

401(k) and 403(b) Fee and investment Litigation: Lessons for Fiduciaries

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WEB Washington Metro Chapter

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401(k) and 403(b) Fee and Investment Litigation

Wave of 401(k)/403(b) Fee and Investment Cases

- Litigation activity remains active
 - 50 to 60 filed in 2016 (hard to keep track!)
 - Boilerplate complaints
 - More multi-million dollar settlements announced
 - Settlements include onerous non-monetary sanctions
 - Scrutiny of fee arrangements and investment offerings, and additional litigation expected to continue

401(k)/403(b) Fee Complaints

Category	Allegations
Record-keeper fees & fee structure	<ul style="list-style-type: none">▪ Multiple record keepers – plan foregoes ability to reduce fees• Failure to put out contract for competitive bid every three years (e.g., University complaints; Northrop complaint filed September 9, 2016)• Asset based – Only flat per participant fee is acceptable• Fees based on revenue sharing – should be capped at flat per participant fee• Financial Engines kickback claims – plan’s fiduciary intrinsically imprudent in allowing deal between record-keeper and FE under which FE pays record-keeper significant percent of FE asset-based fee (up to 45%, depending on record-keeper) Example: Northrop

401(k)/403(b) Fee Complaints

Category	Allegations
High-fee mutual funds	<ul style="list-style-type: none">Offered retail class funds (as well as institutional class, apparently in same category); (University cases; Lockheed) failed to offer Vanguard-only line-up which would be cheapest (Chevron)
Too many funds	<ul style="list-style-type: none">Deprives plan of bargaining power to reduce feesToo much choice is confusing - “decision paralysis” (citing one study, Ps allege “average” is 15)
Duplicative funds	<ul style="list-style-type: none">Duplicative passively managed funds-forego bargaining power to reduce feesMultiple actively managed funds with same investment style: offers essential “index fund return <i>for the Plan</i>” but with higher fees [note sleight of hand here]

401(k)/403(b) Fee Complaints

Category	Allegations
Mutual funds v. common trust, variable annuity or separate account	<ul style="list-style-type: none">• Failure to provide or investigate common trust funds, etc. which for plan with more than \$500 million can provide returns identical to mutual funds but at lower cost (University cases, Anthem, Chevron)
Unnecessary services/costs	<ul style="list-style-type: none">• Lefkowitz v. TIAA (complaint filed March 15, 2016): unnecessary, unreasonable and excessive duplicative mailings to beneficiaries• Aegon (complaint filed Feb. 6, 2015) Superfluous advisors who receive fees to select subadvisors

401(k)/403(b) Investment Complaints

Category	Allegations
Inappropriate fund offering — money market funds	<ul style="list-style-type: none">• Failure to offer stable value fund instead of money market fund as most conservative option (Chevron)
Inappropriate fund offering — stable value funds	<ul style="list-style-type: none">• Ellis v Fidelity Management Trust (complaint filed Dec. 11, 2015): Unduly conservative investment of stable value funds through wrap providers
Inappropriate fund offering — sector funds	<ul style="list-style-type: none">• MIT (complaint filed Aug. 9, 2016): inappropriate retention of “international specialty funds” in contrast with “dramatically lower cost target date funds”• Boeing: inappropriate offering of science and technology fund
Inappropriate fund offering — underperforming funds	<ul style="list-style-type: none">• Fund underperforms its benchmark

401(k)/403(b) Investment Complaints

Category	Allegations
Inappropriate fund offering — target date funds (TDFs)	<ul style="list-style-type: none">• Johnson v. Fujitsu (complaint filed June 2016 ND Cal): custom TDFs designed by an investment advisor with “no public record.” Target asset allocation resulted in “excessive percentage” of assets in “speculative asset classes”• Sylyma v. Intel (Complaint filed November 2015): fiduciary<ul style="list-style-type: none">• allocated TDFs excessively into hedge funds and alternative investment, relative to TDFs offered by “professional managers.”• failed to communicate fees in individual funds constituting component of TDF
Inappropriate fund offering — badly designed actively managed fund	<ul style="list-style-type: none">• Wilson v. Fidelity Mgmt. (complaint filed April 1, 2016) actively managed funds - 30% of assets were placed in Valeant stock, violating IPS diversification command

401(k)/403(b) “Admissions” of Imprudence

Category	Allegations
Communications admit imprudence of prior actions	<p>Tracey v. MIT: Plaintiffs allege that MIT’s explanation to Ps and Bs why it cut investment lineup from over 300 to 37 funds was admission of imprudence of pre-change investment line-up.</p> <p>MIT’s explanation”</p> <ul style="list-style-type: none">• Position MIT for increasingly demanding legal and regulatory standards applicable to 401(k) plans• Dispersed as they are today, it is not possible to take full advantage of participants’ collective purchasing power• Respond to feedback from faculty and staff that the vast number of choices offered in the current line-up is confusing.
Corrective action itself admits imprudence of prior actions	<ul style="list-style-type: none">• 403(b) complaints can be read to state that act of reducing funds choice is admission that previous offering comprised too many funds

Some Representative Settlements

Sponsor	Settlement Terms
Lockheed	<ul style="list-style-type: none">• Excessive investment fees alleged• \$62 million settlement• Nonmonetary settlement provisions (approved by court)<ul style="list-style-type: none">➤ Limit and monitor cash equivalents in the funds➤ Independent review of fund performance➤ RFP for recordkeeper with at least three bids➤ Offer share class with lowest expense ratio
Boeing	<ul style="list-style-type: none">• \$57 million settlement• Nonmonetary settlement provisions (approved by court) include:<ul style="list-style-type: none">• Obtain independent opinion and recommendations on how to provide participants access to technology sector strategy as core option

Some Representative Settlements

Sponsor	Settlement Terms
Ameriprise	<p>Excessive recordkeeping and management fees alleged \$27.5 million settlement</p> <ul style="list-style-type: none">• Nonmonetary settlement provisions (approved by court)<ul style="list-style-type: none">➤ RFP required for recordkeeping, investment consulting➤ Recordkeeping fees must be on flat per-participant basis➤ Limitations on expenses charged to plan➤ Must consider use of collective trusts or separately managed accounts➤ Must hire independent investment consultant to conduct manage

Some Decided Cases

Case	Outcome
White v. Chevron, ND California	<ul style="list-style-type: none">• Plaintiffs alleged fiduciary imprudent to offer (i) a money market fund instead of a stable value fund; (ii) retail-class shares of mutual when cheaper institutional-class shares were available, (iii) non-Vanguard funds when all-Vanguard lineup cheaper; and (iv) mutual funds in the first instance when collective trusts, etc. are cheaper• Court grants defendants' motion to dismiss: "Courts can and do consider the total menu of available investment options in assessing whether excessive-fee allegations are plausible" <i>Cities Hecker v. Deere</i>, <i>Loomis v Exelon</i>.
Urakhchin v. Allianz Asset, CD California	<ul style="list-style-type: none">• Adopts opposite theory.• Plaintiffs claimed fiduciary breached by offering high cost Allianz affiliated funds Defendants asserted that Plan participants were not limited to Allianz-affiliated "core" investment options because they were able to invest in a Schwab Personal Choice Retirement Account, through which they could invest in unaffiliated mutual funds. (<i>Id.</i>) Co• Court found Defendant's argument unavailing; denied motion to dismiss: "Under ERISA, the prudence of investments or classes of investments offered by a plan must be judged individually."• Higher bar for financial institutions offering own funds? OPINION DOESN'T SAY

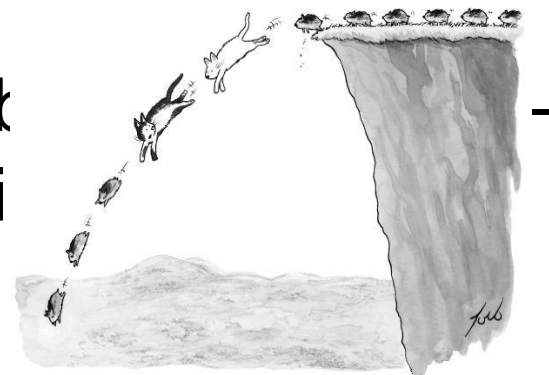
Lessons for Fiduciaries -- And Some Open Questions

Fiduciary Duties: The Basics

- ERISA duty of prudence requires prudent **process**
- Duty of prudence does not command any one decision-- does not required the lowest cost or best performing funds or the “right” number of funds
- Fiduciary should deliberate before reaching decisions, and should document decisions and rationale
- Record should show reasons made in best interests of the Ps and Bs (not, for example, to reduce fiduciary’s legal exposure)
- Fiduciary should document **non-decisions** (see Kraft case)
- Committee structure and delegations should recognize that named fiduciary’s investment duties can be fully delegated only to an ERISA section 3(38) fiduciary

Fiduciary Duties: The Not-So-Basics

- Fiduciary should deliberate—but which issues?
- Plaintiffs' cases advance arguably novel theories: e.g., is it imprudent to offer “too many” funds?
 - How many fiduciaries deliberated this issue?
 - How does the advisor stay ahead of the plaintiffs' lawyers?
- Complaints imply there are “k easy trap for advisors to fall i



Fiduciary Duties: The Not-So-Basics

- Case law undeveloped or conflicting on key points, Must each fund be “prudent” (low cost, non-volatile, etc.)? Or is it OK if participant can choose and put together his/her preferred low cost, diversified portfolio?
- So far, courts seem to favor choice among multiple funds (Chevron, Loomis, Hecker)
- Disciplined and careful communications strategy is needed when changes are made