



## Storms on the Horizon: Protecting Your Agency's 457(b), 401(a), or 403(b) Retirement Plan from the Coming Fiduciary Lawsuits

**VENTURE TO THE CAPITAL**



# Storms on the Horizon: Protecting Your Agency's 457(b), 401(a), or 403(b) Retirement Plan from the Coming Fiduciary Lawsuits

*California Society of Municipal Finance Officers  
Annual conference, Sacramento. CA*

*Marcus Wu, February 9, 2017*

# Overview

- Defined-contribution plans
- Fiduciary duties
- ERISA 404(c)
- Recent lawsuits



# Defined-Contribution Plans

# Overview

- Defined-contribution plans are “account balance plans”
- Participant’s interest is based exclusively on employer/employee contributions plus forfeitures, adjusted for earnings/loss
- Plan types sponsored by California public agencies:
  - Almost all agencies (other than schools) sponsor 457(b) plans; most schools sponsor 403(b) plans
  - A few agencies have grandfathered 401(k) plans
  - Many agencies also sponsor 401(a) defined-contribution plans

# Investment Structure

- Investments under defined-contribution plans can be structured as employer-directed or participant-directed
- Employer-directed = employer selects funds in which participants' accounts are invested
- Vast majority of California agencies' plans are participant-directed:
  - Employer selects funds to be offered under plan's investment menu
  - Menu may include self-directed brokerage account
  - Employer also selects default fund
  - Participants direct the investment of their account balance among the funds on the menu; if participant doesn't provide direction for any part of account balance, the amount is allocated to the default fund

# Fiduciary Duties

# California Constitution

- ERISA, a federal law governing employee benefit plans, applies to nongovernmental entities but not to public agencies
- But California law imposes fiduciary standards identical to ERISA under section California Constitution, Article 16, Section 17
  - Prudent person standard: fiduciary must exercise “care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.”
  - Duty of loyalty to participants
  - Duty to diversify plan investments to minimize risk of loss and maximize rate of return



# Who is a Fiduciary?

- Under ERISA definition, a person is a fiduciary to the extent he or she
  - Exercises discretionary authority or control over plan management
  - Exercises authority or control over management or disposition of plan assets
  - Has discretionary authority or responsibility over plan administration
  - Provides investment advice for compensation (service providers)
- Distinguish from settlor functions, such as adopting or amending plan

# What is Expected of Fiduciaries?

- A fiduciary's performance is not judged with "20/20 hindsight." Rather, fiduciaries are judged on the prudence of the process when making decisions.
  - Take steps to gather relevant information (and may consult with third party experts)
  - Analyze the information (and should consider using experts)
  - Make a reasoned decision

# Potential Consequences of Breaching Fiduciary Responsibilities

- Personal liability for losses
- Range of potential damages under California law. Contrast with federal law, which generally limits damages to lost benefit losses.

ERISA § 404(c)

# Government Code § 53213.5(b)

- Section 53213.5(b) incorporates ERISA 404(c) rule
- Compliance with 404(c) shields the agency from liability for participants' poor investment decisions

# 404(c) Safe Harbor

- ERISA section 404(c) provides “safe harbor” protection against liability for participants’ investment decisions if certain requirements are satisfied. Confirm that:
  - Required participant disclosures are furnished to participants and beneficiaries
  - Participants and beneficiaries are provided with a “broad range” of diversified investment options
  - Participants and beneficiaries are informed that the plan is intended to satisfy 404(c) and fiduciaries may be relieved of liability for participant decisions
- “Default” funds should satisfy QDIA requirements
- Section 404(c) isn’t, however, a defense to imprudent fund selection

# 404(c) and QDIA Checklists

- See handouts

# Recent Lawsuits



# Overview

- Last decade has seen wave of litigation involving 401(k) plans sponsored by nongovernmental entities
- The lawsuits have recently seeped over to 403(b) plans: complaints filed against Yale, MIT, NYU, Johns Hopkins, Duke, University of Pennsylvania, Vanderbilt, Emory, and others
- Claims allege that employers violated fiduciary duties with respect to investments offered by the plan

# Tussey v. ABB, Inc.

- In 2012, the U.S. District Court for the Western District of Missouri ordered ABB, Inc. and its service provider to pay a combined \$36.9 million in damages for breaching their fiduciary duties
  - The bulk of the damages, \$35.2 million, was assessed against ABB
  - In November 2013, the court ordered ABB and its service provider to pay \$13.4 million in legal fees and other costs
- In 2014, the Eighth Circuit Court of Appeals affirmed the \$13.4 million award for excessive recordkeeping fees
- \$21.8 million award vacated

# Tibble v. Edison International

- In 2013, the Ninth Circuit Court affirmed the District Court's decision where participants alleged that 401(k) plan fiduciaries breached their duties of loyalty and prudence
  - Damages of \$370,000 were awarded
  - Although the damages were relatively nominal, this case is important because of the court findings
- In 2015, the Supreme Court ruled unanimously that Edison had a “continuing duty” to monitor and remove imprudent investments from its 401(k) plan
- In 2016, the Ninth U.S Circuit Court of Appeals dismissed the suit saying that while the Supreme Court ruled that federal law imposes an ongoing duty to monitor investments on fiduciaries like Edison, the workers failed to raise that argument in lower courts

# Settlements

- Abbott v. Lockheed Martin
  - Company agreed to pay \$62 million and submit to extensive affirmative relief
- Beesley v. International Paper
  - Company agreed to pay \$30 million and submit to extensive affirmative relief
- Spano v. The Boeing Company
  - Company Pay \$57 million (\$19 million in attorney's fees) and submit to extensive affirmative relief

# Common Themes

| Allegations   | ABB | Edison | Lockheed | International Paper | Boeing |
|---|-----|--------|----------|---------------------|--------|
| Excessive recordkeeping costs   | x   |        | x        | x                   | x      |
| Using “retail” or expensive share classes                               | x   | x      | x        | x                   | x      |
| Failure to follow the plan’s IPS when selecting or removing investments | x   |        |          |                     |        |
| Improper investments  |     |        | x        | x                   | x      |
| Using plan assets to benefit the company                                | x   |        |          | x                   |        |
| Delayed deposits of participant salary deferrals                        | x   |        |          | x                   |        |

# STORMS ON THE HORIZON...BEST PRACTICES

Bill Tugaw

Managing Director, Governmental Plans

NFP

# Overview

- Fiduciary Due Diligence
- Practical Steps
- Liability Protection
- Fee Equalization
- Administrative Expense Reimbursement Allowance

# Fiduciary Duties

## Summary of Duties

- Duty of Loyalty
- Duty of Prudence
- Duty of Diversification
- Duty of Administration in Accordance with Policies



# Fiduciary Duties - Questions

- When to keep it?

vs.

- When to appropriately delegate it?
- Can you delegate it?
- Delegating task, not responsibility

# Fiduciary Liability - Practical Steps

- Comply with Federal / State Laws
  - Current Laws
  - New Legislation
- Develop Investment Policy
- Procedure - Select / Remove
  - Vendors / Vendor Representatives
  - Investments

# Fiduciary Liability - Practical Steps

- Due Process to Resolve Disputes
- Require Periodic Audit
  - Independent Financial Audit
  - Compliance Audit of Contractors
- Establish Performance Monitoring Procedure
  - Benchmark indices
- Educate / Communicate
  - Plan restrictions
  - Investment options
- Make Consistent Decisions

# Fiduciary Liability - Practical Steps

- Meet Minimum ERISA 404(c) - “safe harbor”
- Requirements:
  - Offer Three+ Diverse Investment Options
  - Vary Risk & Return Characteristics
  - Provide Investment Decisions Discretion
  - Allow Periodic Investment Change
  - Communicate Information
  - Monitor Investment Performance

# Fiduciary Liability Protection

- Defense of public employees by the public employer
- Indemnification of public employees by the public employer
- Potentially no punitive damages
- Fiduciary Liability Insurance
- Organizational Options / Considerations
- Waiver of Recourse
  - Not Paid by Plan Assets

# Fee Equalization

- Zero / Low Cost Shares
- Reimbursement to Participants
- Disclosure in Quarterly Statements
- Transparency of fees

# Administrative Expense Reimbursement Allowance

- New Responsibilities – Additional Cost
- Financial Status of Public Sector
- Utilizing Plan Assets
- Identifying Employer Costs
  - Education / Training
  - External / Neutral Experts
  - Internal Administration

# STORMS ON THE HORIZON...CASE STUDY

Jay Castellano,  
City of San Mateo



# STORMS ON THE HORIZON...

## Case Study: City of San Mateo

### **PURPOSE**

- To provide a case study of the City of San Mateo's deferred compensation plan's transformation so that CSMFO attendees can 1) see the benefits to the City and to the plan participants, and 2) get motivated to conduct their own reviews and take action, as appropriate and necessary.

### **PRODUCTS**

- Understanding of San Mateo's starting point
- Understanding of San Mateo's objectives and strategies
- Understanding of San Mateo's changes and benefits

# STORMS ON THE HORIZON...

## Case Study: City of San Mateo

### **2013**

- Participants: 497 FT eligible, 309 active participants, #? Retiree participants
- Six plans: 457(b), OBRA, VEBA, §115 Trust and 401(a) and (h) plans
- Five plan providers: ICMA-RC, CalPERS 457, Nationwide, MassMutual and an unbundled arrangement involving Schwab and Aspire
- \$67 million assets
- 99 457(b) investment options; 3.5 average Morningstar ratings
- Average administrative fees of 30 basis points (plus investment fees)
- Inactive Deferred Compensation Committee

# STORMS ON THE HORIZON...

## Case Study: City of San Mateo

### **OBJECTIVES FOR IMPROVEMENTS**

- Reconstitute and activate Deferred Compensation Committee
- Develop and implement new administrative policy to subject benefits contracts to recurring competitive processes
- Conduct Request For Proposals
  - Consolidate providers to take advantage of economies of scale (i.e., reduced fees)
  - Reduce overall administrative fees
  - Update fund options and reduce fund fees
  - Secure financial and administrative resources to provide ongoing governance, administration and participant education

# STORMS ON THE HORIZON...

## Case Study: City of San Mateo

### **2015**

- Four plans (soon to be three): 457(b), OBRA, VEBA, and 401(a) and (h) plans
- Two plan providers (soon to be one): Voya and an unbundled arrangement involving Schwab and Aspire
- \$67 million assets
- 28 investment options (including TDF); 4.5 average Morningstar ratings
- Administrative fee of 8 basis points (saving \$150,000/year) plus lower investment fees
- New five-person labor-management Deferred Compensation Committee

# STORMS ON THE HORIZON...

## Case Study: City of San Mateo

### **BETTER POSITIONED FOR FIDUCIARY COMPLIANCE**

- Updated governing documents
  - Summary plan documents
  - Investment policy, education policy
- New Deferred Compensation Committee
  - Representative of stakeholders
  - Recurring schedule for reviewing and updating governance, compliance
- New resources for administrative support, web-based and mobile services, communication and education programs