FIDUCIARY TUNE-UP

Southwest Benefits Association
Dallas, Texas
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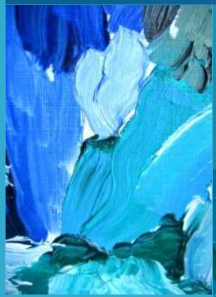

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Who Should Serve on a Fiduciary Committee?

- Does *Dudenhoeffer* Change Who Should Serve on a Fiduciary Committee?
  - <u>Fear is</u> key executives' special knowledge about company's financial circumstances and future prospects <u>may lead to the following types of claims</u> with respect to employer stock funds, where participants direct investments:
    - Special knowledge of key executives serving as fiduciaries should be imputed to fiduciary committee

Who Should Serve on a Fiduciary Committee?

- Executive has duty to educate other committee members, sharing special knowledge relevant to whether to stop stock purchases, sell company stock or disclose special knowledge to participants
- Public statements made by these key executives are made in their capacity as fiduciaries
- Committee members who would not otherwise have had inside information have engaged in insider trading

Who Should Serve on a Fiduciary Committee?

- *Fifth Third Bancorp v. Dudenhoeffer* (U.S. 2014)
  - No “presumption of prudence” with respect to investment in employer stock
  - Dismissive of claims that fiduciaries need to second guess market’s analysis of publicly available information as reflected in stock price
  - Duty of prudence does not require fiduciary to break law, such as by violating securities laws

Who Should Serve on a Fiduciary Committee?

- To state a claim for breach of duty of prudence based on inside information, must “plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it”
- Courts should consider whether a prudent fiduciary might have “concluded that stopping purchases . . . or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price . . . .”

Who Should Serve on a Fiduciary Committee?

- *Harris v. Amgen, Inc.* (9th Cir. 2014)
  - Where fiduciaries had inside information from the beginning, would have been no detrimental effect for participants if fiduciaries had followed their fiduciary obligations
    - Because would have been obliged to act as soon as they knew or should have known the company's share price was artificially inflated

Who Should Serve on a Fiduciary Committee?

- *Harris* suggests reasons for excluding key executives from fiduciary committees for plans holding employer stock are still good, particularly for publicly-traded companies' plans

Who Should Serve on a Fiduciary Committee?

- As to private companies' plans, argument for excluding key executives from fiduciary committees is somewhat less persuasive
  - May not have as deep a pool of management talent from which to draw committee members
  - Typically fewer decisions concerning purchase or sale of shares than under public company plan
    - After initial purchase of stock, may have little opportunity to consider future purchases

Who Should Serve on a Fiduciary Committee?

- Relatively few opportunities to sell shares because no market
  - Exception: when participant exercises right to put shares to company and company offers plan opportunity to purchase
    - If plan does not own 100 percent of company stock, whether to purchase may have real consequences for plan

Who Should Serve on a Fiduciary Committee?

» For 100 percent ESOP owned company, aggregate value of stock in plan will typically be total value of company, so whether plan purchases shares will have little or no effect on aggregate value of stock held by plan, assuming company holds in treasury shares put to and purchased by it

Who Should Serve on a Fiduciary Committee?

» Whether to buy put shares may, though, affect relative value of participants' accounts because probably allocate newly-purchased shares to all participants' accounts, whereas simple increase in value of shares resulting from company holding put shares in treasury would increase value of shares already in participants' accounts, which may favor longer term participants

Who Should Serve on a Fiduciary Committee?

- Whether to distribute cash or stock may be fiduciary decision
- If participants do not make investment decisions, may be lesser need to disclose "inside information"
  - Participants may, however, argue need information to (a) decide when to terminate employment and receive distribution, (b) decide whether to put shares to company at first opportunity, and (c) plan their retirement

Who Should Serve on a Fiduciary Committee?

- Noteworthy case: *Finnerty v. Stiefel Lab., Inc.* (11th Cir. 2014)
  - Affirmed district court judgment in which jury found company and its CEO violated Section 10(b) of Securities Exchange Act of 1934 and accompanying Rule 10b-5, when withheld material information about preliminary merger negotiations it was obliged to disclose to ESOP participant putting shares to company
    - Company had history of proclaiming its interest in remaining a privately held company, but sold to publicly traded company for roughly four times the price paid ESOP participant for put shares
    - Though company not under obligation to disclose existence or status of merger negotiations, it was required prior to repurchasing put shares to make some disclosure to update prior statements that company would continue to be privately held, for example, by indicating that a sale was under active consideration
  - Not an ERISA fiduciary case

Who Should Serve on a Fiduciary Committee?

- Recap: For private companies, allowing key executives to serve on fiduciary committees may be a practical imperative and may be slightly less dangerous from a fiduciary perspective than for a public company plan

Who Should Serve on a Fiduciary Committee?

- Might a board of directors breach its duties of loyalty or prudence by purposefully and categorically excluding certain key executives as committee members?
  - Arguably not, because no clear precedent that must appoint “best” candidates
  - Key executives may have less time to devote to fiduciary obligations
  - Key executives’ skill sets may be inferior to those of others in terms of ability to serve on fiduciary committee

WAMCO Settlement

- What You Should Ask Investment Managers Following the Western Asset Management Company ("WAMCO") Settlement with the DOL
  - Some securities, by terms of their offering documents, are not available for purchase by plans subject to ERISA
    - Concern is assets of company issuing security may become plan assets
    - In that event, company issuing security could become subject to ERISA fiduciary standards in dealing with its own company assets

WAMCO Settlement

- Could also complicate dealings of issuing company with sponsors of investing plan, raising prohibited transaction concerns
- In the case of foreign issuers, may raise question whether impermissibly maintaining indicia of ownership of plan assets outside jurisdiction of U.S. district courts

WAMCO Settlement

- These concerns are inapplicable to many plan investments
  - Where invest in equity interest of entity that is neither a publicly-offered security nor a security issued by an investment company (such as a mutual fund), plan's assets include not only the equity interest, but also an undivided interest in each of the underlying assets of the entity, unless the entity is an "operating company" or equity participation is "not significant"

WAMCO Settlement

- So, okay if issuer is “operating company”
- “Operating company” is entity that is primarily engaged, directly or through a majority-owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital
  - Also includes a “venture capital operating company” (“VCOC”) and a “real estate operating company” (“REOC”)

WAMCO Settlement

- Concern arises only when plan invests in an "equity interest"
  - "Equity interest" means interest other than one that is treated as indebtedness under local law and which has no substantial equity features
    - Profits interest in a partnership and beneficial interest in a trust are treated as equity interests

WAMCO Settlement

- Offering documents may include a flat prohibition on investment by plans subject to ERISA, with requirement that each investor represent it is not a plan subject to ERISA (perhaps through a deemed representation)
- Many investment managers have paid inadequate attention to the statements in issuers' offering documents prohibiting investment by plans subject to ERISA

WAMCO Settlement

- Settlement by SEC and DOL against Western Asset Management Company ("WAMCO"), a subsidiary of Legg Mason
- Many investment managers have, in response to WAMCO settlement, reviewed their investment records
  - Not unusual to find that plans have made these purchases of securities which, by their terms, do not permit investment by plans subject to ERISA

WAMCO Settlement

- Difficult issue for investment managers because, particularly when not buying initial issue of security, but instead buying on secondary market, offering documents may be hard to obtain
  - Also, data bases provided by commercial services to flag these securities have proven to be incomplete or inaccurate (or both)

WAMCO Settlement

- Post-WAMCO, managers are paying more attention to securities of the type that, in their experience, are most likely to include investment prohibition
  - E.g., loan participation notes, perpetual capital securities, credit-linked notes, and participation certificates

WAMCO Settlement

- Corrective Steps
  - Most managers have disposed of securities they have found that are not available for purchase by plans subject to ERISA
  - Most investment managers have error correction policies (consistent with the Investment Advisers Act of 1940)
    - Fiduciaries may wish to address whether the purchase and holding of these securities constituted errors under those error correction policies, and if so what those policies provide for in the way of correction

WAMCO Settlement

- Fiduciaries may also wish to consider whether plan was otherwise damaged
  - One measure of damage might be how the plan’s assets would have performed had they been invested in other securities, though this may be a speculative determination

WAMCO Settlement

- Many investment managers argue plans have not been harmed
  - Managers may argue they did not act negligently and did not violate terms of their investment management agreements
  - May argue no prohibited transaction occurred, though unclear how they reach this conclusion

WAMCO Settlement

- Fiduciary may not know until years later whether there has been:
  - A prohibited transaction
  - A co-fiduciary breach by reason of issuer's actions that are themselves breaches
  - An impermissible holding of the indicia of ownership of assets outside the jurisdiction of U.S. district courts
- May, therefore, wish to examine indemnification provisions in current investment management agreement, and may wish to ask investment manager to waive statute of limitations or laches defenses with respect to any later request for indemnification

WAMCO Settlement

- Consider modifying investment guidelines to expressly prohibit purchase of security if terms of security or governing documents prohibit investment by plans subject to ERISA

Investment Consultants as Fiduciaries

- Making Sure Investment Consultants are Subject to Fiduciary Standards
  - Best to have clear, written understanding as to whether those providing investment advice to plan are fiduciaries
    - For pension plans, the 408(b)(2) fee disclosure requires a statement that service provider will provide services as a fiduciary (if that is the case)
    - This does not help where plan is welfare plan or investment professional does not agree it is a fiduciary

Investment Consultants as Fiduciaries

- Investment professional, such as a broker-dealer, may argue not a fiduciary because:
  - Does not have discretionary authority or control (often true), and
  - Does not make investment recommendations causing it to become a fiduciary
    - Latter argument typically grounded in assertion that there is not “mutual agreement” the investment services will serve as a “primary basis” for investment decisions or, less likely, not rendering “individualized investment advice” based on the “particular needs of the plan”
  - If investment consultant takes the position not a fiduciary, is a sign that if something later goes wrong may need to argue the point in court

Investment Consultants as Fiduciaries

- *Tiblier v. Dlabal* (5th Cir. 2014)
  - Investment advisor not fiduciary because even if rendered investment advice for compensation, did not receive a fee <u>from the relevant plans</u>
    - Instead, advisor received compensation in the form of a commission paid by the company issuing corporate bonds purchased by the plans (that issuer later failed)

Fiduciaries' Reliance on Advice of Counsel

- Fiduciaries' Ability to Rely on Advice of Counsel
  - *Clark v. Feder Semo and Bard, P.C.* (D.C. Cir. 2014)
  - Law firm's defined benefit (cash balance) pension plan terminated with insufficient assets

Fiduciaries' Reliance on Advice of Counsel

- Participant, an attorney, argued that paying firm's founder in full violated Tax Code Section 401(a)(4), the Code's general nondiscrimination rule for qualified retirement plans
  - Plan paid out retirement benefits of principal owner of the firm (and founder) in two lump sums that may have violated the "top 25 employee" rules (plan was alleged to be underfunded at the time payments were made and, allegedly, other participants received only 53 percent of the present value of their retirement benefits)

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Fiduciaries' Reliance on Advice of Counsel

- Court concluded that a participant has no right to force a plan to follow Tax Code plan qualification rules (that are not terms of the plan itself, and are not found elsewhere in the non-tax provisions of ERISA), because those rules relate only to whether the plan is qualified, and not the rights of participants
- Plaintiff also argued it was a fiduciary breach to conclude that she was entitled to a lower level of benefits than one or more other participants

Fiduciaries' Reliance on Advice of Counsel

- Court said with respect to claims of fiduciary breach, a fiduciary may rely on the advice of legal counsel when reasonably justified under the circumstances
  - The propriety of that reliance is judged based on the circumstances at the time of the challenged decision
  - The fundamental question is whether a prudent trustee in those circumstances would have acted in reliance on counsel's advice
  - Reliance would be improper if there were significant reasons to doubt the course counsel suggested

Fiduciaries’ Reliance on Advice of Counsel

- In this case, although legal counsel had misunderstood a potentially important fact, the fiduciaries had no obligation to investigate the propriety of counsel’s advice because they had no reason to know or suspect that legal counsel was relying on mistaken information, his recommendation appeared to be based on reasonable investigation, was accompanied by supporting documentation, and was consistent with the understanding the fiduciaries had about the way the plan’s benefit groupings were structured

Fiduciaries’ Reliance on Advice of Counsel

- Question *Clark* raises, but does not answer in satisfying way, is degree to which relying on advice of counsel will defeat claims of fiduciary breach
- As to benefit claims, particularly where interpreting plan provisions, fiduciary’s reliance on counsel may prove quite helpful, as in *Clark*

Fiduciaries' Reliance on Advice of Counsel

- As to a fiduciary prudence claims, to extent court focuses on "procedural prudence," justified reliance on advice of legal counsel may prove helpful
- As to other types of fiduciary claims, such as those relating to duty of loyalty, the value in relying on advice of counsel is less clear, other than by lessening the chance the fiduciary will actually breach duties

Access to Participants Potentially Making Rollovers

- IRAs estimated to hold $7.2 trillion
  - This is more than the roughly $6.6 trillion in defined contribution plans (both private sector and government)
- Overwhelming majority of IRA assets come from rollovers from qualified plans
  - In 2010, rollovers thought to total almost 12 times amount added through non-rollover contributions

- 2013 Government Accountability Office ("GAO") Report said this:

  Many experts told us that much of the information and assistance participants receives is through the marketing efforts of service providers touting the benefits of IRA rollovers and is not always objective. Plan participants are often subject to biased information and aggressive marketing of IRAs when seeking assistance and information regarding what to do with their 401(k) plan savings when they separate or have separation from employment with a plan sponsor. In many cases, such information and marketing come from plan service providers. As we have reported in the past, the opportunity for service providers to sell participants their own retirement investment products and services, such as IRAs, may create an incentive for service providers to steer participants toward the purchase of such products and services even when they may not serve the participants' best interests.

Access to Participants Potentially Making Rollovers

- Financial Industry Regulatory Authority ("FINRA") warned broker-dealers that advice concerning suitability of rolling over monies from 401(k) plans to IRA should "never be compromised by their financial interests in recommending an IRA rollover or another action"
  - "Suitability" standard applies to advice offered by broker-dealers
  - In contrast, fiduciary duty applies to investment advisers

Access to Participants Potentially Making Rollovers

- FINRA has said, as to rollover advice, “any recommendation to sell, purchase or hold securities must be suitable for the customer and the information that investors receive must be fair, balanced, and not misleading”
- Some think the DOL may be eager to apply a fiduciary duty to brokers who sell IRAs as rollover vehicles

Access to Participants Potentially Making Rollovers

- SEC said, in 2014 examination priorities, it "shared the [GAOs] concerns that investers may be misled about the benefits of rolling over assets . . . to an IRA"
  - SEC will focus attention on practice of broker-dealers, as well as investment advisers, with respect to IRA rollovers
  - Will examine for "possible improper or misleading marketing and advertising, conflicts, suitability, churning, and potentially misleading professional designations" when recommending IRA rollovers

Access to Participants Potentially Making Rollovers

- DOL Advisory Opinion 2005-23A
  - Advice to plan participants on whether to roll over to IRA to take advantage of investment options not available under plan would not make an advisor a fiduciary
    - Merely advising a plan participant to take an otherwise permissible plan distribution, even when that advice is combined with a recommendation as to how the distribution should be invested, does not constitute “investment advice”
    - Recommendation to take a distribution is not advice or a recommendation concerning a particular investment

Access to Participants Potentially Making Rollovers

- Investment recommendation concerning proceeds of distribution would be advice with respect to funds that are no longer plan assets
  - Contrast with FINRA's conclusion that recommendation about type of retirement account in which a customer should hold retirement investments typically involves a "recommended securities transaction"

Access to Participants Potentially Making Rollovers

- Advisor who is not otherwise a plan fiduciary and who recommends that a participant withdraw funds from the plan and invest them in an IRA, would not engage in a prohibited transaction by reason of the advisor earning management or other investment fees related to the IRA
  - This is because a recommendation by someone not connected with the plan to take an otherwise permissible distribution is not investment advice, nor is the recommendation an exercise of authority or control over plan assets

- However, these conclusions that an advisor is not a fiduciary and will not engage in a prohibited transaction in making recommendations about rollovers apply only to advice provided by a person who is not a plan fiduciary on some other basis

Access to Participants Potentially Making Rollovers

- If a plan officer or someone already a plan fiduciary were to respond to participant questions concerning advisability of taking a distribution, or investment of amounts withdrawn from plan, that fiduciary would be exercising discretionary authority with respect to management of the plan and must act prudently and solely in the interest of the participant

Access to Participants Potentially Making Rollovers

- In addition, DOL warned that if a fiduciary were to exercise control over plan <u>assets</u> to cause participant to take a distribution and then invest in an IRA account managed by fiduciary, the fiduciary may be using plan assets in his or her own interest, in violation of the ERISA Section 406(b)(1) prohibited transaction rules

Access to Participants Potentially Making Rollovers

- Big practical concern may be to what degree plan fiduciaries should be concerned about contacts a plan's trustee or other existing fiduciary may have with participants poised to receive a distribution
  - Example: financial institution serving as trustee that communicates with participants about IRAs it offers

Access to Participants Potentially Making Rollovers

- One possible approach:
  - Prohibit trustees and other fiduciaries from providing participants with materials relating to their proprietary IRAs, or otherwise discussing or promoting, or even proactively educating participants about, the fiduciary's proprietary IRA options, <u>but</u>
  - Not prohibit fiduciary from responding to participants' unsolicited requests for information
    - In the event of unsolicited request for information, may wish to limit fiduciary to providing materials only in form of generally available promotional materials, rather than providing specific advice to participant about advantages to that participant of fiduciary's proprietary IRAs

Access to Participants Potentially Making Rollovers

- Note that best chance to keep distributed assets in the retirement system may be through rollover to an IRA product of an incumbent plan vendor, which may argue for no prohibition on vendor responding to unprompted request from participant about IRA products
  - Harder case for distribution not resulting from involuntary cash-out, because better option for participant may be to leave monies in plan, rather than roll over

Lessons from *Tussey v. ABB, Inc.*

- *Tussey v. ABB, Inc.* (8th Cir. 2014)
  - Two 401(k) plans, one for union employees and the other for non-union employees

Lessons from *Tussey v. ABB, Inc.*

- Eighth Circuit considered three general topics:
  - Whether ABB and its fiduciaries paid too much in 401(k) plan fees and whether they allowed those fees to improperly subsidize the costs of services provided by Fidelity to other plans and the company
  - Propriety of removing Vanguard Wellington Fund and adding Fidelity target date funds
  - Whether Fidelity acted improperly with respect to its handling of float income

Lessons from *Tussey v. ABB, Inc.*

- ABB initially paid Fidelity flat fee for each plan participant for recordkeeping services
- Fidelity later primarily paid through revenue sharing
  - Compensation from non-union plan came solely from revenue sharing, whereas ABB paid Fidelity $8 per participant and some revenue sharing for union plan

Lessons from *Tussey v. ABB, Inc.*

- Fidelity provided services to ABB unrelated to 401(k) plans
  - These included processing ABB's payroll and acting as recordkeeper for defined benefit plans and health and welfare plans
  - Eighth Circuit said Fidelity incurred losses from these additional services, but made substantial profits from its services to the 401(k) plan

Lessons from *Tussey v. ABB, Inc.*

- ABB and Fidelity later negotiated comprehensive agreement concerning Fidelity's services to ABB
  - When negotiating, Fidelity advised ABB that Fidelity provided services for health and welfare plans at below market costs and did not charge for administering other ABB plans
  - Outside consulting firm advised ABB it was overpaying for 401(k) plan recordkeeping services and cautioned that revenue sharing under 401(k) plans might have been subsidizing other services Fidelity provided to ABB
    - ABB did not act on this advice from the consulting firm

Lessons from *Tussey v. ABB, Inc.*

- Fiduciary committee developed investment policy statement, calling for three tiers of investments
  - Director of staff for committee recommended offering life-cycle or target date fund
  - Director also suggested remove Vanguard Wellington Fund due to deteriorating performance and because participants could, under the new investment option framework, create their own balanced fund
  - Committee decided to eliminate Wellington fund, add Fidelity target date funds, and map monies from Wellington fund to age-appropriate Fidelity target date fund

Lessons from *Tussey v. ABB, Inc.*

- Eighth Circuit first considered whether *Firestone* abuse of discretion standard should apply to plan administrator's interpretation of plan documents, even though dispute did not involve a benefit claim, but instead involved fiduciary and prohibited transaction allegations
  - Court concluded *Firestone* deference is not limited to benefit claims, and district court should have reviewed plan administrator's determinations under plans for abuse of discretion

Lessons from *Tussey v. ABB, Inc.*

- Eighth Circuit affirmed district court on recordkeeping fee claims
  - Rejected fiduciaries' argument that they could not be liable for excessive fees because they had offered participants a wide range of investment options with a broad array of fees, including low priced funds
  - Eighth Circuit noted that district court did not condemn in the abstract the bundling of services or revenue sharing

Lessons from *Tussey v. ABB, Inc.*

- Eighth Circuit upheld ruling that ABB fiduciaries breached their duties by failing to:
  - Calculate amount plans were paying Fidelity for recordkeeping through revenue sharing
  - Determine whether Fidelity's pricing was competitive
  - Adequately leverage the plans' size to reduce fees, and
  - "Make a good faith effort to prevent the subsidization of administration costs of ABB corporate services" (for example, health and welfare and defined benefit plan services)

Lessons from *Tussey v. ABB, Inc.*

- As to the removal of the Wellington fund and selection of Fidelity target date funds, the Eighth Circuit had sympathy for fiduciaries' contention that district court applied "improper hindsight bias" in criticizing that change
  - Remanded to district court to reconsider whether fiduciaries breached their duties in this connection
    - Presumably, district court will need to consider to what degree *Firestone* deferential standard of review applies to investment decisions, which may turn on whether those investment decisions involved the fiduciaries' interpretative authority with respect to plan documents

Lessons from *Tussey v. ABB, Inc.*

- Measuring investment damages
  - 8th Circuit had two problems with district court approach
    - Wellington Fund not correct fund against which to measure performance
      - Should use difference between target date funds and <u>minimum return</u> of subset of managed allocation funds fiduciaries could have chosen without breaching fiduciary obligations
    - Speculative to assume participants would have remained invested in Wellington Fund
      - Inference appeared to ignore investment policy statement, participant choice under the plans, and popularity of managed allocation funds

Signature Authority on Corporate Bank Account

- Signature Authority on Corporate Bank Account May Make One a Fiduciary: *Perez v. Geopharma, Inc.* (M.D. Fla. 2014)
  - Due to Technical Release 92-01, many employers do not put in trust participant contributions relating to cafeteria plans and fully insured health plans
  - *Perez v. Geopharma, Inc.* (M.D. Fla. 2014) concerned allegations that welfare benefits had not been paid
  - An old lesson: When company is in dire financial condition, may wish to hold participant contributions, and any other plan assets, in trust, even as they relate to a cafeteria plan

Signature Authority on Corporate Bank Account

- Geopharma allegedly withheld from employees' pay premium contributions totaling $225,000, which it did not segregate from company assets and which it failed to use to pay benefit claims (same for another $16,000 in COBRA premiums)
- The question was whether CEO, who had signature authority on company's corporate bank accounts, was, as a consequence of this authority, a fiduciary

Signature Authority on Corporate Bank Account

- DOL sought to hold company, CEO, and other individual defendants jointly liable for:
  - Participating knowingly in an act of another fiduciary, knowing it was a breach
  - Failing to monitor or supervise another fiduciary and thereby enabling a breach
  - Having knowledge of a breach by another fiduciary and failing to make reasonable efforts to remedy the breach

Signature Authority on Corporate Bank Account

- CEO said if merely having signature authority on company corporate bank account makes him a fiduciary "it would transform nearly every member of senior management of any corporation into an ERISA fiduciary"
- DOL argued when employee contributions were commingled with corporate general assets and never remitted or used to pay claims, CEO exercised fiduciary authority or control over both the company's assets and plan assets simultaneously

Signature Authority on Corporate Bank Account

- DOL also argued that company, as plan administrator, had duty to monitor actions of those administering the plan, and CEO had a fiduciary duty on behalf of the company to monitor other fiduciaries and the company's management and administration of the plan
  - DOL alleged CEO knew or should have know the company was having cash flow issues and using employee compensation to fund operations rather than pay claims

Signature Authority on Corporate Bank Account

- District court denied CEO’s motion to dismiss
  - Allegations that CEO had signature authority on company’s corporate bank accounts and employee premiums were commingled with the company’s general assets and never remitted or used to pay claims allowed court to “reasonably infer” CEO exercised authority or control over plan assets as an ERISA fiduciary when employee premiums were commingled with company’s general assets

- If *Geopharma* is upheld on appeal or adopted by other courts, employers and fiduciaries may wish to return to the common practice of the mid-1980s of holding in trust participant contributions to cafeteria plans and insured health plans

- Fresh Consideration of Money Market Funds?
- Changes to money market rules adopted by SEC in Release No. 33-9616
  - Government funds (at least 99.5 percent in cash and Treasury securities) largely unaffected
  - Non-government funds
    - Retail money market funds, including those offered in participant-directed defined contribution plans
    - Institutional money market funds, such as those purchased by defined benefit plans

Fresh Consideration of Money Market Funds

- Non-government money market funds may, when liquid assets are low, impose:
  - Liquidity fees
  - Redemption dates
    - As to redemption dates, can temporarily suspend redemptions if imposing such a "gate" is in fund's best interest, but must lift gate within 10 days and cannot impose gate for more than 10 business days in any 90 day period
  - Liquidity fee and redemption gate rules apply to both retail and institutional (non-government) money market funds
- Institutional (non-government) money market funds, such as for db plans, must use a floating net asset value ("nav")

Fresh Consideration of Money Market Funds

- Potential problems for dc plans in retail (non-government) money market funds
  - QDIA (capital preservation for first 120 days of participation)
    - Generally requires, for a 90 day period following first investment, ability to transfer or withdraw without restrictions, fees, or expenses
    - SEC suggests can satisfy QDIA rules because any liquidity fee can be paid by plan sponsor or a service provider, and not by the participant, beneficiary, or plan
    - SEC suggests plan sponsor or other party in interest may loan funds to avoid the effect of a gate

- Note that these workarounds not only involve plan complication, but also may raise concern under the “restorative payment” precedents as to whether they are annual additions for Section 415 purposes or contributions for 401(a)(4) nondiscrimination purposes

- Minimum distributions (or other mandatory distributions)
  - SEC indicated it believes gates will, in practice, not impose a difficulty for satisfaction of minimum distribution requirements because participants unlikely to have entire account invested in non-government money market fund imposing a gate
  - Even if that were to occur, SEC said participant could request a waiver of potential excise taxes for failure to meet minimum distribution rules by filing a Form 5329, and plan sponsor could use EPCRS to correct the minimum distribution failure

Fresh Consideration of Money Market Funds

- Upshot is that the potential communication complications associated with notifying participants of imposition (or potential imposition) of liquidity fees and gates, may cause fiduciaries to reconsider whether non-government money market funds are a good investment option under participant-directed defined contribution plans
  - As always, fiduciaries may wish to seek advice on this type of issue from their investment consultants
  - Will presumably wish to consider potential disadvantages of alternative capital preservation funds, such as stable value funds, which may have insurance wrapper issues, including those under which there are insurer-imposed investment or other restrictions

Increased Importance of Procedural Prudence

- *Tatum v. RJR Pension Investment Committee* (4th Cir. 2014)
  - Question was whether fiduciaries could avoid liability for failing to follow prudent process if decision reached was one they nevertheless "could have" reached had they followed a good process
  - Fourth Circuit said "no" – a "could have" standard is too low a bar to avoid liability
    - Instead, fiduciaries that breached duty of procedural prudence are excused from liability only if they "would have," rather than "could have," made the challenged decision had their process been a good one
  - Dissenting opinion warns "As for those who might contemplate future service as plan fiduciaries, all I can say is: Good luck."

Increased Importance of Procedural Prudence

- *Tatum* concerned the elimination of two employer stock funds
  - A working group of corporate employees, with no particular authority under the plan documents, spent no more than an hour considering what to do with the funds
- Company decided against hiring a financial consultant, outside counsel, or independent fiduciary to assist it in deciding whether and when to eliminate stock funds

Increased Importance of Procedural Prudence

- Decided to keep stock funds for six months
  - On the date the stock funds were eliminated, market price of stock in one fund had dropped by 60 percent from date of corporate spin-off precipitating elimination of funds, and price for stock in other fund had dropped by 28 percent
  - Less than a year after elimination of the stock funds, the stock that had been in the funds had increased by 247 percent for one and 82 percent for the other

Increased Importance of Procedural Prudence

- Court concluded plan document did not mandate divestment of stock funds
  - Decision to remove those funds was a fiduciary act
- Failure to follow plan documents is evidence of imprudent conduct
  - Plan required the stock funds to remain in the plan as frozen funds
  - Fiduciaries with responsibility under the plan for making investment decisions and amending the plan were not the parties that made the decisions to eliminate the funds

Increased Importance of Procedural Prudence

- Decision to eliminate funds over a period of six months was made with "virtually no discussion or analysis and was almost entirely based upon the assumptions of those present and not on research or investigation"
  - One of the criticized assumptions was that the funds should be removed, rather than retained
- Company later reconsidered decision (before divestment was complete), but decided not to reverse course because of fear employees who had already sold stock might sue the company

Increased Importance of Procedural Prudence

- The Fourth Circuit said:

  The [district] court found that, without undertaking any investigation, RJR forced the sale, within an arbitrary timeframe, of funds in which Plan participants had already invested. The court found that RJR adhered to that decision in the face of sharply declining share prices and despite contemporaneous analyst reports projecting the future growth of those share prices and “overwhelmingly” recommending that investors “buy” or at least “hold” Nabisco stocks. The court also found that RJR did so without consulting any experts, without considering that the Plan's purpose was to provide for retirement savings, and without acknowledging that the spin-off was undertaken in large part to enhance the future value of the Nabisco stock by eliminating the tobacco taint.

Increased Importance of Procedural Prudence

The district court further found that RJR sold the Nabisco funds when it did because of its fear of liability, not out of concern for its employees' best interests. RJR blinks at reality in maintaining that its actions served to protect[] participants” or to “minimize the risk of large losses.” To the contrary, RJR's decision to force the sale of its employees’ shares of Nabisco stock, within an arbitrary timeframe and irrespective of the prevailing circumstances, ensured immediate and permanent losses to the Plan and its beneficiaries.

Increased Importance of Procedural Prudence

- The Fourth Circuit said for the decision to divest the plan of the funds, and to do so within six months, to be "objectively prudent" so the fiduciaries would not have liability for their breach of the duty of procedural prudence, the question was:
  - "Whether the evidence established that a prudent fiduciary, <u>more likely than not</u>, would have divested the [stock funds] at the time and in a manner in which the [company] did" (emphasis added)

Increased Importance of Procedural Prudence

- Dissent said this standard effectively requires that a fiduciary make an "optimal" decision
- Will make objective prudence difficult to show when there is a choice among several options, such as
  - Investment decisions (for example, choice of large cap U.S. stock to offer under 401(k) plan, where it would be remarkable if it were "more likely than not" that a prudent fiduciary would choose <u>any</u> particular candidate from a pool of possibilities)
  - Selection of service providers

Increased Importance of Procedural Prudence

- Other decisions involving more than two options (such as the timing of the removal of an investment option, where, say, 30 percent of hypothetical prudent investors would choose to do so over a period of six months, 30 percent over a period of one year, 30 percent over a period of two years, and 10 percent over a market cycle)

Increased Importance of Procedural Prudence

- Dissent pointed out that "more likely than not" standard may be difficult even where there are only two options:
  - "Take a scenario in which 51% of hypothetical prudent fiduciaries would act one way and 49% would act the other way. What sense, let alone justice, is there in penalizing a fiduciary merely for acting in accordance with a view that happens to be held by a bare minority?"

Record Retention: Meddling by SSA

- How long to keep records?
  - Six year rule
  - As long as necessary to calculate benefits
  - Statute of limitations

Record Retention: Meddling by SSA

- Increasingly, baby boomers are retiring and receiving notices from the Social Security Administration that they may be entitled to private pension benefits, depending on whether they have already collected the amounts owed them
  - This is result of Schedules SSA filed with Forms 5500 over the years, and now new Forms 8955-SSA
  - Plan administrators are now challenged with establishing that benefits have already been paid (or were never owed), if that is the case

Recent DOL Settlements of Note

- 401(k) Excessive Fee Case Settlement Requires Employer's Fiduciaries to Solicit Unbundled Bids for Recordkeeping Services
  - *Nolte v. CIGNA Corp*. (C.D. Ill. 2013)
  - Case included allegations of payment of excessive fees by 401(k) plan
  - As part of settlement, fiduciaries of 401(k) plan agreed to solicit <u>unbundled bids</u> for recordkeeping services (that is, separate from investment management services)

Recent DOL Settlements of Note

- 401(k) Excessive Fee Case Settlement Requires Fiduciaries to Solicit Unbundled Bids for Recordkeeping Services (cont.)
  - CIGNA defendants also agreed:
    - To pay $35 million
    - Not include retail or proprietary funds as plan investments
    - Retain an independent consultant to consider whether the plan's fixed income fund should be backed by insurance company general assets or instead a separate account, and consider other stable value fund issues

Recent DOL Settlements of Note

- 401(k) Excessive Fee Litigation Settlement Requires that Recordkeeper Not be Paid on Percentage of Assets Basis
  - *Beesley v. Int'l Paper Co.* (S.D. Ill 2013)
  - In a 401(k) excessive fee class action, International Paper defendants agreed to a settlement which included, among other features, the following:
    - A payment of $30 million
    - A prohibition on plans' recordkeeper being paid on a percentage of assets basis, though plans not prohibited from allocating fixed recordkeeping expenses to participants on a percentage of assets basis

Recent DOL Settlements of Note

- Conduct an RFP competitive bidding process for recordkeeping services
- Offer at least one passively managed investment option investing primarily or exclusively in large cap domestic equities in the plans’ core investment lineup
- Not offer any retail mutual funds as core options

Recent DOL Settlements of Note

- Settlement of DOL Claim that Retirement Plan Assets Were Used Improperly to Reimburse Company for Expenses
  - *Perez v. Sunkist Growers Inc.* (C.D. Cal. 2013)
  - Department of Labor filed lawsuit alleging that over a period of just over five years, retirement plan fiduciaries used retirement plan assets to improperly reimburse company for expenses, including salaries and benefits for employees and managers working in various departments at the company
  - DOL concluded that company was reimbursed by plans based on projected expenses determined at the beginning of the year, rather than on the actual expenses incurred, and that no adjustments were made to repay the plans for the overpayments that were made
  - Sunkist Growers Inc. and the fiduciaries were required to restore $1.6 million to the plans

IRS Emphasis on Internal Controls

- The IRS has indicated as follows:

  "When auditing a retirement plan, the agent begins by evaluating the plan's internal controls to determine whether to perform a focused or expanded audit. In addition, if the agent finds plan errors, the strength of internal controls is a factor in the negotiation of the sanction amount under Audit Cap. The agent will make every effort to ensure that the plan has internal controls in place when the audit concludes."

IRS Emphasis on Internal Controls

- The IRS has a special audit policy for benefit plans of large employers, which are handled through an Employee Plans Team Audit ("EPTA")
  - An EPTA audit is a special type of pension plan audit a team of more experienced IRS agents conducts of a plan or plans of a "large employer" (which generally means an employer with qualified pension plans that, in total, have at least 2,500 participants)

IRS Emphasis on Internal Controls

- In an EPTA audit, agents conduct an in depth audit of what “internal controls” the employer has and how the employer applies those controls to a specific plan or plans for a specific open year or years
  - IRS says the number of plans and years it examines depends upon what the agents find during the initial audit
  - In deciding whether to expand an investigation, a key element is whether the agents are able to conclude from the initial audit that the employer has sufficient internal controls in place to avoid major mistakes and to identify and correct quickly any mistakes the internal controls reveal

IRS Emphasis on Internal Controls

- If, in their initial review, agents find that the employer has checks and balances, whether automatic or mechanical, that are likely to prevent errors or quickly catch errors, the IRS will consider limiting the focus of the audit and not audit every plan in every year
  - Initially, EPTA audits involve only one year, and then the EPTA team decides whether to expand the audit depending on what it finds with respect to that year and the internal controls in place

IRS Emphasis on Internal Controls

- "Internal controls" are the methods that the employer has in place to minimize the risk of mistakes
  - They can be anything from electronic systems that "talk" to each other to peer cross checks to annual reviews
  - The concept is that internal controls will help avoid mistakes or at least catch them quickly

IRS Emphasis on Internal Controls

- To examine internal controls, at the beginning of an EPTA audit agents generally interview an employer's human resource staff, payroll staff, plan administrators, and other responsible parties such as recordkeepers and paying agents
  - EPTA agents also gather information with respect to electronic records and computer systems and how one system interrelates to another
  - The IRS says this process gives its agents a good idea, based on experience, of what problems are likely to exist, and forms the basis for the initial focused review

IRS Emphasis on Internal Controls

- In conducting the focused review, agents look at whether the systems perform in the manner represented
- If the employer indicates that it conducts regular self-audits or reviews, the agents give the employer the opportunity to share all or part of those self-audits and reviews
- The EPTA website provides sample internal control questions EPTA agents could ask during their interviews and examination

IRS Emphasis on Internal Controls

- In public presentations, the IRS has indicated that as part of an audit – even non-EPTA audits – plan sponsors need to be prepared to explain the plan administrative processes, including internal controls
- The IRS has said potential audit questions probing the strength of an employer's internal controls might include the following:
  - Who is responsible for making timely amendments to the plan for changes in the law?
  - If there has been a merger or acquisition, and the plans are merged, who verifies that the language of the resulting plan is correct as intended?

IRS Emphasis on Internal Controls

- Who determines the participants' compensation amount for plan purposes from the payroll records?
- Who verifies that participants' compensation used for all plan purposes is according to the definitions in the plan document?
- Who determines when an employee is eligible to participate in the plan?
- Who verifies the plan's loan provisions?
- Who verifies that correct data was used to complete the annual testing?

IRS Emphasis on Internal Controls

  - Who verifies deferrals allocated to participants' accounts are correct?
  - Who ensures that each participant receives the correct matching and/or nonelective contribution?
- It is notable also that to self-correct plan defects under the IRS' qualified retirement plan correction program – which is called the Employee Plans Compliance Resolution System (and which is sometimes referred to by the acronym "EPCRS") – a plan must have "established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with applicable [Tax] Code requirements."

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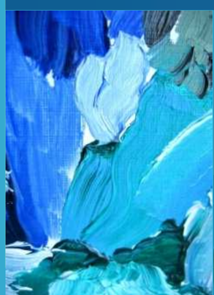

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