Fiduciary Update: Providing Clarity in Uncertain Times

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Presenters

Fred Rutler
Vice President,
Lockton Investment Advisors, LLC
fred.rutler@Lockton.com

Howard Levine
Partner,
Drinker Biddle & Reath LLP
howard.levine@dbr.com

Rose Ann Abraham, CPA
Partner,
Baker Tilly Virchow Krause, LLP
roseann.abraham@bakertilly.com
Fred Rutler

- Economic Update
- Market Update
- Legislative Update
## Economic Scorecard for Q1 2017

<table>
<thead>
<tr>
<th>Topic</th>
<th>Status</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Growth</td>
<td>Picking Up</td>
<td>▶ Industry expansion</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Capacity utilization steady</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Retail sales up</td>
</tr>
<tr>
<td>Employment</td>
<td>Full Employment</td>
<td>▶ Unemployment down</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Government and private sectors adding jobs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Labor force participation up</td>
</tr>
<tr>
<td>Inflation</td>
<td>Low but Rising</td>
<td>▶ Oil prices down</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Headline inflation rates remain low</td>
</tr>
<tr>
<td>Interest Rates</td>
<td>Low but Rising</td>
<td>▶ Fed raising rates</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Treasury curve flattening</td>
</tr>
<tr>
<td>Markets</td>
<td>Near All-Time Highs</td>
<td>▶ S&amp;P and Nasdaq up</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Earnings expected to continue to increase</td>
</tr>
</tbody>
</table>
## Market Update for Q1 2017

### Annualized Return: Broad Market Equity Indices

<table>
<thead>
<tr>
<th>Index</th>
<th>Q1 2017</th>
<th>YTD</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
<th>10 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dow Jones Industrials</td>
<td>5.19%</td>
<td>5.19%</td>
<td>19.91%</td>
<td>10.61%</td>
<td>12.15%</td>
<td>8.10%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>6.07%</td>
<td>6.07%</td>
<td>17.17%</td>
<td>10.37%</td>
<td>13.30%</td>
<td>7.51%</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>9.82%</td>
<td>9.82%</td>
<td>21.39%</td>
<td>12.08%</td>
<td>13.84%</td>
<td>9.34%</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>7.25%</td>
<td>7.25%</td>
<td>11.67%</td>
<td>0.50%</td>
<td>5.83%</td>
<td>1.05%</td>
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<tr>
<td>MSCI ACWI</td>
<td>6.91%</td>
<td>6.91%</td>
<td>15.04%</td>
<td>5.08%</td>
<td>8.37%</td>
<td>4.00%</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>11.45%</td>
<td>11.45%</td>
<td>17.22%</td>
<td>1.18%</td>
<td>0.81%</td>
<td>2.72%</td>
</tr>
<tr>
<td>MSCI US REIT</td>
<td>0.99%</td>
<td>0.99%</td>
<td>3.17%</td>
<td>10.05%</td>
<td>9.82%</td>
<td>4.71%</td>
</tr>
<tr>
<td>Bloomberg Commodity</td>
<td>-2.33%</td>
<td>-2.33%</td>
<td>8.71%</td>
<td>-13.91%</td>
<td>-9.54%</td>
<td>-6.22%</td>
</tr>
</tbody>
</table>

Sources: Dow Jones, Standard & Poor’s, NASDAQ, and MSCI. Data as of 03/31/17

### Annualized Return: S&P 500 Sectors

#### Q1 2017

- Information Technology
- Consumer Discretionary
- Healthcare
- Utilities
- Consumer Staples
- S&P 500 Index
- Materials
- Industrials
- Energy
- Energy

#### 1-Year Annualized Return as of 03/31/17

- Financials
- Information Technology
- Materials
- Industrials
- Energy
- Consumer Discretionary
- Healthcare
- Utilities
- Consumer Staples
- Real Estate
- Real Estate
- Transportation

Source: Standard & Poor’s. Data as of 03/31/17

### Q1 2017 vs. 1-Year

<table>
<thead>
<tr>
<th>Size</th>
<th>Value</th>
<th>Core</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>3.27%</td>
<td>6.03%</td>
<td>8.91%</td>
</tr>
<tr>
<td>Mid</td>
<td>3.76%</td>
<td>5.15%</td>
<td>6.89%</td>
</tr>
<tr>
<td>Small</td>
<td>-0.13%</td>
<td>2.47%</td>
<td>5.35%</td>
</tr>
</tbody>
</table>

<table>
<thead>
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<th>Size</th>
<th>Value</th>
<th>Core</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>19.22%</td>
<td>17.43%</td>
<td>15.76%</td>
</tr>
<tr>
<td>Mid</td>
<td>19.82%</td>
<td>17.03%</td>
<td>14.07%</td>
</tr>
<tr>
<td>Small</td>
<td>29.37%</td>
<td>26.22%</td>
<td>23.03%</td>
</tr>
</tbody>
</table>

Source: Russell Investment Group. Data as of 03/31/17
Legislative Updates

Tax Reform Looms

There remains a great deal of uncertainty within the GOP about what tax reform will look like and whether or not it should be paid for with revenue offsets.

Senate Marches Toward Retirement Reforms

Unanimous Senate Finance Committee approval of a number of reforms packaged into the single Retirement Enhancement and Savings Act (RESA) could be the beginning of significant change.

Areas of impact for retirement plans:

- Modifications of hardship withdrawals rules
- Nondiscrimination plans for closed defined benefit plans
- Limit on automatic enrollment safe harbor
- Safe harbor 401(k) changes
- Updates to 5500’s
Legislative Updates

Electronic Disclosures

There are discussions on making electronic disclosures the default for participant communications.

Lawmakers Look to Ease Student Loan Debt Burden

New legislation proposes giving employers tax exclusions for benefits that help employees payoff student loan debt.
Howard Levine

- Fiduciary Rule Delay Period Ends – What It Means for Plan Sponsors and Fiduciary Committees
- What We Can Learn From Recent 401(k) Plan Fee Litigation
Overview of the New DOL Fiduciary Rule

> In April, 2016, the DOL released the long-awaited, revised final Fiduciary Rule; generally effective April 10, 2017

> In April, 2017, the DOL issued a final rule extending the effective date of the Fiduciary Rule to June 9, 2017

> In May, 2017, the DOL released a non-enforcement policy and FAQs regarding how the new Fiduciary Rule will be enforced during a transition period that ends December 31, 2017
New rule revises the definition of “fiduciary” to be a person who:

(1) receives a fee or other compensation, whether directly or indirectly, in exchange for providing;

(2) recommendations to a plan, plan fiduciary, plan participants, IRA or IRA owner regarding (a) buying, selling or holding securities or other investment property, (b) how investments should be invested after they are distributed or rolled over from a plan or IRA or (c) management of securities or other investment property; and

(3) either (a) acknowledges the fiduciary nature of the advice or (b) acts pursuant to an agreement, arrangement or understanding that the advice is individualized to or specifically directed to the recipient for consideration in making investment or management decisions regarding plan assets.
Overview of the New DOL Fiduciary Rule (cont’d)

- Eliminates current five-part test to determine whether a person is acting as a fiduciary advisor
  - Makes investment recommendations
  - On a regular basis
  - Pursuant to a mutual understanding that
  - Advice will be a primary basis for investment decisions
  - Advice will be individualized to the plan’s needs
The new definition expands the types of retirement investment advice covered by fiduciary protections, including advice given by investment brokers, insurance agents, and registered investment advisers:

- Advice no longer needs to be provided regularly – a single recommendation is enough to confer fiduciary status on an individual
- Advice does not need to be the primary basis for the recipient’s decision – it just needs to be considered
- A mutual agreement that the advice is specific to the plan is no longer needed – only an understanding that the investment advice is individualized
Exceptions to Fiduciary Definition

> Investment Education Exception
> Exception for Advice from Plan Sponsor’s Employees
> Platform Provider Exception
> Sophisticated Counterparty Exception
> “Hire me” Exception
Best Interest Contract (BIC) Exemption

- In the absence of an exemption, receipt by investment fiduciaries of various types of variable compensation, including commissions and 12b-1 fees, would violate ERISA’s prohibited transaction provisions
- BIC exemption provides relief if certain requirements are met
- Not applicable to discretionary advice if variable compensation received
Intended to promote the provision of investment advice untainted by conflicts of interest and in the best interests of retirement investors – IRA clients, participants in plans subject to ERISA with self-directed investments and “retail fiduciaries” (a fiduciary that is not an RIA, registered broker-dealer or plan fiduciary that manages or controls $50 million or more in assets)

Requirements include written contract (not applicable to ERISA plans), various disclosures, adoption of anti-conflict policies and procedures and compliance with the impartial conduct standards
Impartial Conduct Standards

The fiduciary must act in the best interests of the plan – i.e., must satisfy the prudent person standard without regard to the financial or other interests of the fiduciary or its affiliates.

The aggregate compensation received by the fiduciary and its affiliates must not be in excess of “reasonable” compensation.
The fiduciary’s statements about the transaction, fees and compensation, material conflicts of interest and any other matters relevant to the plan’s investment decision must not be materially misleading when made.

- Failure to disclose a material conflict of interest is deemed to be a misleading statement.
During June 10 to December 31 transition period, BIC exemption available with fewer conditions

- Advisers must comply with impartial conduct standards
- Level-fee advisors may rely on BIC exemption during transition period if they comply with impartial conduct standards

During transition period, DOL will not pursue claims against fiduciaries “who are working diligently and in good faith to comply” with the Fiduciary Rule
Implications to Plan Sponsors & Committees

> Fiduciary Rule significant for service providers, lesser impact on plan sponsors and fiduciary committees
  - The rule will not change the committee’s fiduciary status
  - The rule may change the fiduciary status of certain plan service providers – now must provide their services taking into account the best interest of the participants

> Many common services provided by investment advisors are now fiduciary activities
  - New 408(b)(2) disclosures may be required, updates to service agreements, assessment of reasonableness of compensation
Implications to Plan Sponsors & Committees (cont’d)

> Changes to Products Offered by Advisers
  - Service providers may be making changes to their services offered and the impact on participants, including possible changes in pricing
  - Advisers may move to zero revenue-sharing fund offerings

> Impact on Rollovers and Distributions
  - Recommendation regarding whether to take a rollover or distribution is now considered fiduciary advice
Fee Lawsuits – Where are they now?

> Fee lawsuits have become a frequent occurrence in the past few years

> Plaintiffs’ firms are “investigating” 401(k) plans with a view toward filing class action lawsuits

  • They are taking out advertisements in local newspapers that convey the idea to employees that their 401(k) provider might be charging excessive and hidden fees

  • They are targeting potential plaintiffs using social media
Tactics of Plaintiff’s Law Firms

> Plaintiffs’ law firms have amassed a war chest from contingency fees and now seem to have their cases (and settlements) down pat

> Discovery from prior cases has given Plaintiffs’ law firms knowledge of industry practices
Tactics of Plaintiff’s Law Firms

> How They Work

- Plan administrator receives letter from law firm representing a participant
- Letter requests that the plan administrator produce documents relating to the plan within 30-days or face $110/day penalty pursuant to ERISA 104(b)(4)

> Large plans have been targeted so far mid-size and smaller plans are likely next

- Other plaintiff’s firms are seeing success of Schlicter firm
Issues plaintiff attorneys are raising in these cases include:

> No formal RFP for recordkeeping for many years (and even the suggestion that a 3 year standard is appropriate)

> Revenue sharing:
  - Revenue sharing amounts too high/plan didn’t offer least expensive share class
  - Revenue sharing amounts used to benefit employer/other plan

> Committee didn’t consider offering non-mutual fund option (i.e., separate accounts and collective trusts in same investment class, but at lower expense)
Issues plaintiff attorneys are raising in these cases include:

> Committee imprudently retained poorly performing funds
  • Consistently underperformed benchmarks
  • Fees too high in investment options – higher than comparable investments
  • Plan lost money by investing in target date funds offered by recordkeeper (as compared to other target fund families)

> Administrative expenses paid to recordkeeper were based on percentage of assets (resulting in uncapped fees that are not reasonable)

> Use of actively managed investment options not appropriate/too expensive
Issues plaintiff attorneys are raising in these cases include:

- Internal plan fiduciaries (including committees) were not properly monitored
- Written plan documents (plan, IPS, charter, etc.) were not followed
- Committee failed to monitor all sources of income to recordkeeper
  - Recordkeeper benefited from “float” interest
  - Also consider short-term trading fees, finders fees, fees for investment advice, etc.
Best Practices to Mitigate Risk and Limit Fiduciary Liability

> Establish and follow a prudent process:

- Gather relevant information
- Analyze the information
- Make a decision based on the information and the analysis
- Employ consultants to assist you when necessary and rely on their advice
- Make sure fiduciaries are familiar with plan documents
- Be consistent in interpretation and application of plan provisions
Best Practices to Mitigate Risk and Limit Fiduciary Liability

- **Documentation** of the fiduciary process is probably the single most important factor in minimizing potential liability
  - Use charters or written “policies and procedures” to confirm responsibilities
  - Meeting minutes and other materials should clearly describe the prudent, deliberative process followed in reaching decisions
  - Maintain formality as to actual votes taken
  - Specifically note advice received from third party experts and the fiduciary’s reliance upon it
  - Use minutes as the basis for summary reports to the Board
Best Practices to Mitigate Risk and Limit Fiduciary Liability

- Hold regular committee meetings and maintain a heavy focus on procedure
  - Committee should meet at least semi-annually, and otherwise as necessary
  - Distribute materials well in advance of meetings
  - Hear reports from the committee’s experts (e.g., investment and legal advisors)
  - Process for taking, approving and maintaining meeting minutes is essential
  - Make decisions by majority vote
  - Designate whether decisions are fiduciary or settlor functions on agenda
  - Make sure all committee members are engaged in the role
  - Update Board at reasonable intervals
Best Practices to Mitigate Risk and Limit Fiduciary Liability

> Ensure prudent selection and monitoring of service providers
  - Monitor performance of all service providers on an ongoing basis
  - Review service provider contracts to ensure they contain clear terms and commercially reasonable terms
  - Ensure that all fees paid by the plan are reasonable, relying on independent advisor’s input with respect to industry norms, etc.
> Ensure prudent selection and monitoring of investment options

- Implement an appropriate Investment Policy Statement – review and update, if necessary
  - Although not specifically required by ERISA, an IPS does help insure that the fiduciaries make prudent investment policy decisions – such as what criteria to use for investments

- Engage an independent investment advisor and follow the advice of your independent advisor unless there is a clear (and clearly documented) reason for not doing so

- Evaluate the reasonableness of fees
Rose Ann Abraham

- Fiduciary responsibility and internal controls
- Merger & acquisition - Challenges & best practices
  - Financial statement controls
  - Plan operations controls
Fiduciary Responsibility & Internal Controls

Why an emphasis on internal controls?

> Plan can be designed in accordance with ERISA but may not be operating based on the terms of plan document

> Plans are heavily regulated and the monetary impact of compliance violations can be substantial

> Design and implementation of controls ensures compliance with rules and regulations mitigating risk of non-compliance

> Fiduciaries can be prosecuted in criminal as well as civil court
Mergers & Acquisitions – Challenges & Best Practices

> Financial statement controls

- Review of financial transactions during and after the merger
  - Asset transfer review and reconciliation
  - Contribution review and reconciliation
  - Review of asset type and potential valuation issues
  - Asset liquidation restrictions

- Those charged with governance still responsible for oversight
  - Obtain trustee/custodian transfer documentation
  - Designate individual with financial knowledge and expertise to review plan transactions
  - Review contracts for lock up periods or other restrictions
Mergers & Acquisitions – Challenges & Best Practices

> Plan operations controls
  - Fiduciary issues or compliance issues in predecessor plans can be challenging to identify
  - Controls, or lack thereof can be an indicator of potential issues
  - Common areas for compliance error
    o Definition of compensation
    o Untimely remittance of contributions
    o Reconciliation of contribution transmissions to trustee
    o Improper loan and hardship distributions
Mergers & Acquisitions – Challenges & Best Practices

> Plan operations control (contd.)
  - Data availability and HRIS capabilities
    o Audits require participant level data as well as plan level data
    o Differing systems for HR and Payroll
    o Paper files
    o Incomplete data
    o Transfer of data Plan documents
  - Plan administration
    o Plan oversight committee
    o Compliance errors in the past
    o Open regulatory investigations

> Review plan documents, minutes, communications from auditors
> Understand data requests for audits and compliance purposes and tailor transition accordingly
Questions?