Benefits Briefing: Company Stock Oversight

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Today’s Speakers

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Company Stock Oversight

July 29, 2020
Options for Plan Sponsors

In discussions with many plan sponsors, including SSGA clients and prospects, various options have been discussed, including the following:

• Sunset the stock fund
• Adding limits – freeze fund to new investment or impose cap on % invested in stock
• Status quo – fund remains open
• Change internal procedures and/or committee composition
• Appoint an independent fiduciary
• A combination of the above

- Each option raises different considerations and may have both settlor and fiduciary implications.
- All options require a diligent process and a prudent and well-planned implementation.

Source: State Street Global Advisors.
Current Trends in Company Stock

Sponsors have continued to evaluate company stock and opportunities to reduce risk.

**Sponsors Removing Company Stock**

<table>
<thead>
<tr>
<th>Year</th>
<th>% of Participants in Large Plans* that Offer Company Stock</th>
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<tr>
<td>2006</td>
<td>69%</td>
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<tr>
<td>2016</td>
<td>49%</td>
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* Large Plans: Plans > 5,000 participants

**Participant Limits**

22% of Callan survey respondents affirming that they cap contributions to, or percent invested in, company stock.

Source: Callan DC Trends Survey, 2020

**Independent Fiduciary**

Callan reports an increase in the percentage of plans outsourcing oversight (37% in 2019 vs. 21% in 2018), and SSGA continues to see strong interest in the broader market.

Source: Callan DC Trends Survey, 2020

14 companies hired SSGA as their independent fiduciary in the last three years.

Source: State Street Independent Fiduciary Team
Independent Fiduciary Services

Why use an independent fiduciary for company stock in a defined contribution plan?
• May eliminate potential conflicts for internal plan fiduciaries
• Provides fiduciary oversight from an experienced provider

What services can an independent fiduciary provide for company stock in defined contribution plans?
• Ongoing investment oversight to monitor the stock and ensure that it remains a prudent investment consistent with ERISA
• Develop or review participant communications
• Establish liquidity level and perform appropriate monitoring
• Implement and oversee trading to support plan activity
• Review of trading results
• Fiduciary oversight for proxy voting
• Comprehensive reporting to plan sponsor
• Independent fiduciary role can be as investment manager (ERISA § 3(38)) and/or independent fiduciary (ERISA § 3(21))

Source: State Street Global Advisors.
SSGA’s Investment Oversight Process

Daily & Weekly Review
- Monitor relevant news and perform additional due diligence as necessary
- Review stock price and trading volumes
- Benchmark the stock return to an appropriate comparable industry index
- If stock return for any four week period, measured at the end of each week, deviates from the index benchmark by more than -10% or +20% three out of four weeks in any rolling four week period, the stock is presented to the Stock Review Team
- The benchmark deviation report is delivered weekly to members of the Stock Review Team
- Discussions with Senior Fiduciary Officer and Portfolio Manager, if necessary

Monthly Review/ Stock Review Team
- Senior members of team meet monthly and ad hoc as necessary to:
  - Review all stocks which returns for any four week period, measured at the end of each week, deviated from the index benchmark by more than -10% or +20% three out of four weeks in any rolling four week period
  - Receive ad hoc reporting on any material issues with any stock
  - Identify and review companies for heightened monitoring and due diligence
  - Receive report on and discuss all stocks on Stock Review List

Quarterly Review
- All stocks on Stock Review List are reported to the Independent Fiduciary Committee
- Stocks with non-investment grade credit ratings (excluding stocks already on Stock Review List) are reported to Stock Review Team
- Review and confirm liquidity target recommendations, if applicable
- If applicable, State Street Global Markets reports to the Independent Fiduciary Committee on trading performance

Annual Review
- The financial fundamentals of every stock are reviewed and reported to Stock Review Team and Independent Fiduciary Committee
- Review all benchmarks and report on appropriateness and any recommended changes to the Stock Review Team
- Reporting to the Global Fiduciary Committee and Investment Strategy Review Committee annually

Source: State Street Global Advisors.
Practical Steps to Consider

- Review all plan documentation
  - Who has fiduciary authority for determining whether stock and stock fund is not imprudent?
  - Is the language requiring the offering of a stock fund mandated (hardwired) within the plan document? Is this still helpful?
- If company stock will continue to be offered, create or enhance a well-documented oversight process for monitoring investment and determining whether offering company stock is not imprudent
- If internal fiduciaries have responsibility for fiduciary oversight of the stock and stock fund within the plan, develop an internal process regarding access to inside information and identifying “special circumstances”
- Document all fiduciary decisions made with respect to the stock and the stock fund. This will be critical in establishing the existence of a prudent process and well-reasoned decisions
- If you currently have or plan to retain an investment manager or independent fiduciary, devote time on a regular basis to meet for purposes of understanding their oversight process and to monitor whether they are performing in accordance with agreements

Source: State Street Global Advisors.
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ERISA Stock Drop Litigation

Recent Developments & Strategy Considerations

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Overview

• In 2014, the Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer* dismantled the longstanding legal principle that retirement plan investments in the employer’s stock are presumptively prudent.

• But the Court also established a new test, holding that, because the market price is the best estimate of a stock’s value, allegations that a fiduciary should have recognized from publicly available information that the market over- or undervalued stock are “implausible as a general rule, at least in the absence of special circumstances”

  – Lower courts have suggested that fact patterns that may qualify as “special circumstances” include the existence of illicit forces (e.g., fraud, improper accounting) and inefficiencies in the market.

• The Court further held that, to plead a plausible imprudence claim based on “inside” information, a plaintiff must allege an alternative action that a fiduciary could have taken that would have been consistent with the securities laws, and that a prudent fiduciary would not have viewed as likely to do “more harm than good” to the stock price.
Case Outcomes

• Following *Dudenhoeffer*, courts have generally imposed a stringent pleading standard and dismissed these types of stock drop cases
  
  – *Coburn v. Evercore Trust Co.*, 844 F.3d 965 (D.C. Cir. 2016)

  • **Background:** Plaintiff claimed that Defendant breached its duty of prudence by failing to prevent plan participants from purchasing or holding J.C. Penney Corporation, Inc. stock in their retirement plans after the stock price “tumbled” between 2012 and 2013

  • **Holding:** The D.C. Circuit affirmed dismissal due to Plaintiff’s failure to allege any “special circumstances”
Case Outcomes

• There were some exceptions where courts denied a motion to dismiss
    • **Background:** Plaintiffs claimed that plan fiduciaries imprudently continued to invest in Kodak stock “even after it became obvious that Kodak was headed for bankruptcy”
    • **Holding:** The court distinguished *Dudenhoeffer* from Plaintiffs’ “allegations that a company’s downward path was so obvious and unstoppable that, regardless of whether the market was ‘correctly’ valuing the stock, the fiduciaries should have halted or disallowed further investment”
    • **Settlement:** Settled in 2016 for $9.7 million, with the settlement agreement citing *Dudenhoeffer* in noting potential issues regarding the “viability” of the action
    • **Background:** Plaintiffs alleged that Invacare misrepresented its compliance with FDA safety and manufacturing regulations, causing the company’s stock prices to suffer losses
    • **Holding:** Denied motion to dismiss, finding a prudent fiduciary could have concluded that stopping further investment in the stock would not have caused more harm than good
    • **Settlement:** Settled in 2016 for $1.4 million
Case Outcomes

• Examples of cases denying a motion to dismiss (continued)
  
  – *In re SunTrust Banks, Inc. ERISA Litigation, No. 08-CV-3384, 2015 WL 12724074 (N.D. Ga. 2015)*

    • **Background:** Plaintiffs alleged imprudence given information available to fiduciaries. Alternative actions alleged included investing more assets in cash, disclosing the company’s condition, seeking guidance from the DOL, resigning as plan fiduciaries, retaining outside experts as advisors or fiduciaries, or limiting participants on their investments in the fund

    • **Holding:** While dismissing the claims based on public information, the court found it “premature” to dismiss the claims based on non-public information prior to discovery

    • **Settlement:** Settled in 2018 for $4.75 million, with the motion for preliminary approval of the settlement stating that a potential motion for summary judgment “would have been a difficult test for plaintiffs” in light of *Amgen v. Harris* (2016)

• The Second Circuit’s ruling in *Jander v. Retirement Plans Committee of IBM* was a key outlier to the post-*Amgen v. Harris* (2016) pattern of courts granting dismissals
Jander v. Retirement Plans Committee of IBM

• Background
  – Plaintiffs allege that Defendants knew or should have known about undisclosed issues in IBM’s microelectronic business that led to an overvaluation of company stock, and that Defendants should have issued a corrective disclosure

• Case No. 15-CV-3781, 272 F. Supp. 3d 444 (S.D.N.Y. 2017)
  – Applying Dudenhoeffer, the court granted dismissal, finding that Plaintiffs failed to establish that disclosure would have cleared the “more harm than good” standard

• Case No. 17-3518, 910 F. 3d 620 (2d Cir. 2018)
  – Reversing, the Second Circuit determined that Plaintiffs plausibly allege that disclosure of the truth was “inevitable” and a prudent fiduciary should have concluded a corrective disclosure would benefit participants more than silence
Jander v. Retirement Plans Committee of IBM

- Case No. 18-1165, 140 S. Ct. 592 (2020)
  - The Supreme Court unanimously remanded case to the Second Circuit to decide what it perceived as a new argument: whether fiduciaries have an obligation to act on inside information
    - Justice Kagan suggested that IBM waived arguments on this question by not previously raising the issue
  - The Supreme Court did not answer question presented: What does a plaintiff need to allege to survive a motion to dismiss in an ERISA stock-drop action?

- On June 22, 2020, the Second Circuit remanded to the district court for further proceedings consistent with its original opinion
Other Recent Notable Cases

• Courts have distinguished *IBM* and generally continued to dismiss stock drop lawsuits
  
  – *O’Day v. Chatila*, No. 18-CV-2621 (2d Cir. June 7, 2019)

    • **Background:** Plaintiffs alleged that Defendants continued to offer company shares as an investment option despite having public and nonpublic information on their dire finances

    • **Holding:** Affirmed dismissal because, unlike *IBM*, (1) disclosure of the overvaluation was not inevitable, and (2) Plaintiffs did not show that “early disclosure of fraud would soften the reputational damage” of a later disclosure


    • **Background:** Plaintiff alleged that Defendants should have sought to persuade those responsible for Exxon’s federal securities law disclosures to refrain from making affirmative misrepresentations regarding the value of Exxon’s oil reserves

    • **Holding:** Granted dismissal, finding that the disclosure was not inevitable and that the Fifth Circuit had rejected the *IBM* argument that the fraud became more damaging over time
Trends in Case Filings

• While stock drop litigation initially declined in number after *Dudenhoeffer*, there has been an uptick in the filing of these types of cases recently

  – **Key Examples**

    - *Kraft Heinz*
    - *Boeing*
    - *Johnson & Johnson*
Strategy Considerations

- Who is on the fiduciary committee and what is each member’s respective knowledge of internal, confidential business developments and considerations?
- What process is in place for the committee to monitor the stock fund? Is it enough to rely on the market if the company trades on an efficient market?
- Does the plan provide for a cap on participants’ company stock holdings?
- Is any match by the plan in company stock? If so, may participants trade out of the stock holdings at any time?
- Is it sufficient to minimize risk by closing the fund to new investments but not divesting the fund altogether?
- What should an employer do about legacy stock holdings?
Questions / Discussion