the help of outside investment experts). The fiduciaries also will select a "default" investment fund for participants who do not, for whatever reason, choose their own investments.

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The U.S. Department of Labor (DOL) ERISA 404(c) regulations provide fiduciaries with a well-worn path for prudently selecting, monitoring, and changing program investments. Many non-ERISA auto-IRAs use the 404(c) regulations as a guide. Under 404(c), the board/committee should consider adopting a general "investment policy statement" that sets investment goals and guides the selection/removal of funds, chooses an array of investments that allows participants to diversify their investments among various asset classes, and selects a default investment.

The 404(c) default investment is itself diversified, typically as an age-based target date fund (TDF) in which investments become increasingly conservative as participants near, reach, and (sometimes) pass an assumed retirement at age 65. However, state auto-IRA programs may wish to consider the needs of their typically first-time saver participants to accumulate rainy-day funds before preparing for retirement in case they need to withdraw their money well before retirement. Thus, a combination default investment of short-term safety of principal for the first level of savings (say, $1,000) and a long-term TDF for the rest of the account might make sense.

Investment fiduciaries should regularly monitor the performance of their investment funds. A fund that underperforms its benchmarks over a market cycle, experiences management/legal concerns, or has fees that are too high should be considered for replacement. Offering an array of prudent investments does not necessarily excuse having some imprudent funds on the menu. Investment funds that do not meet the program's criteria should be considered for removal.

2. *Fees.* Investment and recordkeeping fees have been the focus of much litigation in the ERISA world. The basic requirement for programs is that fees be reasonable considering the services provided and program characteristics: total assets, account size, participant demographics, and the like. What is "reasonable" is relative and partly depends on a subjective evaluation of quality. The key takeaway is that a fiduciary should engage in a sound process for selecting and monitoring investments and all service providers.

3. *Prohibited Transactions.* ERISA and many states have laws that specifically prohibit certain types of activities between a program and related parties. The concern is that the duty of loyalty to act for the sole benefit of the program and participants may be particularly difficult when a fiduciary or service provider has conflicting interests. Sometimes the rules are designed to avoid even the appearance of a conflict of interest. One obvious example is if a board member owns or is associated with a provider that wishes to serve the program. The prohibited transaction rules can be very complicated, with many exemptions if extra safeguards are added. The key takeaway here is that boards should be aware of the existence of these related-party rules and seek counsel when needed.

4. *Cybersecurity.* Cybersecurity is the most recent addition to a board's list of concerns. The primary focus should be on the service providers' own protocols for preventing and remedying a breach, including handling past attacks, insurance, and internal validation/upgrades to security. Service provider contracts regarding indemnification, insurance, and limitations of liability should be carefully reviewed and negotiated. Boards also may decide to educate participants about user best practices to safeguard their accounts.

5. *Violations and Liability.* State laws and ERISA and other federal laws impose liabilities for fiduciary violations. These can include fines and penalties, restoration of losses and profit, payment of the program's attorney's fees, removal from office, and — in egregious situations like fraud — criminal sanctions. A fiduciary may have co-fiduciary liability for someone else's violations. For example, a fiduciary who knew or should have known about another fiduciary's breach can also be held liable. A fiduciary must speak out and take reasonable actions to stop another fiduciary's breach.

   Depending on the situation, fiduciaries may have personal liability for breaches of duty. Most states

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have special rules protecting elected officials and government staff from liability, especially where there was no criminal wrongdoing or egregious behavior. These state-level protections are needed because many board members are volunteers or serve, as part of their positions as elected officials or state employees, without any added compensation.

Board members should understand the protections offered by their states. It also may be possible to purchase fiduciary insurance. Which entity pays the premiums for such insurance can be important; coverage paid with program money may be available only to cover the program's losses and costs, and not protect against a board member's personal liability.

Follow a Prudent Decision-Making Process. Fiduciaries do not need superpowers to fulfill their duties. Being human, they will make mistakes, such as selecting a poorly performing investment fund. The key to fulfilling their duties (and avoiding liability) is having and following a prudent decision-making process. This includes meeting regularly, hiring experts as needed, understanding the issues, and making reasoned decisions. Decisions should be documented, regularly reviewed, and — when appropriate — modified.

How often should boards meet? Like most fiduciary duties, it depends. However, as a rule of thumb, there should be periodically scheduled meetings (quarterly is somewhat typical) plus a process to call a special meeting when something important occurs: COVID, market crash, security breach, legislative response need; whatever.

Fiduciary Best Practices. To summarize, these are the key best practice takeaways.

1. Assemble, understand, and discuss key program documents.

2. Become familiar with applicable laws.

3. Hire, add, or replace experts as needed.

4. Have written procedures for meetings, voting, delegating authority, selecting investments, etc. Follow these procedures or amend them as appropriate.

5. Meet regularly. Members should attend meetings regularly, devote necessary time and effort, and be engaged in discussions.

6. Document all important decisions.

7. Conduct periodic fiduciary training. Implement a process for bringing new board/committee members up to speed.

8. Solicit competitive bids for providers. The bidding process can demonstrate that the fees are reasonable, and the fiduciaries used reasonable and prudent procedures for selecting providers.

Each board member and staff member will have a unique set of statutory requirements and social, economic, and political realities in launching and supervising their program. The job does not require superpowers, but rather establishing and following a reasoned decision-making process for the exclusive benefit of participants.

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