CliftonLarsonAllen

How to Lower Your Litigation Risk on ERISA Plans

June 9, 2016

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About CliftonLarsonAllen

- A professional services firm with three distinct business lines
  - Wealth Advisory
  - Outsourcing
  - Audit, Tax, and Consulting

- More than 4,500 employees
- Offices coast to coast
- With more than 60 years of experience in the nonprofit sector, we have one of the largest nonprofit practices in the country

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC.

Speaker Introductions

Mark Griffin, CIMA®, Managing Principal

CliftonLarsonAllen Wealth Advisors, LLC

Mark oversees the Institutional Investment Services and Retirement Plan Services groups within CLA. As such, he also works closely with the firm’s larger foundation, endowment and retirement plan clients.

Kris Tveit, CPA, Principal

CliftonLarsonAllen

Kris is a principal in the Benefit Services Group, specializing in providing assurance, tax, and consulting services to plan sponsors of various employee benefit plans including 401(k), profit sharing, money purchase pension, employee stock ownership, defined benefit, and health and welfare plans.

Learning Objectives

- At the end of this session, you will be able to:
  - Discuss best practices for avoiding litigation
  - Recognize areas for risk
  - Determine how your institution can reduce fiduciary exposure

Only One Goal….

Keep you off the "list"

We'll Discuss:

- Best practices for Plan Sponsors and fiduciaries
- Recognizing areas of risk
- Reducing your risk exposures
- Tools and resources to assist a Plan Fiduciary

What List?

Boeing

Aegon (Transamerica)

Ameriprise Financial

Fidelity Investments

Lockheed Martin

IBM

All Were Successfully Sued By Their Participants

Fidelity Investments – 2014

Ameriprise Financial –2015

Lockheed Martin – 2015

Boeing – 2016

IBM – 2016

5 Settlements Total: 478,000,000

Why Were These Suits Successful?

Where to Start?
With the Past.
Why?

The ERISA Statute of Limitations does not apply.

Statute of Limitations?

Tibble v. Edison International – May 2015

- Complaint related to retail oriented funds added to the plan in 1999 and 2002. Less expensive shares were available.
- Defendant position: complaint was untimely because it was filed more than 6 years after funds were added so Statute of Limitations applies.
- U.S. Supreme Court decided unanimously for the Plaintiffs.

Statute of Limitations?

Tibble v. Edison International – May 2015

- The Court held that “Fiduciary Duty” follows old, common law trust standards of prudence.
- So, even though decisions were made years ago, their effects on current plan operations need to be considered.
- The win by the plaintiff could precipitate a rash of lawsuits under a “continuance of prudence” standard.

Statute of Limitations?

- Takeaway:
  Ruling forces plan fiduciaries to review prior (even old) plan decisions regularly.

- What's still in your plan – that perhaps shouldn't be?

Who's a Fiduciary?

- The Employee Retirement Income Security Act (ERISA) sets standards of conduct for those who manage an employee benefit plan and its assets.

Who's a Fiduciary?

- Fiduciaries include:
  - Internal administrative committee
  - Internal investment committee
  - Plan Administrator
  - Human Resource Director
  - Board of Directors
  - Third Party Administrator or Record Keeper
  - Investment Advisor

Who’s a Fiduciary?

Anyone with discretion over the plan

Fiduciary Status

- Fiduciary status is based on the functions performed for the plan, not just a person's title.

- A plan must have at least one fiduciary named in the written plan, or through a process described in the plan, as having control over the plan's operation.

Fiduciary Status

- Attorneys, accountants, and actuaries generally are not fiduciaries.
  - when acting solely in their professional capacities.

- An individual or an entity is a fiduciary when they are exercising discretion or control over the plan.

Fiduciary Status

- Decisions that are not fiduciary actions:
  - Establishing plan
  - Amending a plan
  - Determining features in a plan (i.e. eligibility requirements, or presence of matching contributions)
  - Determining benefit package (i.e. amount of employer contributions)

Fiduciary Status

- However,
  - Implementing the decisions on behalf of the plan and carrying out these actions, likely creates fiduciary status.

Significance of Fiduciary Status

- Fiduciary responsibilities include:
  - Acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them;
  - Carrying out their duties prudently;
  - Following the plan documents (unless inconsistent with ERISA);
  - Diversifying plan investments; and
  - Paying only reasonable plan expenses.

Significance of Fiduciary Status

- Duty to act prudently
- Focus on the **PROCESS** for making fiduciary decisions
- Requires documentation of decision and basis of decisions

Beware

- Fiduciaries who do not follow the basic standards of conduct may be personally liable to:

- restore any losses to the plan, or

- restore any profits made through improper use of the plan's assets resulting from their actions.

Prohibited Transactions

- A sale, exchange, or lease between the plan and party in interest;
- Lending money or other extension of credit between the plan and party in interest; and
- Furnishing goods, services, or facilities between the plan and party in interest.
- A party in interest using the plan's assets in their own interest or acting on both sides of a transaction involving a plan.
- Fiduciaries cannot receive any consideration for their personal account from any party doing business with the plan related to that business.

Prohibited Transactions – Who?

- Employer
- Union
- Plan fiduciaries
- Service providers
- Owners, officers, and relatives of parties in interest.

Prohibited Transaction Exemptions ERISA Section 408(b)(2)

- Hiring a service provider as long as the services are necessary to operate the plan and the contract and compensation paid is **reasonable.**
- "Reasonable" is not well defined. (So you better be able to support your position…)
- Providing investment advice to participants by an advisor.
- Participant Loans
- Class and individual exemptions may be available through the DOL exemption process

The Common Theme in Litigation - Expenses

- The use of retail or similar share classes of mutual funds when a lower cost share class was available.
- Significant use of proprietary funds.
- Directing revenue or services to related/affiliated entities.
- Charging excessive fees for recordkeeping/administrative services or benefitting from the revenue sharing offset available from plan funds.

Revenue Sharing?

- A portion of the mutual fund's expense ratio that is paid to the recordkeeper and/or custodian and used to offset fees including broker's commissions or advisor's fees.

ERISA Fee Litigation

- 13 Class Action Lawsuits have been filed in the past 8 years.

- Accused U.S. Companies of failing to act in the best interest of the participants.

  – Failure to monitor excessive fees
  – Favoring high cost mutual fund options over lower cost options
  – Using investment products managed by affiliated companies

Example

- Tussey v. ABB (8th Cir., March 19, 2014)
  - ◊ District court awarded $35.2 million for breaches of fiduciary duty by ABB to 401(k) plans
  - ◊ Appellate court Upheld $13.4 million judgment against plan fiduciaries for failure to monitor and control recordkeeping costs
    - – Consultant notified ABB that fees were excessive and might be subsidizing non plan costs (pursuant to a bundled arrangement)
    - – ABB failed to calculate fees, assess whether they were reasonable, negotiate lower fees, or prevent the use of fees to subsidize costs unrelated to the plan

Requirements of 408(b)(2) Regulations

- Service providers to qualified plans must disclose the amount of all direct and indirect fees that they receive including any revenue sharing with related entities.
- Requires written service agreements
- Requires sponsor to assess overall fees for reasonableness.
- These regulations were effective July 1, 2012.

Typical Plan Costs

- Custody and Trust Services
- Recordkeeping/Technology Services
- Broker Commissions/Investment Advisor Fees
- Investment Expenses charged by the mutual fund or other plan investment
- Plan compliance and Reporting Services(if bundled)

Open Architecture vs. Bundled

- Open Architecture:
  - generally no proprietary funds
  - Each service (i.e. recordkeeping, investment advisory, custody) and related fee is itemized, along with the amount of any anticipated revenue sharing income.
- Bundled solutions
  - Most fees rolled in as additional fund expenses, which generally include proprietary funds of the service provider.
  - The recordkeeping may be “free”.

What is “Reasonable” as it pertains to plan fees?

- There is no definite answer or formula
- Do not have to pick the lowest cost provider
- Should be able to document the value the plan receives for those fees.
- Broker vs. 3(21) fiduciary vs. 3(38) fiduciary
- Yes, **it’s grey.**

Plan Investments

Best Practices

Participants Are Hurting Themselves

- 2014 Dalbar Study:
  - 20-year annualized S&P return was 9.85% while the 20-year annualized return for the average equity mutual fund investor was only 5.19%
  - an annual gap of 4.66% - over 20 years!
  - They've done the study numerous times – same result.

Why?

Behavioral Finance

- We're greedy after markets go up.
- We're more risk averse after markets go down.
- Participants tend to buy high and sell low.
- Participants tend to buy last years winner.

If You're a Fiduciary – How to Help?

Fewer Options

Ideally – no individual fund options!

Passive Strategies

Managed Portfolios

Target Date Funds

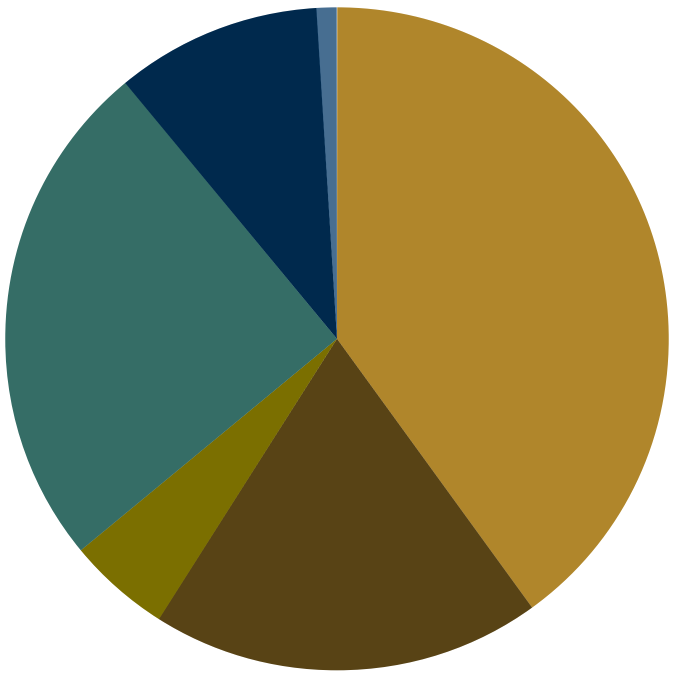
Low Cost Target Date Funds Can Be Considered Mandatory

Target Date Funds – Adjust With Participant

Growth Assets
U.S. Equity
Large cap
Small cap
International Equity
Developed markets
Emerging markets

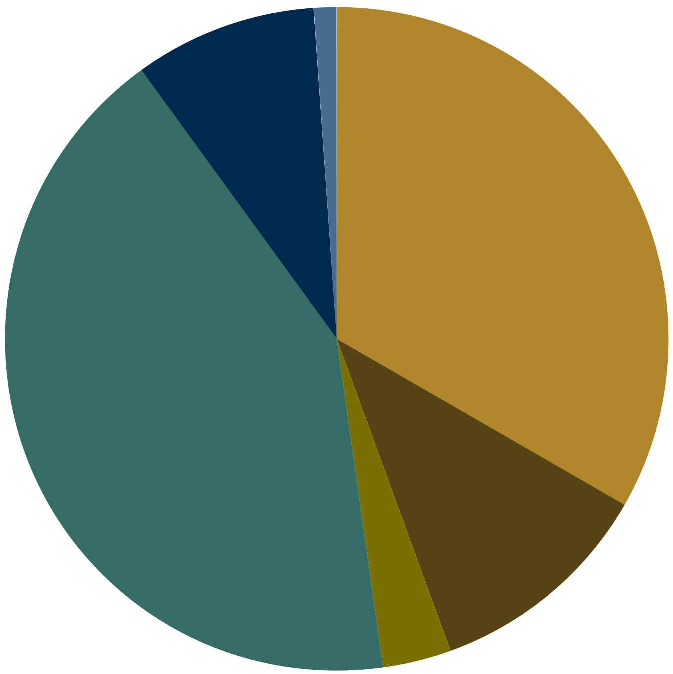
Risk Reduction Assets
Investment Grade Credit
Cash
Treasuries
Investment grade credit
Foreign market debt

2015



Target Date Funds – Adjust With Participant

2020



Growth Assets
U.S. Equity
Large cap
Small cap
International Equity
Developed markets
Emerging markets

Risk Reduction Assets
Investment Grade Credit
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Target Date Funds – Adjust With Participant

Growth Assets
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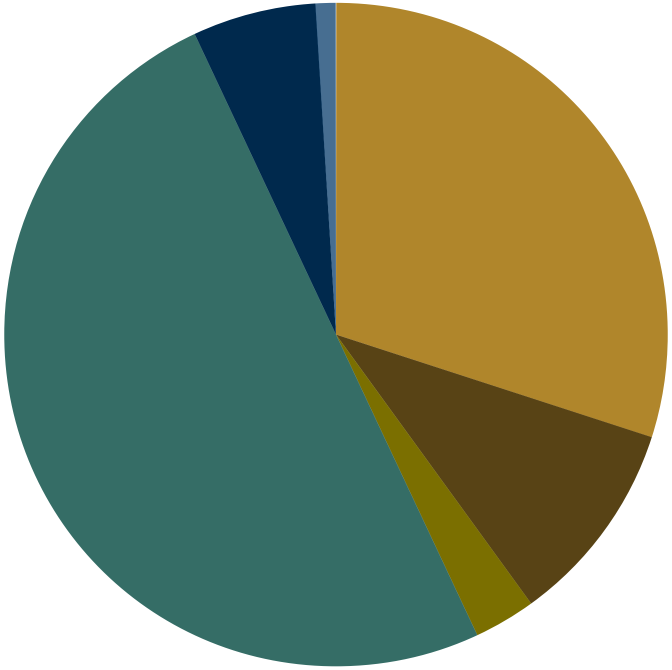
Developed markets
Emerging markets

Risk Reduction Assets
Investment Grade Credit
Cash
Treasuries
Investment grade credit
Foreign market debt

2025



Target Date Funds – Adjust With Participant

Growth Assets
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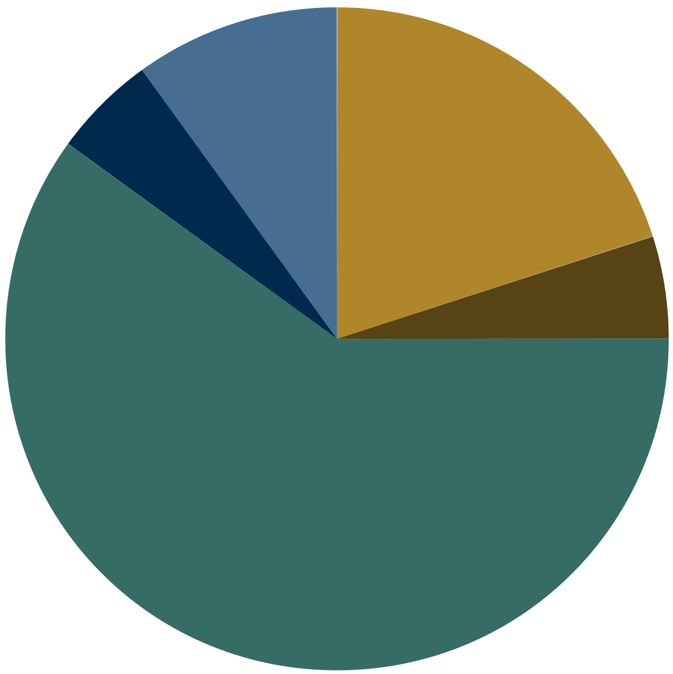

Target Date Funds – Adjust With Participant

Growth Assets
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Risk Reduction Assets
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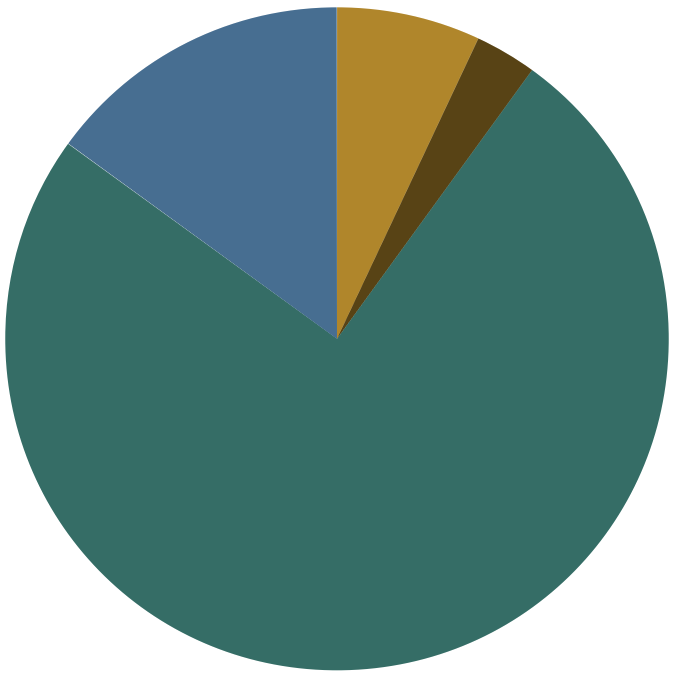
2035



Expenses are Real and Necessary

You May Be Paying Too Much

Mutual Fund Expenses

- Management fee
- 12(b)1 Fee
  - Distribution fee paid to the broker for on-going "service" to the investor. (A,B, and C shares only.)
- Sub TA Fee
  - Paid to the recordkeeper for maintaining the participants' accounts
- Daily Asset Charge
  - Additional fee added in order to cover recordkeeping fees
- Sum of the above = Expense Ratio

What Do Investors Want?

Earn a Return without Too Much Risk

Can you mitigate risk through active management?

- Protect on the downside?
- Reduce volatility?

Active Management Presumes Alpha

Alpha is the statistical measure of an investment's excess return in relation to it's <u>risk-adjusted</u> return.

$$\alpha = Rp - [Rf + \beta\{p\} * (Rm - Rf)]$$

Jensen's alpha = Portfolio Return − [Risk Free Rate + Portfolio Beta * (Market Return − Risk Free Rate)]

We believe the data is highly convincing:

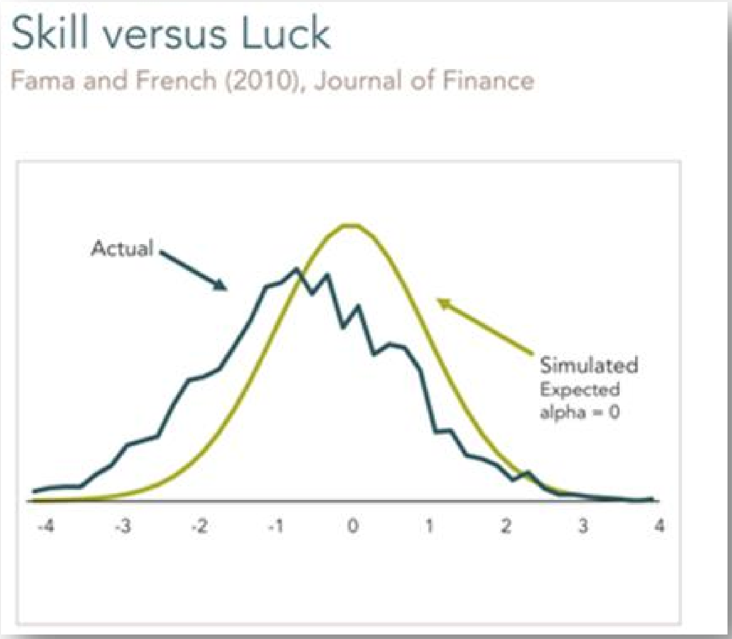
Alpha (if it exists at all) is fleeting in traditional (public market) asset classes.

Positive Alpha?
We Call it Luck

However, there's plenty of "negative" Alpha. (aka expenses)

Solution = Passive Wherever Possible

Active vs. Passive - Why is this Still Debated?



*** It is not possible to invest in an index without expense**

- Eugene Fama (University of Chicago) studied 3,156 U.S. equity mutual funds from 1984 to 2006, excluding index funds.
- Over time, the active managers in conventional asset classes collectively performed no better than what would be expected by pure luck.
- The study concluded that there is little evidence that active managers add value, in either advancing or declining markets.
- However, the additional expenses are a frictional drag to returns. Very few of the funds produced benchmark-adjusted returns sufficient to cover their costs.
- There is little evidence that better managers can be successfully selected through qualitative or quantitative analysis.

Reducing Expenses

- Emphasize passive over active funds where possible. You want the Beta of the underlying asset class as inexpensively as possible.
- Insist on institutional share classes instead of retail shares distributed by broker/dealers.
- Look for low turnover in actively managed strategies.
- Hire consultants/advisors who share these views.

Not Assessing Reasonableness of Fees - Risks

- The service providers fees could be deemed “unreasonable” and, therefore, a prohibited transaction(PT).
- Contracts would be void and the fees paid would need to be refunded to the plan for all years in effect.
- Excise tax assessed on each PT for all years in effect.
- Remember – Statute of Limitations may not apply.
- If the plan has over 100 participants, the independent auditor may refuse to issue an opinion on the financial statements.

Determining if Your Fees are Reasonable

- Annually request the fee disclosures from each service provider to the plan.
- Periodically solicit proposals from reputable service providers.
- Obtain an independent fee benchmark report comparing your plan to industry averages (of comparably sized plans).
- CLA can do it for you (without charge). We're happy to help!

Summary

- If you're a fiduciary – you're responsible.
- It can happen to your organization.
- Pay attention to the details discussed today.
- Know what's in your plan – and why.
- Substantiate, Document and Test.
- We're here to help!

Questions?

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