

LEGAL UPDATE

Intel Class Action Opens New Frontier in 401(k) Litigation

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There has been a surge in 401(k) fee litigation over the last decade, but a recently filed class action lawsuit by a former employee against Intel Corporation and its 401(k) and profit sharing plans seeks to improve returns and

reduce expenses by significantly restricting the range of assets in which a 401(k) plan may invest. The reasonableness of the Intel plans' investment fees is one of the many fiduciary issues raised in the new Intel case, but the core issue is whether

the plan's investment options should include exposures to alternative asset classes. Specifically, the Intel plans offered customized model portfolios that included a target date strategy, as well as a balanced strategy. These model portfolios provided exposures to various asset classes, including alternative investments, that is, hedge funds and private equity. The participant complaint alleges that the alternative investment allocations were too high and that they were determined imprudently by the plan fiduciaries.

Customized Portfolios Incorporating Alternative Investments

The legal claims made in the Intel complaint are complicated, but in a word, the plaintiff is second-guessing the fiduciary committee's strategic asset allocation decisions for the plans' customized model portfolios. These custom portfolios featured target date and balanced investment strategies, and they used the plan's existing menu options as underlying investments. The plan menu included a wide range of investment options, including hedge fund and private equity investment alternatives, which participants could select for their plan accounts. The plans' custom portfolios incorporated these hedge fund and private equity investments from the plan menu to give participants who selected the portfolios as a plan investment substantial exposure to the alternative investments.

The complaint alleges that the target date and balanced portfolios both underperformed in relation to selected benchmarks and had an excessively high cost as a result of its heavy allocation to alternative investments. The complaint also alleges that plan participants never received sufficient disclosures concerning the plan menu's private equity and hedge fund investment options.

To appreciate the nature of the fiduciary allegations being made in the Intel case, it should be understood that the Intel plans are very large and cover over 60,000 participants. The 401(k) plan features automatic enrollment for new participants, and the target date model portfolio is the default investment under the plan. As a result this feature, roughly 40 percent of the 401(k) plan participants are invested exclusively in the target date portfolio. The balanced model portfolio is the primary investment strategy under the profit sharing plan and, and because of that plan's history and design, about 90 percent of its participants are invested in the balanced portfolio.

The factual allegations of the Intel complaint focus on the target date portfolio, the alternative investment allocation of which increased to over 20 percent in 2011. Allegedly as a result of this high allocation, the portfolio underperformed by roughly 4 percent during 2013, in comparison to the Morningstar category for target date funds. In addition to causing the target date portfolio to underperform, the

alternative investments also caused the target date portfolio's annual fees to increase from roughly 70 basis points to over 130 basis points, a figure over eight times the annual fee for Fidelity's index-based target date fund.

ERISA Duties

Plan fiduciaries have a duty of prudence under ERISA, which requires both procedural and substantive prudence. Procedural prudence goes to whether the fiduciary has performed the necessary due diligence and gathered all relevant information before making investment decisions. Substantive prudence goes to whether the fiduciary decisionmaker has the necessary investment expertise. If a plan fiduciary does not have the required investment skills, it must consult an investment expert.

The DOL has issued regulatory guidance on how fiduciary decisionmakers must give "appropriate consideration" to all relevant factors. Such factors include the role of the proposed investment in the plan's portfolio, the risk of loss and opportunity for gain, portfolio diversification, as well as the plan investor's liquidity and cash flow needs. These rules are consistent with modern portfolio theory, which has also been embraced by the courts. Instead of looking at a proposed investment in isolation to determine whether it is prudent, the courts will look at its relationship to the overall portfolio. Thus, a high yield, high risk investment may be viewed by a court as an investment that improves portfolio diversification and reduces overall risk for the plan investor, even if it loses money.

There are several other important investment duties under ERISA that are closely related to the fiduciary duty of prudence. First, there is the duty to diversify which requires a fiduciary to choose investments so as to minimize the risk of large investment losses. Second, plan fiduciaries have a duty to ensure that the plan's investment fees are reasonable in light of the investment services provided. Finally, there is the duty to provide sufficient information to participants regarding their investment options under the plan, as set forth in DOL regulations. Courts will typically look at all of these duties together, to determine whether the plan's fiduciaries are acting in accordance with the fiduciary standard of care under ERISA.

Institutional pension plans routinely include a sizable allocation to alternative investments. Although defined benefit plans are different from participant-directed 401(k) plans in that the participants are responsible for deciding the investment allocations for their individual plan accounts, the same fiduciary duties apply. In accordance with the duty of prudence, the plan fiduciary must choose menu options with procedural and substantive prudence. In accordance with the duty to diversify, the menu must include a broad range of options, giving participants the opportunity to minimize the

risk of large losses. And, in accordance with ERISA's fee-related duties, the investment options must have reasonable fees.

Does ERISA Require Plain Vanilla Investment Options?

ERISA does not expressly prohibit a plan fiduciary from including alternative investment options in the plan's menu. All menu options must be selected for the benefit of the plan's participants, but nothing in ERISA requires "dumbing down" the plan menu so that it only includes "plain vanilla" investment options. In fact, in order to satisfy the duty to diversify, it would be beneficial for plan fiduciaries to consider including alternative investment options. Even in the Intel lawsuit, the plaintiff is not taking issue with the fact that the plan investment menu included hedge fund and private equity investment options. The plaintiff is taking issue with the fact that the plan's customized model portfolios included alternative investment allocations.

Many defined contribution plans offer model portfolios as an investment solution for participants, and, therefore, based on the general principles discussed above, it should be permissible for a defined contribution plan fiduciary to construct a model portfolio that features alternative investment allocations. The complaint in the Intel lawsuit seems to anticipate this legal hurdle for their case. In the complaint, the plaintiff argues that plan fiduciaries "must focus always on the most vulnerable participant" and "protect the average employee." It goes on to state that alternative investments are highly risky and that they are unsuitable for plan participants. It is unclear whether a court will approve this new legal theory, particularly in light of the fact that alternative investments are acceptable in defined benefit plans.

Potential Liability under Traditional ERISA Theories

Even if the court disagrees with the plaintiff's untested legal theory, it could still find that a fiduciary breach occurred

if it turned out that Intel's fiduciary committee acted imprudently when it decided to allocate assets in the plans' model portfolios to alternative investments. This will require an examination of whether the plan committee observed proper fiduciary practices by conforming with any written guidelines for asset allocations used in the plans' model portfolios and whether it met and reviewed the model portfolios on a regular basis. Both are important from a procedural prudence standpoint.

For purposes of the committee's substantive prudence, whether the committee consulted with an investment expert and examined investment analytics or reports demonstrating that the alternative investments improved diversification and helped manage risk within the model portfolios will be relevant. The committee may also be required to show that it conducted a fee benchmarking analysis for the model portfolios, as well as the alternative investment options in the plan menu, in accordance with its fee-related duties under ERISA.

The Intel lawsuit raises a number of interesting policy concerns, including the threshold question of whether alternative investment options should be included in a defined contribution plan's investment menu, as well as the further question of whether alternative investments should be included in a plan's target date or other risk-based investment option. With regard to the plan menu, the duty to diversify argues in favor of allowing alternative investment options, which can help participants diversify their plan accounts. With regard to the issue of whether alternative investments should be used in target date or other risk-based investment solutions, the matter is ultimately a question of whether alternative investments can help improve the retirement outcomes for participants. This question should be answered by investment experts, not the courts.

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