Janus Henderson Labs™

Recent Case Studies in Fiduciary Failures

Why Plan Sponsors are Being Sued and the Importance of Process

DEFINED CONTRIBUTION

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Recent Case Studies in Fiduciary Failures

Agenda

+ Overview of Recent Class-Action Lawsuits
+ What We Learned from These Lawsuits
+ Action Plan for Sponsors

Overview

Of Recent Class-Action Lawsuits

Overview of Recent Class-Action Lawsuits

Some Lawsuits Have Settled

+ International Paper: $30M (2014)
+ Boeing: $57M (2015)
+ Lockheed Martin: $62M (2015)

Overview of Recent Class-Action Lawsuits

Decisions

+ Edison
  - $18.9M (2017) awarded to the plaintiffs for failure to meet an “ongoing duty to monitor” specific to not investing in less expensive, institutional share classes for 17 mutual funds within the company’s 401(k) plan
    + Original damages awarded on March 21, 2013, were only $370,000
+ ABB
  - $36.9M, $35.2M of which was assessed against ABB (March 2012), was awarded to the plaintiffs for failure to follow the plan’s Investment Policy Statement, monitor recordkeeping fees, and prudently deliberate prior to removing and replacing investments, among other violations
  - $13.4M (March 2014) awarded for excessive recordkeeping fees; $21.8M award regarding investment selection was vacated
  - On July 9, 2015, the U.S. District Court ruled in favor of ABB and reversed its 2012 decision

Overview of Recent Class-Action Lawsuits

A Few Have Been Dismissed

+ Chevron
  - Dismissed in 2015; employees have filed an amended complaint that is currently being challenged by the company
+ Intel
  - Dismissed in 2016; court found claims time-barred under ERISA's three-year statute of limitations

Overview of Recent Class-Action Lawsuits

While Others Have Spread to Higher Education

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Overview of Recent Class-Action Lawsuits

Common Themes

Participant Allegations	ABB	Edison	Lockheed Martin	International Paper	Boeing
Excessive recordkeeping costs	✓		✓	✓	✓
Using "retail" or expensive share classes	✓	✓	✓	✓	✓
Failure to follow the plan's IPS when selecting or removing investments	✓				
Alleged improper investments			✓	✓	✓
Using plan assets to benefit the company	✓			✓	
Prohibiting transfers out of company stock				✓	
Delayed deposits of participant salary deferrals	✓			✓	

What We Learned

From These Lawsuits

What We Learned from These Lawsuits

Excessive Recordkeeping Fees

+ The costs of providing plan services may be paid:
  - Outside the plan directly by the plan sponsor
  - By participants in a DC plan through an allocation across all accounts and/or indirectly through a practice known as “revenue sharing”
    + Generally, “revenue sharing” means the record-keeper’s fees are covered by the investment options’ internal operating expenses

What We Learned from These Lawsuits

Excessive Recordkeeping Fees

+ In both the ABB and Edison cases, the court held that plan sponsors' decisions to implement a revenue-sharing model did not breach their fiduciary responsibilities
  - In the ABB case, the court even acknowledged that revenue-sharing arrangements were common and that the work done by record-keepers reduces the accounting work that normally would have to be done by investment managers

What We Learned from These Lawsuits

Excessive Recordkeeping Fees

+ While “revenue sharing” is a legitimate practice used to pay recordkeeping fees, plan sponsors must still ensure that their fees are reasonable
  - In the ABB case, the court ruled that the company did not understand the amounts of revenue sharing being paid, never benchmarked their plan’s fees, never attempted to negotiate lower fees, and allowed fees that were excessive relative to what similar size plans were paying
  - In 2008, after its lawsuit was filed, International Paper negotiated a lower fee of $52 per participant, reduced from $112 per participant. As a result of the settlement, the plan will be put out to bid
  - In the Lockheed Martin settlement, the company agreed to a competitive bidding process that will involve at least three providers who service plans greater than $5B
  - In the Boeing case, the company obtained competitive bids for recordkeeping services which resulted in significant savings for participants

What We Learned from These Lawsuits

Using “Retail” or Expensive Share Classes

+ Investment companies typically offer several share class options, with varying internal operating expenses, for a single investment option
  - The availability of multi-share classes facilitates a revenue-sharing arrangement
  - Plan sponsors can select the share class that provides sufficient revenue to offset all or some recordkeeping costs
  - Too little revenue sharing must be made up by the sponsor and/or plan participants; too much revenue sharing may be credited back to participants or used to pay other plan expenses (audits, employee education, consultant fees, etc.)

What We Learned from These Lawsuits

Using “Retail” or Expensive Share Classes

+ While there is no requirement that sponsors always choose the least expensive share class, they must have a deliberate process in their selection criteria and attempt to minimize expenses
  - The ABB’s Investment Policy stated, “When a selected mutual fund offers a choice of share classes, ABB will select that share class that provides plan participants with the lowest cost of participation.” The court found that ABB violated its IPS by using a more expensive share class
  - In the Edison case, the court determined the company breached its fiduciary duty because the selection process did not “immediately” switch to lower-fee institutional share classes once they became available. Also notable is the fact that the Supreme Court, in May 2015, ruled that Edison had a “continued duty” to monitor and remove imprudent investments

What We Learned from These Lawsuits

Using “Retail” or Expensive Share Classes

+ When using a revenue-sharing arrangement, care must be taken to ensure that excessive recordkeeping fees are not paid simply because plan assets increase due to growing participation or appreciating markets
    - In the International Paper settlement, the company agreed not to pay its record-keeper on a percentage of plan assets and not to use “retail” funds
    - Lockheed Martin also agreed to provide participants with the lowest-cost share class available
    - Boeing moved to rid its plan of mutual funds and replace them with lower priced separate accounts

What We Learned from These Lawsuits

Failure to Follow the Plan’s Investment Policy Statement

+ Plan sponsors who use an Investment Policy Statement to assist with the removal of investment options must be sure to follow its provisions
  - The process for removing a fund in ABB’s IPS involved examining the five-year performance, putting underperforming funds on a watch list, and removing them within six months
  - The investment committee removed the Vanguard Wellington Fund due to “deteriorating performance.” According to the court’s ruling, the committee did not indicate the fund’s five-year performance or put the fund on a watch list
  - The assets (approximately $254M) would be “mapped” into a new lifestyle fund

What We Learned from These Lawsuits

Failure to Follow the Plan’s Investment Policy Statement

+ Plan sponsors who use an Investment Policy Statement to assist with the selection of investment options must be sure to follow its provisions
  - ABB’s IPS also stated that for the selection of a new fund, there must be a “winnowing” process
  - When the investment committee decided to add a lifestyle fund (target-date fund), they considered three managers including their record-keeper’s proprietary offering; this option was chosen and subsequently underperformed its predecessor – the Vanguard Wellington Fund
  - The court held that evaluating three funds does not constitute “winnowing,” the committee’s research was “scant” and “minimal,” and the committee’s decision was motivated, in part, by the recordkeeping pricing ramifications of their decision

What We Learned from These Lawsuits

Failure to Follow the Plan's Investment Policy Statement

+ The District Court eventually ruled in favor of ABB in July 2015 because the participants "failed to prove damages consistent with the method of damage calculation" as recommended by the 8th U.S. Circuit Court of Appeals, St. Louis
+ It should be noted that although ABB prevailed on this aspect of the lawsuit, the decision reads, "The court finds that there are too many coincidences to make the beneficial outcome for ABB serendipitous, particularly considering the powerful draw of self-interest when transactions are occurring out of sight and are unlikely to ever be discovered"
  - On March 9, 2017, the Eighth Circuit Court of Appeals vacated the 2015 ruling (in favor of ABB); in October 2017, the Supreme Court declined to hear the plaintiffs' case
  - As of December 2017 the case sits with the U.S. District Court where it is attempting to calculate damages

What We Learned from These Lawsuits

Alleged Improper Investments

+ There are no guidelines, only debate, on whether plans should use active or passive managers, but hired active managers must add value
  - According to the allegations, in 2002 International Paper replaced their S&P 500 Index fund with an actively managed fund-of-fund structure. Not only were the fees higher, but the fund failed to outperform its benchmark - the Russell 1000 Index®
  - In the settlement, the company agreed to add a passively managed large-cap equity option to the plan's core lineup

What We Learned from These Lawsuits

Alleged Improper Investments

+ Decisions regarding plan investments must be made prudently
  - According to the allegations, the Lockheed Martin plan’s Stable Value Fund was imprudent because it should have had no more than 5% of its assets invested in money market funds instead of 50% to 99% that was actually invested
    + In the settlement, Lockheed Martin agreed to provide the court with periodic reports that disclose how the Stable Value Fund is invested
  - According to the allegations, Boeing included a science and technology fund in its plan menu. This fund incurred “excessive fees and investment losses.” The allegations also questioned the validity of having such a fund as part of the plan menu
    + In the settlement, Boeing agreed to have an Independent Investment Consultant provide a recommendation on if and how such an investment could be included

What We Learned from These Lawsuits

Using Plan Assets to Benefit the Company

+ Under ERISA, plan assets must be used for the exclusive and sole purpose of benefiting the participants and their beneficiaries
  - In the ABB case, the court held that the company ignored a report by its consultant, Mercer, that concluded that its record-keeper was providing 401(k) services at above-market rates but defined benefit, non-qualified and health and welfare services at below-market rates
  - According to the allegations, International Paper’s 401(k) and pension engaged in security lending although all interest was credited to the pension plan until 2008

What We Learned from These Lawsuits

Prohibiting Transfers Out of Company Stock

- There is no prohibition against offering company stock as an investment option or using company stock to make employer contributions
  - The allegations against International Paper included a plan provision that required all matching contributions and employee contributions that were matched to be invested in the International Paper stock fund. Divesting was not allowed until age 55, and then only 20% per year
    - The International Paper settlement allowed all employees to transfer their investments out of the International Paper stock fund

What We Learned from These Lawsuits

Participant Salary Deferral Allegations

+ Salary deferrals must be deposited into the retirement trust as soon as administratively feasible, but no later than the 15th of the following month withheld
    - In the International Paper case, the suit alleged that the company delayed making deposits and kept the accrued interest for its own benefit. In the settlement, International Paper agreed not to profit in any way from the operation of the plan

Action Plan

For Sponsors

Action Plan for Sponsors

Fees

+ The law states that plan sponsors are not required to pay the lowest fees possible, but rather, pay reasonable fees for the services rendered
  - Plan sponsors should understand, and document, how much is being paid, the parties being paid and the services being provided
  - Review share classes available and selected at least annually
  - Benchmarking may be a helpful exercise to determine how your plan compares to similar-size plans or similar companies within your industry
  - Many industry experts suggest a RFI or RFP every three to five years
  - If you determine that your plan fees are relatively high, you should ask your service providers to explain their pricing. In some cases, you may be able to negotiate lower fees and/or additional services

Action Plan for Sponsors

Revenue Sharing

+ Revenue sharing is a common and acceptable practice, however, plan sponsors should review and rationalize their approach
  - At issue is whether it is “fair” for participants who select funds that pay revenue sharing (typically actively managed funds) to subsidize the recordkeeping costs for the participants who choose funds that pay no revenue sharing (typically passively managed, money market and company stock funds)
  - Some plan sponsors have decided to credit all revenue sharing back to the participants who paid them, or use investments that pay no revenue sharing and allocate the same fee across all participants as a flat dollar or percentage
  - Overall, plan sponsors need to carefully consider and be proactive in their knowledge about what share classes are available and what is ultimately selected

Action Plan for Sponsors

Investment Policy Statements

+ Investment Policy Statements (IPS) are not legally required but are considered a best practice to help plan sponsors make informed decisions regarding their plan's investments
  - Having an IPS and not following its provisions can be more harmful than not having an IPS
  - Some IPSs have an "override" clause, allowing plan fiduciaries to take action in conflict with the IPS provisions, provided such action is solely in the interest of participants

Action Plan for Sponsors

Company Stock

- The Pension Protection Act of 2006 requires immediate diversification rights for employee contributions upon completion of three years of service for matching and other employer contributions
  - Companies may elect to institute a more liberalized diversification policy
  - On June 25, 2014, the Supreme Court unanimously overturned the presumption of prudence defense that has been applied to “stock drop” cases brought under ERISA for nearly two decades
- Sponsors who offer stock as an investment option should carefully review the court’s decision and discuss its implications with legal counsel

Action Plan for Sponsors

Target-Date Funds

+ According to the 2017 PLANSPONSOR/Janus Henderson survey of approximately 4,000 sponsors, more than 56% of respondents report that a target-date fund is the best Qualified Default Investment Alternative (QDIA) for their employees
  - In February 2013, the Department of Labor released its “Tips for Plan Fiduciaries” for the selection and monitoring of target-date funds
  - Several recommendations were offered including the suggestion to “inquire about whether a custom or non-proprietary target-date fund would be a better fit for your plan”

Action Plan for Sponsors

Plan Advisors

+ These cases illustrate not only the importance of engaging a competent plan advisor, but also carefully considering their recommendations
  - In the ABB case, the company turned a “blind eye” to its consultant’s conclusion that it appeared the defined contribution plan expenses were “subsidizing” other corporate benefit expenses
  - In the Edison case, the court ruled that “fiduciaries should make an honest, objective effort to grapple with the advice given, and if need be, question the methods and assumptions that do not make sense”
+ Look to advisors who specialize in retirement plans, such as 3(21) and 3(38) advisors, who can act in a fiduciary or co-fiduciary role

Action Plan for Sponsors

Fiduciary Training and Education

+ There is no regulation that requires formalized fiduciary training and education
    - According to the Plan Sponsor Council of America, however, several recent DOL audits included requests for plan sponsors to provide documentation of training within the last year
    - Please inquire about our quarterly publication, **Defined Contribution in Review**, to keep you informed about recent events that may impact your company's plan

Defined Contribution

Capabilities

Defined Contribution Capabilities

+ 45+ years of industry experience
+ Retirement excellence and leadership
+ Three highly specialized investment managers: Janus Henderson, Intech and Perkins
+ Experience in:
  - Fiduciary responsibility
  - Industry trends
  - Legislative and regulatory updates

+ $30.3 Billion in DC Assets Under Management as of 3/31/18
+ Products utilized by the top 25 DC record-keepers in the industry
+ Availability on over 200 recordkeeping platforms

Defined Contribution Capabilities

Continuing Education

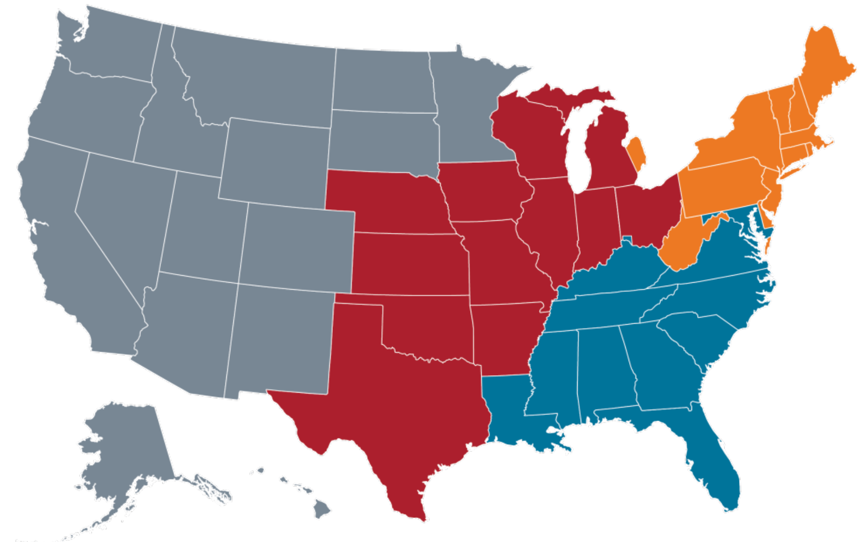
+ Janus Henderson offers accredited continuing education seminars for financial advisors, CPAs, human resources professionals and other retirement and financial industry participants
+ Each seminar qualifies for one credit hour of continuing education (CE) credit
+ Live, in-person, on-demand and webcast options available
+ Available for CFP®, CIMA®, CPWA®, CRPC®, CRPS®, CRC®, AIF®, CPA®, HR and CEBS designations

Defined Contribution Capabilities

Additional Support

Experience in:

+ Fiduciary Responsibility
+ Wealth Management
+ Industry Trends
+ Legislative and Regulatory Updates



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For more information about defined contribution resources, contact your **Janus Henderson Director** at **800.668.0434**.

Important information

This document is not intended to be legal or fiduciary advice or a full representation of all responsibilities of plan sponsors and advisors.

A retirement account should be considered a long-term investment. Retirement accounts generally have expenses and account fees, which may impact the value of the account. Non-qualified withdrawals may be subject to taxes and penalties. For more detailed information about taxes, consult a tax attorney or accountant for advice.

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In preparing this document, Janus Henderson has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources.

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