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Regulators, the Courts and the Fiduciary Standard: What's Happened, What's Happening, What's Next

Wednesday, November 29, 2017

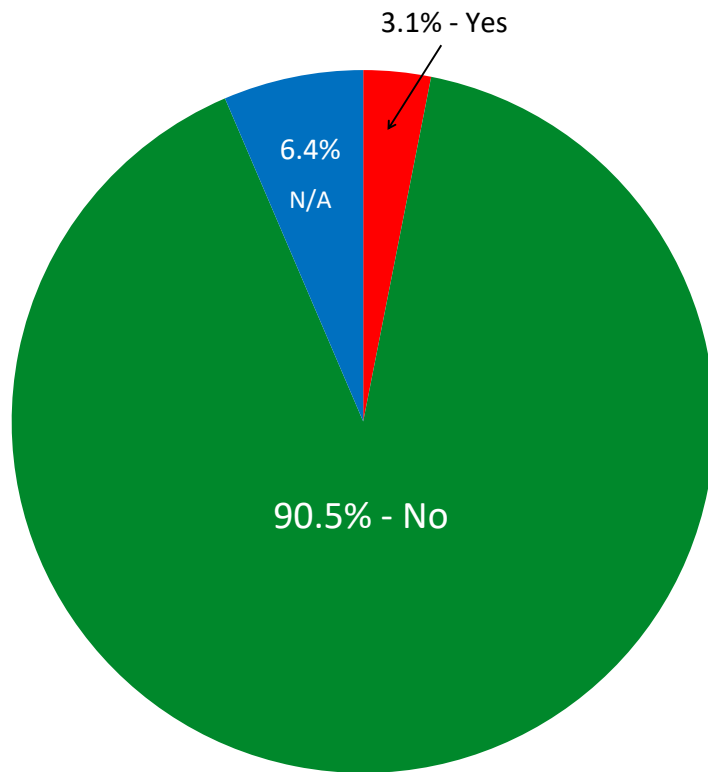
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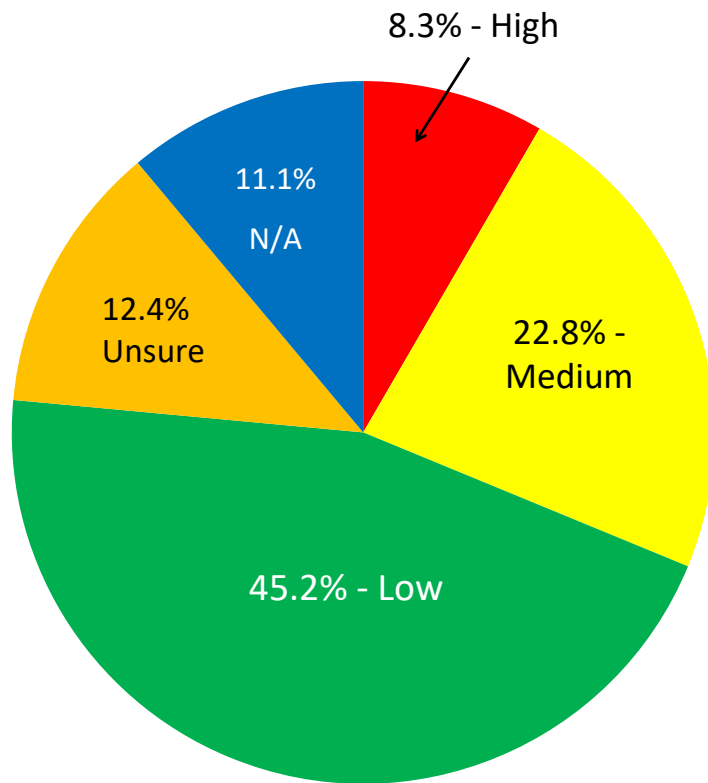
Overview

1. ERISA – recent litigation trends
 - a. Duty to monitor
 - b. Church plans
 - c. In-house plans of financial services companies
 - d. University plans
 - e. Stock drops
 - f. Small plans
2. Class actions – are individual advisors next?
3. SEC and FINRA exams – focus on investment expenses, rollovers
4. Status of Fiduciary Rulemaking
5. Takeaways
6. Best Practices

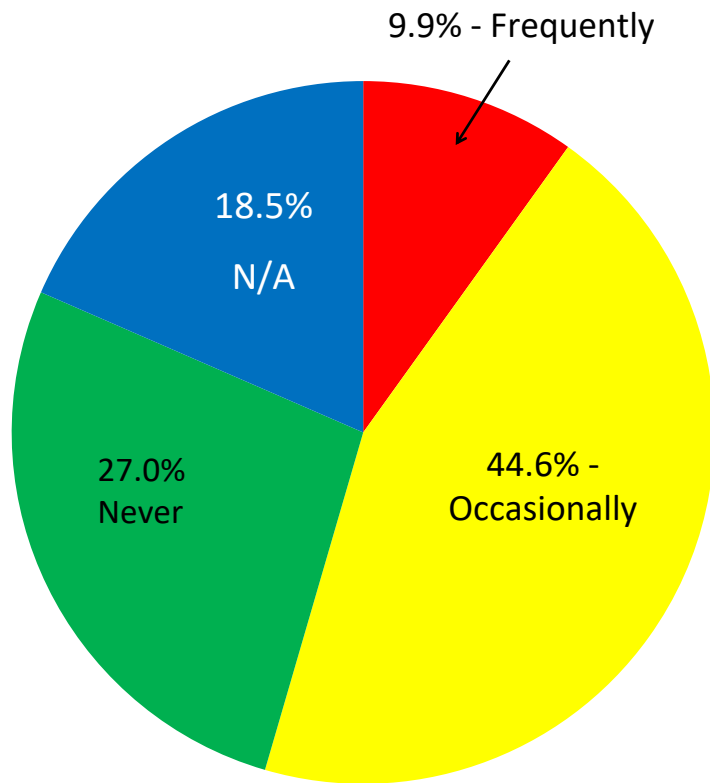


Question 1:

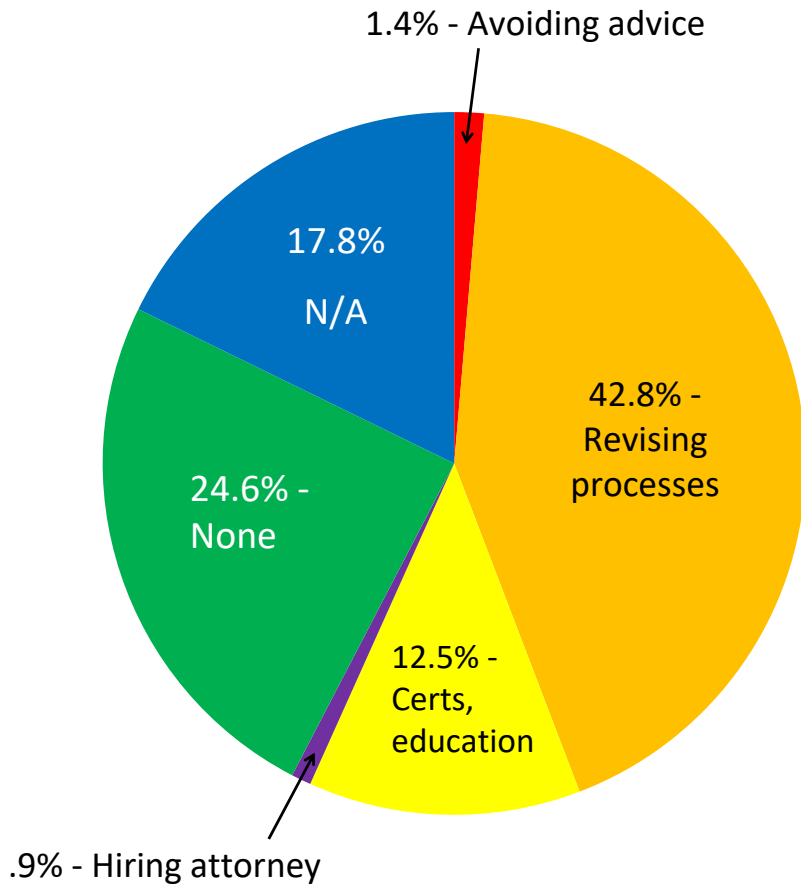
Has your business been a participant in a retirement-related lawsuit in the last 10 years?



Question 2:
How much litigation risk do you believe your advisory business is under today?



Question 3:
How frequently are your plan sponsor clients talking with you about litigation risks?



Question 4:

While all of the options below may help protect your business from litigation, which of the following will you be investing in over the next 3-6 months?

- Avoiding/eliminating fiduciary advice and services
- Revising your consistent, documented processes
- Requiring professional certifications, fiduciary education
- Hiring a good attorney
- None of these – we are in a good place
- Not applicable



Duty to Monitor

- *Tibble v. Edison Int'l* (5/18/15)
 - Supreme Court, in unanimous decision
 - Affirmed continuing duty of fiduciaries to monitor plan assets
 - Held that courts cannot dismiss breach claims involved with monitoring based on ERISA's six-year statute of limitations
 - Declined to elaborate on meaning of 'continuing duty'
- DOL guidance on annuities
 - Field Assistance Bulletin 2015-02
 - Fiduciary's duty to monitor for insurer's insolvency ends when plan no longer offers annuity option; no continuing duty for lifetime of annuity payments
 - Fiduciary must consider ability to make future payments at time of selection



Church Plans

- Supreme Court held, in unanimous decision
 - Hospitals can operate ERISA-exempt church plans
 - Relied on ERISA language that an exempted church plan is a plan “established and maintained by a church” including a plan “maintained by” a church-connected entity
- Background
 - Four-years of litigation involved 2 dozen religiously affiliated hospital plans
 - DB plans faced \$4 billion in shortfalls
 - Decision impacts 300,000 hospital workers
 - Several earlier cases led to multi-million settlements
- Recent case, *Bence v. Presence Health*, suggests ERISA church exemption may also be challenged when it involves a church-affiliated hospital’s DC plan.



Financial Service Co. Plans

- Background
 - 2 dozen+ class actions filed in last 3 years against in-house plans of major financial services firms
 - Defendants include Schwab, Morgan Stanley, JP Morgan, Blackrock
- As of October 2017
 - Two suits dismissed; now on appeal
 - Three settled for total of \$11m.
 - 20 cases pending; 4 class-certified
- Central claims
 - Use of proprietary funds breached duty of loyalty
 - Certain fund options underperformed benchmarks
 - Excessive fees



Case Review -- Putnam

- Background
 - Putnam funds used in plan
 - Workers alleged high fees, failure to monitor, led to losses
 - Also claimed no other large plans used same funds
 - 7-day bench trial
- Case dismissed; now on appeal
 - First post-trial ruling among 24 cases filed
- Court held
 - Putnam workers failed to identify instances when company put interests ahead of plan, fiduciaries' motivation behind "specific, disloyal conduct"
 - Burden on participants to prove breach, even if fiduciary's decisions incidentally benefit fiduciary

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University Plans

- Background
 - 16 prominent colleges sued in past year
 - Big names include MIT, Duke, Johns Hopkins, Yale
 - 1 case dismissed; 15 pending
- Central claims
 - Excessive fees, including use of retail vs. institutional share classes
 - Too many investment options
 - Investment underperformed benchmarks
- Key issue
 - Courts divided on whether use of retail vs. institutional share classes a viable claim



Stock Drops

- Background
 - Supreme Court vacates *Dudenhoeffer v. Fifth Third Bancorp* (6/26/14)
 - Plaintiffs claimed 401(k) plan fiduciaries retained company stock too long
- Decision reverses *Moench* presumption used to dismiss stock drop claims
 - Fiduciaries do not need to react to publicly available information
 - Most stock drop claims come from ESOPs
- Court guidance
 - ERISA duty of prudence never requires a fiduciary to break the law, i.e. act on insider information
 - Fiduciaries must weigh whether disclosure or stopping stock purchases would do more harm than good
- Current trend
 - Stock drop suits failing to gain traction



Small Plans

- Background
 - Past class actions targeted large, billion-dollar plans
- Current trend
 - Slight uptick in small plan suits
 - *Sandoval v. Novitex* (\$157 m. plan)
 - *Hay v. Gucci America* (\$96.5 m. plan)
 - *Bernaola v. Checksmart Financial* (\$25 m. plan)
 - *Damberg v. LeMettry's Collision* (\$9 m. plan)
 - One law firm (CT) driving 3 of 4 suits
 - Similar claims to large plans

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Are individual advisors next?

- DOL Rule 'effect'
 - Thousands of new fiduciary advisors, as of 6/9/17
 - Greater public awareness
 - Enforcement cases
- Why few cases reported
 - Most 3(21)s are not deep pockets
 - Binding arbitration
 - No private right of action under '40 Act
 - Best Interest Contract Exemption unlikely to survive
- No clear trend
 - Large robo (Financial Engines) ignored in five class-actions (May 2016-current)
 - 3(21) advisor named in small plan suit (Checksmart) (7/14/16)
 - Investment consultant named in *Ramos v. Banner Health* (9/29/17)



Major plaintiffs firms

- Top 10
 - DC (2)
 - Hartford, CT (1)
 - Minneapolis (1)
 - NYC (2)
 - Philadelphia (2)
 - St. Louis (1)
 - San Francisco (1)
- Most common claims
 - Plan fees
 - Exemption status for religious-affiliated hospitals
 - Prohibited transactions



SEC and FINRA Focus

1. Enforcement Actions
 - a. Selection of mutual fund share classes
 - i. Retail vs. institutional -- *Manarin Investment Counsel, Ltd.*, (10/2/13), *Envoy Advisory, Inc.* (9/8/17), *SunTrust Investment Services, Inc.* (9/14/17)
2. Regulatory Alerts
 - a. OCIE share class initiative (June 2016)
 - b. OCIE exam priorities – retirement savings (2014-2017)
 - c. OCIE ReTIRE initiative (June 2015)
 - d. FINRA 2016 exam priorities – 529 plan share classes
 - e. FINRA 2014 exam priorities (rollovers)
 - f. FINRA Regulatory Notice 13-45 (rollovers)

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SEC ReTIRE Initiative

Initiative includes a focus, among other things, on

1. Rollover advice
 - a. Account selection
 - b. Due diligence on investment options
 - c. Initial investment recommendations
 - d. On-going account management
2. Conflicts of interest
 - a. Identify, design compliance programs to avoid/disclose material conflicts
 - b. SEC staff will review
 - i. Sales and account selection practices compared to fees charged
 - ii. Services provided to investors



Status of Fiduciary Rulemaking

1. DOL Fiduciary Rule
 - a. June 9, 2017 – Expanded fiduciary definition and Prohibited Transaction Exemption obligation to apply Impartial Conduct Standards take effect
 - b. July 1, 2019 – New final applicability date as the result of an 18-month delay imposed this week (no extension of grandfathering provisions)
 - c. Changes expected, including a new streamlined class exemption
 - d. Enforcement relief continues during transition period (requires diligent and good faith effort to comply)
2. SEC Chair Clayton: “we are working on a fiduciary rule and exploring it for brokers and investment advisers” – Title regulation is also a possibility
3. States are engaged in or contemplating fiduciary rulemaking
4. “Harmonization” presents significant challenges; trade groups are realizing this



Takeaways

- Full fiduciary accountability is in effect for advice rendered under ERISA
- DOL fiduciary definition and Impartial Conduct Standards apply in IRAs
- “[RIAs] continue to grab a bigger share of the roughly \$13 trillion market. Last year, Cerulli said, the share of assets held by the brokerage industry fell below 50%” WSJ Wealth Adviser Briefing, Nov. 28, 2017
- Fiduciary rulemaking efforts and Wall Street versus Main Street court battles will result in at least two years of regulatory uncertainty
- “The one closest to the client always wins” – Tiburon CEO Summit 2017
- Fiduciary practices are the best way to manage risk and be closest to clients



Best Practices and Strategic Decision-making

- Litigation and regulatory focal points: conflicts of interest, inadequate due diligence, failure to follow governing documents or monitor, excessive costs
 - Avoid conflicts whenever possible, properly manage unavoidable conflicts, especially compensation and proprietary offering conflicts (BICE principles)
 - Apply sound, consistent due diligence procedures for asset class, investment, and service provider selection, monitoring, and replacement
 - Carefully craft and follow governing documents, including the IPS
 - Benchmark costs and services
 - Monitor: There is nothing passive about being a fiduciary.
- Focus on fulfilling client expectations and desires; less on regulatory prognostication
 - Model and market fiduciary best practices
 - Enhance your personal credentials (designations, specialized expertise, reputation)
 - Enhance your firm's credentials (fiduciary differentiation, seek public recognition, CEFEX certification)

Questions, Answers and Discussion

Additional information on fiduciary trends can be found at Fi360 Fiduciary Talk Podcast

www.fi360.com/fiduciarytalk (also available on iTunes)

and the Fi360 Blog www.fi360.com/blog