Welcome to the September issue of Investments & Wealth Institute’s Washington Insights. This month’s column reviews a series of class actions filed a year ago for alleged violations of the Employee Retirement Income Security Act (ERISA) against retirement plan fiduciaries holding low-cost BlackRock target-date funds (TDFs). The complaints are a marked departure from excessive fees claims in recent years by focusing solely on claims of underperformance. Washington Insights also provides a brief wrap-up of other public policy topics of interest to wealth and institutional managers.

Score is 3–0 for Plan Fiduciaries as Courts Reject Benchmarks

Last summer this column examined a series of 11 novel ERISA complaints, filed within a three-week period by the New York-based law firm Miller Shah LLP, against large, mostly billion-dollar retirement plans. The lawsuits alleged underperformance in a series of low-cost BlackRock TDFs. Although underperformance claims are common, in this instance plaintiffs alleged the BlackRock LifePath Index Funds were selected solely for their low fees, ignoring better-performing and “readily available” options, a choice that resulted in millions of dollars in lost returns.

One year later, the cohort is struggling to gain traction with a legal theory asserting that four of the largest TDF series available to retirement plans—American Funds Target Date Retirement, Fidelity Freedom Index, T. Rowe Price Retirement, and Vanguard Target Retirement—were an ideal group for comparing investment performance to the BlackRock funds in the absence of a widely accepted TDF benchmark.

The lawsuits also have garnered considerable attention in the ERISA space due to the size of the plan sponsors. The defendants include well-known U.S. companies such as Stanley Black & Decker, Citigroup, Cisco Systems, Capital One, and Microsoft. BlackRock, the largest asset manager in the world, isn’t named as a defendant in any of the lawsuits.

As of mid-August, the score is 3–0 for defendants (subscription-only) with at least several other cases appearing to be on life support. Three cases were closed this past spring¹ and the remaining eight still are struggling to move past the initial motion-to-dismiss pleading stage. Of the remainder, four were already dismissed once but granted leave to file amended complaints. The other four are still exchanging briefs with defendants. Defendants, in turn, are asserting failure to state a claim, or a fiduciary breach of ERISA’s duty of prudence. Courts to-date, including those that are willing to entertain amended
complaints after dismissing the original lawsuits, generally have concluded that the comparator TDFs are not meaningful benchmarks.

One of the main challenges that have stymied plaintiffs is the difficulty in finding industry consensus on an “appropriate index” for TDFs. As financial advisors in the ERISA space know well, all TDFs inherently are actively managed funds because they inevitably progress to a more-conservative mix of assets over time and are dependent on whether the TDF goes “to” a specific retirement date or takes a “through” retirement approach and continues to change the asset allocations. Adding complexity are the TDF series that contain actively managed underlying funds while others rely solely on index funds, such as the BlackRock series.

A typical reception of the courts is provided in Luckett v. Wintrust Financial Corp. et al. Illinois District Judge Mary M. Rowland dismissed the first complaint in mid-July, noting that two of the comparator TDFs—American Funds and T. Rowe—were actively managed whereas BlackRock was passively managed. Moreover, the two other comparator funds—Fidelity Freedom and Vanguard—had “through retirement” investment strategies whereas BlackRock was a “to retirement” strategy.

Judge Rowland concluded that at the initial pleading stage, Luckett must provide “a sound basis for comparison—a meaningful benchmark.” She added that courts do not “infer imprudence every time a fiduciary retains a fund that fails to turn in best-in-class performance for any specific period,” and that even if the plaintiff’s allegations are taken as true, the lawsuit fails “to take a claim of fiduciary duty violation from the realm of ‘possibility’ to ‘plausibility,’” the basic minimum threshold for denying a motion to dismiss. However, she allowed plaintiffs to file an amended complaint by August 2, which remains pending.

The Wintrust opinion was similar to the previous court decisions in Booz Allen, Capital One, and Microsoft. In Booz Allen, the court rejected the plaintiff’s amended motion that added two new comparators, the S&P Target Date indexes and the Sharpe ratio. The court stated that the original complaint “lacks facts showing that the TDFs shared the same investment strategy, investment style, risk profile, or asset allocation,” concluding that the differences between the BlackRock TDFs and the comparators “is fatally defective in plausibly stating a claim.”

The court also noted that the amended complaint did not remedy this problem because it was silent on the use of “to” or “through” glidepaths in the comparators, whether the comparator TDFs invested only in actively managed or passively managed funds, and how the comparators’ underlying asset mixes were meaningful comparators to the BlackRock TDFs. Nor was the Sharpe ratio helpful because “Sharpe ratios are not magic wands that equalize any two investments as meaningful benchmarks in the first place.”

Finally, in Microsoft, the district court also rejected the new metrics—S&P Target Date indexes and Sharpe ratio—for the same reasoning, noting that in its previous rejection of the lawsuit “courts across the country have rejected claims for breach of the fiduciary duty of prudence under ERISA where the plaintiffs allege nothing more than underperformance relative to other investment vehicles.”

With the remaining eight cases still active, the stakes are high. TDFs are expected to hold more than half of all retirement plan assets within a few years, including the nearly nine in 10 401(k) plans that have adopted TDFs as the default investment option. The BlackRock complaints emphasized this point. BlackRock TDFs were default investments, ranging from 17 percent to 76 percent of total plan assets in the 11 plans, averaging 32 percent of total assets.
In summary, it should be noted that courts do not operate in a vacuum. With similar pleadings filed in each complaint, the courts no doubt will look at those earlier decisions.

The Miller Shah plaintiffs and their experts undoubtedly are going to have to dig deeper in their analysis to come up with a meaningful benchmark in an area of the industry without consensus on what that means, let alone the courts.

As noted on Miller Shah’s website, class actions in which the firm was involved can take as few as six months to six years to resolve, with the typical class action taking two to three years. Given that the ERISA class actions are exceedingly complex, it cannot be positive news when three of the cases closed in little more than six months.

THE WRAP-UP

ESG

SIFMA files legal challenge against Missouri ESG restrictions. The Securities Industry and Financial Markets Association (SIFMA), Wall Street’s major trade group, sued the state of Missouri on August 10 for adopting new restrictions that would require federal and state-regulated brokerage and investment advisory firms to obtain a client’s written consent prior to considering environmental, social, and governance (ESG) investing strategies. In addition to conflicting with preemptive federal laws that prohibit states from regulating federally registered firms, SIFMA asserted that the new rules “are incompatible with the best interest obligations of investment firms and professionals.”

The new rules also require firms to provide clients with “state-scripted” documents and to secure new client signatures acknowledging receipt every one to three years.

It’s likely that the Missouri Secretary of State, which oversees securities regulation in the state, will argue in court that because the rules come under existing regulations labeled “Dishonest or Unethical Business Practices,” that exceptions for state enforcement against activities involving fraud or deceit of SEC-registered brokerage and advisory firms would cover ESG advice.

ESG funds at issue in American Airlines 401(k) plan not in core lineup. After fighting a lawsuit alleging American Airlines’ plan fiduciaries, through proxy voting, pursued an ESG agenda primarily by “leftist activist groups,” American Airlines responded in an August 4 motion to dismiss (subscription-only) that the pilot who sued, Bryan Spence, never held any of the funds he criticized. Moreover, none of the ESG funds are in the plan’s core lineup, but available exclusively through the plan’s self-directed brokerage window, according to the American Airlines filing.

In his original complaint, Spence argued that global ESG funds have underperformed the “broader market” with an average 6.3-percent return compared to an 8.9-percent return over the past five years, or by more than 250 basis points per year. As such, an ERISA manager must focus solely on pursuing “the highest risk-adjusted financial return possible,” according to the complaint. American Airlines responded in its brief that Spence provided no meaningful benchmark for comparison.
Securities Enforcement

Wall Street firms fined $2.5 billion for failing to keep records of WhatsApp, texts, and emails. Firms including Wells Fargo, BNP Paribas SA, and nine other Wall Street firms were fined $289 million, the Securities and Exchange Commission announced on August 8, following a string of similar cases affecting other major Wall Street firms in recent years. Combined with penalties of $266 million announced by the Commodity Futures Trading Commission, the total amount of fines for recordkeeping failures is $2.5 billion since December 2021.

Rollover Advice

PIMCO survey: Plan sponsors prefer to retain worker assets. A July 26 survey of pension advisors and advisory firms by PIMCO suggests plan sponsors prefer retaining retiree assets in order to maintain 401(k) scale, purchasing power, and potential cost-savings for clients. Advisory firms responded that retaining assets in plans would help them provide former workers with better retirement incomes.

If the survey is evidence of a broader trend, then perhaps the current focus by the Department of Labor on more closely regulating rollover advice may be of less concern in the future.

Research

Differences in retirement account balances between low- and high-income households increased. A newly released report by the Government Accountability Office has found disparities in the number of retirement accounts and account balances widened between 2007 and 2019 based on income and other factors.

The report cites one example in which the share of retirement accounts in low-income households declined from one in five in 2007 to one in 10 by 2019 while there was no detectable difference in percentage of higher-income households with retirement accounts during the same time period. The low-income group was defined as having a median income of about $19,100 and the high-income group with a median income of about $282,000. The median account balances also increased substantially for the highest-income households, from $333,000 in 2007 to $605,000 in 2019.

Tax Planning

Inherited IRA beneficiaries get reprieve for third year. Beneficiaries of inherited IRAs got a break for the third straight year from the Internal Revenue Service (IRS). Helping the IRS reach that decision was last year’s congressional passage of SECURE Act 2.0, which increased the required minimum distribution (RMD) age to 73 in 2023. The recent IRS notice now waives penalties for RMDs missed in 2023 from inherited IRAs (in which the decedent already was subject to RMDs), similar to previous relief for missed RMDs from inherited IRAs in 2021 and 2022.
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If you have questions after reading this update, please contact the Institute’s general counsel, Robert (Rob) Frankel at rfrankel@i-w.org.

ENDNOTE

1. The three complaints closed were Tullgren v. Booz Allen Hamilton, Hall v. Capital One Fin. Corp., and Beldock v. Microsoft. The Booz Allen and Capital One cases were appealed to the 4th Circuit Court of Appeals but voluntarily withdrawn.