SUPREME COURT HOLDS PLAN FIDUCIARIES HAVE CONTINUING DUTY TO MONITOR ALL INVESTMENT OPTIONS, NOT MERELY OFFER A ‘DIVERSE MENU’

In only the third excessive fee case to go before the Supreme Court, on January 24, 2022, the Court clarified in Hughes v. Northwestern University that an ERISA fiduciary’s duty to monitor includes all plan investments and removal of imprudent options in a reasonable time period.

Hughes was one of a dozen excessive fee lawsuits filed in 2016 against prominent universities’ 403(b) plans in which participants claimed their defined contribution (DC) plans held underperforming, high-cost investments, expensive administrative fees, and too many investment options, resulting in duplicate options in every major asset class and investment style, ultimately leading to “decision paralysis” for plan participants.

Northwestern’s two plans had a total of 429 investment options and two recordkeepers. Other university defendants had similar plan features: Vanderbilt, 340-plus investments and four recordkeepers; Cornell, 600 options in its two plans; and Johns Hopkins, 440-plus along with five recordkeepers. The St. Louis law firm that brought the cases, Schlichter Bogard & Denton LLP, cited a 2014 Callan study that DC plans on average offered only 15 investments in the lineup.

According to the Court, three alleged violations of the fiduciary duty of prudence were at issue on appeal: whether a plausible claim could survive a motion to dismiss for (1) failure by plan fiduciaries to monitor and control recordkeeping fees; (2) offering higher-cost retail share classes when identical institutional shares were available; and (3) offering too many investments that led to confusion and poor investment decisions by participants.
The Supreme Court remanded the case back to the 7th Circuit for further review, which it said had erred by relying on the fact that the university plans offered “an adequate array of choices,” including “the types of funds plaintiffs wanted (low-cost index funds).”

The Court also said the 7th Circuit did not apply its reasoning in *Tibble v. Edison*, in which the high court held that under the common law of trusts, ERISA fiduciaries have a continuing duty to monitor and remove imprudent trust investments. Instead, the 7th Circuit relied on “choice” that allowed plan fiduciaries to put together “an adequate array of investment choices,” but failed to result in an independent evaluation by fiduciaries of each option.

The Court’s opinion in *Hughes* was closely watched by legal experts to see if a decision favoring plan fiduciaries would dampen the steady wave of class-action suits that have been filed in recent years. Instead, the Court’s decision ended up being welcomed by the plaintiffs’ bar and appears likely to keep the door open to even more excessive fee complaints that have bedeviled the plan industry.

Jerry Schlichter, founding and managing partner of Schlichter Bogard, called the *Hughes* decision a victory. He said the Court’s opinion in *Hughes* reaffirms existing law, “which is that fiduciaries and these plans must monitor every fund in the plan and remove those that are imprudent.”

Although it’s too early to tell, according to the *Bloomberg Law* database, in January 2021 five excessive fee cases were filed in federal courts for a total of 47 that year, while seven have been filed year-to-date (as of January 26, 2022).

The dozens of cases still pending or paused while awaiting the decision in *Hughes* also are likely to have better odds of surviving the critical motion-to-dismiss stage of litigation. Before *Hughes*, about one-third of cases were dismissed or voluntarily withdrawn. Just one day after the *Hughes* decision, a district judge cited the Court’s ruling in denying dismissal of an ERISA class action against a Georgia hospital system’s $183 million 401(k) plan. More courts are likely to follow this approach.

As such, it appears the wave of ERISA complaints will continue unabated, and may even increase. In addition, the days of 400-plus investment options and several recordkeepers for university plans are over. During the six-year interim after the first university lawsuits were filed, many have settled out of court and most have made extensive changes to their investment lineups, even while litigation was ongoing.

Although the university plans were unusually large and complex, it is likely many plan advisors will increasingly review their plans for redundancy and eventually trim the total number in the lineup. In addition, the move to replace retail share classes with institutional where available is likely to continue; the use of more expensive share classes in retail client portfolios also an examination concern of the U.S. Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA).
THE WRAP-UP

Speaking of ERISA, novel theories continue to be tested in federal courts related to excessive fee claims. One of these is a pending lawsuit against John Hancock Life Insurance Co. for allegedly pocketing more than $100 million in foreign tax credits that belong to the 401(k) plans holding the company’s variable annuity contracts. A magistrate judge approved class certification in January. In another recently filed ERISA class action—actually refiled after being dismissed a year earlier for not exhausting internal administrative appeals—plaintiffs are now alleging not just failure to monitor the plan’s investment lineup, a common claim, but also for failure to monitor the plan’s pension advisors who they alleged were not affiliated with the firm they claimed to represent and had a history of disciplinary issues.

Retirement plan legislation is still on hold in Congress. Insiders say bipartisan bills pending on the Senate side are awaiting votes in the Senate Finance and Health, Education, Labor and Pension committees. Tax and pension committees on the House side are working closely with their Senate colleagues to see if a final bill—dubbed SECURE Act 2.0—can be attached sometime later this spring to another must-pass legislative vehicle in order to avoid—in part—any holds by individual Senators. Both House and Senate versions include numerous, overlapping provisions that would encourage plan adoptions by small businesses, promote retirement savings, extend the required minimum distribution age from 72 to 75, and add penalty-free fixes to minor administrative errors by plan sponsors.

The Department of Labor (DOL) is putting the kibosh on investing in crypto currencies in 401(k)-type plans for the time being—not even via brokerage windows—according to recent insider reports. The pension arm of the agency—the Employee Benefits Security Administration (EBSA)—also threw cold water on the use of private equity as a component of a managed fund in DC plans. The December 2021 guidance does not outright prohibit private equity but clarifies that an earlier letter by the Trump administration “did not endorse or recommend such investments.” Rather fiduciaries are still obligated to “engage in an objective, thorough, and analytical process,” particularly when considered by small retirement plans.

So-called model portfolios sold as one-stop solutions by asset managers to third-party financial advisors for their retail clients are rife with conflicts, according to an academic paper published late last year. The authors conclude the model providers recommend their affiliated exchange-traded funds (ETFs) more often, which tend to have higher fees and lower performance than unaffiliated ETFs.

BlackRock Chief Executive Officer Larry Fink can’t win for losing the environmental, social, and governance (ESG) debate in supporting sustainable business practices, with critics from both sides pouncing. “Stakeholder capitalism is not about politics,” Fink wrote in an annual investment letter. “It is not a social or ideological agenda. It is not ‘woke.’” Both the left and right aren’t happy, though. The left complains that BlackRock and other financial institutions aren’t putting enough pressure on the companies they invest in, and the right—basically some U.S. states—are saying they won’t do business with investment managers that avoid portfolio investments in oil, gas, private prisons, and other non-ESG companies.

Now that state legislatures are back in session, new auto-individual retirement account (IRA) bills have been introduced in at least five states, including Arizona, Mississippi, Missouri, Rhode Island, and Virginia. Programs have been adopted in 14 states and two cities, with only a handful fully operational.
The auto-IRA programs are intended to help workers in small businesses without retirement plans. The state typically takes fiduciary responsibility for the assets, hires a professional money manager that often includes target-date funds in the lineup, exempts companies with ERISA plans, and allows workers to opt out.

A lot is going on at the SEC these days as Chair Gary Gensler is considering an expansion of the Commission's cybersecurity rules. This could include a change in the time to disclose after a data breach for investment companies, advisory firms, and brokerages.

Wealth managers and other advisors should stay tuned for what are likely to be a few surprises in 2022 coming out of both the DOL and the SEC.

ABOUT WASHINGTON INSIGHTS

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