Evaluating Fiduciary Risks

By Randy Myers

Over the past decade, the retirement plan industry has been subject to a wave of litigation under the Employee Retirement Income Security Act. Allegations have included breaches of fiduciary duty in connection with excessive fees for both investment management and record-keeping services.

In a presentation at the 2013 SVIA Fall Forum, Jeremy Blumenfeld, a partner in the Labor and Employment Practice Group at Morgan, Lewis & Bockius LLP, said these ERISA lawsuits can be segmented into three categories. In the first, cases tend to be filed only against plan sponsors. In the second, service providers are named as defendants, too, making all communications between sponsors and vendors subject to discovery. In the third, claims are brought against service providers by class-action lawyers representing groups of small retirement plans.

A few trends can be discerned, Blumenfeld said. One is that while there is no “magic number” in terms of what is a reasonable investment management fee, plaintiffs’ attorneys have tended to focus on actively managed investment options, which are usually more expensive than passively managed options. Another is that plaintiffs’ attorneys often try to discern which retirement plans are most profitable to service providers, and allege that those are the plans being overcharged.

Three current cases bear close watching, Blumenfeld said. One is a lawsuit filed by plan participants against ABB Inc. in which a U.S. district court in Missouri awarded $35.2 million in damages against ABB and related defendants. That case is on appeal, Blumenfeld said. It revolves around an allegation that the plan substituted one investment option for another not because it thought the new option would outperform but because it would generate revenue for one of the plan’s service providers. “There wasn’t proof of this,” said Blumenfeld, whose firm represented ABB. “The principal evidence the plaintiffs offered was the fact that the investment option selected underperformed the option that was taken out. That led to roughly half of the damages in that case. The case is now on appeal and is certainly something that will affect the industry and how these cases are brought and litigated.”

From the left: Stephen Kolocotronis, Fidelity Investments; Jeremy Blumenfeld, Morgan Lewis & Bockius LLP; Michael Richman, Morgan Lewis & Bockius LLP

Another case to watch, he said, is a lawsuit pending against ING Life Insurance and Annuity Co. relating to whether or not ING was a fiduciary with respect to the investment options selected by its plan sponsor clients. It is similar to another suit that was brought against John Hancock Life Insurance Co., which was dismissed without trial by a district court in New Jersey earlier this year, and is also now on appeal.

There has been no particular focus on stable value funds in the fee litigation cases filed to date, Blumenfeld said. Rather, stable value has been treated like other investment options. In an ongoing class-action case involving Lockheed Martin, for example, plaintiffs have charged that they didn’t earn as much as they could have in their stable value fund because its portfolio of safer, less risky investments underperformed one of the Hueler stable value indexes, which averages results for multiple stable value

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Stable Value Outperforms

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To further explore how this might impact investor outcomes, the researchers used these results to create three optimal model portfolios—conservative, moderate, aggressive—and plot them along an efficient frontier. Only two asset classes were needed to create the optimal portfolios, Sipper said: stable value and U.S. equities. The conservative portfolio had an 85 percent allocation to stable value and a standard deviation risk of about 1.5 percent. The moderate portfolio had a 59 percent allocation to stable value and a standard deviation risk just under 5 percent, while the aggressive portfolio had a 21 percent allocation to stable value and a standard deviation risk about 9 percent.

Two important conclusions could be drawn from the research, Sipper said. One was that whether an investor had a conservative or moderate tolerance for risk, stable value could play a significant role in their portfolio—whether interest rates rose steadily or quickly. The other was that without stable value, the only way an investor could hope to achieve the same returns achieved by the model portfolios would be by assuming more risk. SVIA

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funds. "Of course, if you're picking an index that is based on an average of a lot of different investment options, by definition about half will underperform," Blumenfeld noted. He said the case includes other absurdities. For example, of the four named plaintiffs, three had not invested in the Lockheed Martin stable value fund at all, and the one who had did so during a period in which it outperformed the Hueler Index.

In yet another case, involving Cigna Corp., participants in the company's 401(k) plan challenged not only the performance of the plan's stable value fund, but also argued that it should have had a more diverse collection of wrap contracts. The plaintiffs also complained about the fund's crediting rate not matching the performance of the fund's underlying investments. Cigna denied liability but settled the suit for $35 million. As part of the settlement, it agreed to hire an independent consultant to monitor and advise on the stable value fund and other investments in its 401(k) plan.

The lesson for service providers, Blumenfeld said, is to make sure their clients understand the products and services they're buying, and, to the extent possible, put that information in writing and keep reminding clients of it. "It doesn't do them any good if they forget or don't understand, and it doesn't do you any good," he said.

Blumenfeld also recommended that service providers and plan sponsors alike establish and document prudent processes for choosing and managing stable value products. Areas to be mindful of include performance, fees, wrap costs, wrap diversification, and crediting rates.

On the regulatory front, Michael Richman, of counsel to Morgan, Lewis & Bockius, updated Forum participants on what's been happening in the year since plan sponsors and service providers became subject to new disclosure requirements under ERISA sections 408(b)2 and 404(a)5. The former requires service providers to disclose information about their fees and fiduciary status to their plan sponsor clients, while the latter requires sponsors to disclose information about plan expenses to plan participants.

Richman noted that 408(b)2 allows service providers to make disclosures once and forego annual updates unless something changes. However, he said, a number of providers are doing annual updates anyway to make sure they didn't miss any changes and to ensure that all their clients have up-to-date information. Meanwhile, the Department of Labor is considering mandating a new "Form of Disclosure" guide under 408(b)2 that could serve as a roadmap for finding disclosures in the documents provided to plan sponsors. However, he said, the initiative is apparently on hold under pressure from industry trade associations.

In other regulatory developments, Richman said the DOL is still considering whether to broaden the circumstances under which a service provider could be deemed a fiduciary under ERISA. The DOL has said it will re-propose such a rule, but it has not done so yet and action, Richman said, does not appear imminent.

Elsewhere, both the DOL and the Securities and Exchange Commission are considering new rules for target-date fund disclosures. The DOL had expected to issue a final rule in November of this year, Richman said, but it now appears that will not happen.

Finally, Richman noted, the DOL has issued an advance notice of proposed rulemaking that would impact defined contribution plans. Plans would be required to include in the benefit statements sent out to plan participants an estimate of what a participant's account balance might be worth in terms of lifetime income. The DOL is currently reviewing comments on its proposal.

In terms of Department of Labor investigations, Richman said it's hard to discern trends because little information about them is made public. He did note, though, that the DOL has made a number of general requests to service providers asking for broad amounts of information. "When you drill down, it turns out that, in some of the ones we've seen, the focus is on certain issues: abandoned plans, which is an issue for the Department of Labor if a company is gone and there is no fiduciary to wind down the plan," he said. "There's a DOL initiative, and some regulations out there, that allow the Department of Labor to step in, or for a process where a service provider appoints someone to take over the plan and wind it down."

The DOL also appears to be looking into trade errors made when a plan moves its assets to another provider, Richman said. SVIA

Stable Value Roundtable

By Randy Myers

What's happening in the stable value market? Seven experts from diverse sectors of the industry brought participants at the 2013 SVIA Fall Forum up to speed during a lively roundtable discussion in Washington, D.C. Among the highlights:

Wrap diversification: A preference for having multiple wrap contract providers for a stable value fund still persists among retirement plan sponsors, said Warren Howe, national sales director for stable value markets at Metropolitan Life Insurance Co. But he said the fact that some plan sponsors embraced single-wrap insurance-company stable value products in the aftermath of the 2008 credit crisis, when wrap capacity was constrained, demonstrated that many have become more comfortable with that approach, too.

Unwrapped stable value portfolios: A few defined contribution plans introduced market-value sleeves of securities into their stable value funds prior to the 2008 financial crisis, and interest in such structures increased after the crisis when stable value wrap capacity became constrained, said Jessica Mohan, managing director with Bank of Tokyo-Mitsubishi UFI Ltd., where she oversees its stable value business. Mohan says her firm hasn't done any new transactions with funds that have included market-value sleeves, but "we're ready to." She suggested that these unwrapped portfolios should generally adhere to the investment guidelines established for the wrapped portion of a stable value fund, and that plan sponsors who offer such funds should communicate to their plan participants that their fund is "not 100 percent a stable value fund."

Tom Schuster, vice president of stable value management with Metropolitan Life, warned that there is headline risk associated with such structures if they lose money and plan participants later say they thought they had been getting traditional stable value guarantees. "It's not a stable value fund," he said, adding that he doesn't think the structures make much sense

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