Knowledge & Insights

MORNEAU SHEPELL

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U.S. class action points to best practices for pension committees

Pension plan fiduciaries involved in plan governance should consider the recent legal decision of a U.S. district court in *Wildman v. American Century Services, LLC ("Wildman")*, as a framework for governance best practices, especially in defined contribution pension plans.[1] In *Wildman*, the plaintiffs claimed that the plan fiduciaries had breached their fiduciary duties of loyalty and prudence under the *Employee Retirement Income Security Act of 1974* ("ERISA").

[1] 362 F. Supp. 3d 685 - Dist. Court, WD Missouri 2019.

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Despite the case falling under U.S. jurisprudence, it can provide Canadian pension plan fiduciaries with practical guidance on meeting their duties and managing potential conflicts of interest.

Introduction

A group of former employees (the "Plaintiffs") brought a class action lawsuit in respect of a defined contribution 401(k) plan that allows participants to contribute a percentage of their pre-tax earnings and invest their contributions into one or more investment options (the "Plan").

The Plan was sponsored by American Century Services ("ACS"). ACS, the employer and Plan sponsor, delegated administration of the Plan to the Retirement Committee (the "Committee"). Committee members were comprised of employees with significant experience in investment products, retirement plans and financial markets. Given that the Committee members had significant experience, senior management did not provide any oversight or review of the Committee's decisions.

The Plaintiffs claimed that ACS, its affiliates and the Committee members (the "Defendants"), breached their fiduciary duties of loyalty and prudence by only offering actively managed funds, by only offering proprietary funds and by causing the Plan to pay high fees. In addition, the Plaintiffs claimed that ACS had breached its duty to monitor the Committee. Lastly, the Plaintiffs argued that the Defendants had engaged in prohibited transactions and self-dealing.

Ultimately, the court ruled in favour of the Defendants. Some of the areas considered by the court are summarized below.

Conflicts of interest

The Plaintiffs argued that the Committee members served as both the employees of the company, and also as fiduciaries, and therefore operated under a conflict of interest which should be inferred as impropriety. The court noted that to serve as a plan fiduciary merely requires the individual to "wear the fiduciary hat when making fiduciary decisions." Ultimately, the mere fact that the Committee members had competing duties was insufficient evidence to show that their decisions were motivated by a desire to place the company's interests over those of the Plan participants.

Selection of proprietary funds

The Plaintiffs claimed that the Defendants only considered the employer's proprietary funds in the Plan, which they argued was evidence of motivation to benefit the company. The court confirmed that it was not disloyal as a matter of law to offer only proprietary funds, and that it was common for financial services companies to offer their own investment funds in their retirement plans.

The evidence demonstrated that Committee members made careful investigations of investment decisions and acted in the best interests of the Plan participants. The Committee believed that the funds were more beneficial to Plan participants, as they had the ability to closely monitor the investments, and could receive direct access to fund managers for consultation. Furthermore, the Committee thoroughly monitored the independent merits of each fund in relation to funds from other asset management companies to determine whether it was a prudent investment and would remain in the lineup.

Failing to offer passively managed funds in the Plan

The Plaintiffs claimed that the Defendants acted imprudently by failing to offer passively managed options. The court found that the Defendants did not act imprudently, and relied on evidence from the Committee which demonstrated that they had given "appropriate consideration" to adding passive options, taking into account the benefits and detriments of adding these funds before deciding not to do so.

Maintaining too many options in the Plan

While the Plan offered a large number of investment options to Plan participants, the court did not find that it was imprudent to do so, given the sophisticated investor base of the Plan participants.

The number of options did not lead to confusion or non-participation in the Plan. In fact, the participation rate was shown to be higher than other plans. Notably, the Committee was regularly receiving and considering information regarding the rate at which its employees were participating in the Plan, to ensure that the number of options in the Plan was not causing confusion among its participants.

Monitoring funds on the watch list

Although the Plaintiffs claimed that certain funds remained on the watch list for many quarters despite their poor performance compared to similar funds, the evidence demonstrated that the Committee followed a prudent process in monitoring and retaining funds in the Plan. The court found that the Committee members did not act imprudently, and relied on evidence that the Committee received and reviewed analysis respecting funds which had been placed on the watch list, and continuously monitored the funds on the watch list to come to a reasoned decision to allow them to remain in the Plan.

Excessive fees

The Plaintiffs argued that the Defendants had acted imprudently by retaining funds with excessive fees in the Plan. However, the court found that the Committee did not act imprudently. The Committee reviewed relevant information to ensure that the fees were reasonable in light of the fund's performance and level of risk.

Comments

The court's decision in the *Wildman* case provides valuable insight into pension plan governance best practices for pension plan fiduciaries responsible for investment monitoring and management.

Pension plan governance refers to the structure and processes in place for the effective administration of the pension plan to ensure the fiduciary and other responsibilities of the plan administrator are met. The following actions of the Committee enabled the Committee and the employer to successfully meet their fiduciary responsibilities and successfully defend against a class action:

- **Providing training and information to new Committee members.** The Committee provided new members with a "Fiduciary Toolkit" which included a copy of the investment policy statement, an outline of the Plan document and information on their fiduciary duties.
- **Receiving advice from experts.** The Committee would regularly invite consultants, lawyers and investment professionals to present at the Committee meetings, in order to share research and information relevant to the Committee's work.
- **Keeping thorough and documented meeting minutes.** The Committee's meeting minutes captured the topic of discussion, who initiated questioning, and the outcome of the vote or the ultimate decision.
- **Meeting on a regular basis.** The Committee met regularly three times a year, and had special meetings on an ad-hoc basis. Each meeting was sufficiently long to fully address each issue on the agenda.
- **Preparing and distributing adequate meeting materials to Committee members.** The Committee assembled and distributed a set of meeting materials for their meetings, which included such items as the investment policy statement, a list of funds on the watch list, a performance report for the investment options in the core lineup, a Plan update regarding the Plan assets, participation rates, and information respecting each fund's fees.

Morneau Shepell's governance experts can assist pension plan administrators in establishing and improving their governance processes, both as a matter of risk management as well as optimizing the pension plan's performance for members.

Saskatchewan court finds that pension plan beneficiary designation could not be altered using will

A recent Saskatchewan court case demonstrates some of the complexities involved in making and changing beneficiary designations in pension plans, particularly when a member attempts to make a beneficiary change using a will or other format not provided for by the pension plan administrator.[1]

Background

Mr. Gerbrandt was a former member of the Saskatchewan Wheat Pool pension plan who died in 2018 before retiring under the pension plan. Mr. Gerbrandt lived in a common law relationship with Ms. Nickel for 15 years, and the couple had three children together. During this relationship, Mr. Gerbrandt designated Ms. Nickel as the beneficiary of his pension plan. However, the couple ended their relationship in 1998. Mr. Gerbrandt did not have a spouse at the time of his death in 2018.

Two days before he passed away, Mr. Gerbradt executed a handwritten will, providing that his daughter from a previous relationship would receive "any money owed to me from all pension plans." Ms. Nickel and the daughter submitted competing claims for Mr. Gerbrandt's pre-retirement death benefits. Ultimately, Ms. Nickel brought an application for directions from the Saskatchewan Court of Queen's Bench as to the entitlement to pre-retirement death benefits.

Court finding and reasons

The court found that, since Mr. Gerbrandt did not use the prescribed form to make the change in "the manner specified in the plan," the designation in his will was not an actual change to the beneficiary. Ms. Nickel remained the designated beneficiary and was entitled to the pre-retirement death benefit.

The pension plan text stated that, "A Member who has made a beneficiary designation may, by written notice to the Company in the form prescribed by the Company, alter or revoke such designation from time to time…" Mr. Gerbrandt did not provide written notice to the Company or use the form prescribed by the Company when he attempted to alter his designation naming Ms. Nickel. Instead, he attempted to do so in his handwritten will.

The court also reviewed section 67(2) of *The Pension Benefits Act, 1992* (Saskatchewan) which requires that an alteration or revocation of benefits designated, "be made only in the manner specified in the plan." The court stated that, if the legislature intended to permit employees in Saskatchewan to designate beneficiaries by will, then the legislation would have indicated this.

Comment

The finding in this court case is based on this specific pension plan's wording, as well as, the wording in the provincial pension legislation. The result could have been different if the same facts had arisen in a different province, since legislation supporting beneficiary designations varies across provinces. The result could also have been different if the pension plan had not specified that beneficiary designations be revoked or altered in the form specified by the employer.

In light of the complexities of the law, pension plan members and former members should be strongly encouraged to use the specified form to make, alter and revoke beneficiary designations. Although they may be able to make or alter beneficiary designations using a will, there is a risk that the beneficiary designation or alternation in the will could be found invalid pursuant to the terms of the pension plan and the applicable legislation.

Where there are competing beneficiaries for a pre-retirement death benefit or there is uncertainty as to the validity of a beneficiary designation, it is important for pension plan administrators to consider legal advice and allow both potential beneficiaries to make their submissions. In some cases, a court decision may be required to settle such disputes.

[1] *Nickel v. Gerbrandt*, [2019] S.J. No. 176.

Highlights of Morneau Shepell's annual salary projection survey for 2020

Morneau Shepell Limited recently released the results of its 37th annual survey on salary projections for 2020 (the "Survey"). The Survey results reflect input from 506 organizations employing more than one million non-unionized employees and cover a broad array of possible increases in salaries, including salary structure, length of service, cost of living and merit pay.

The results from the Survey revealed the following:

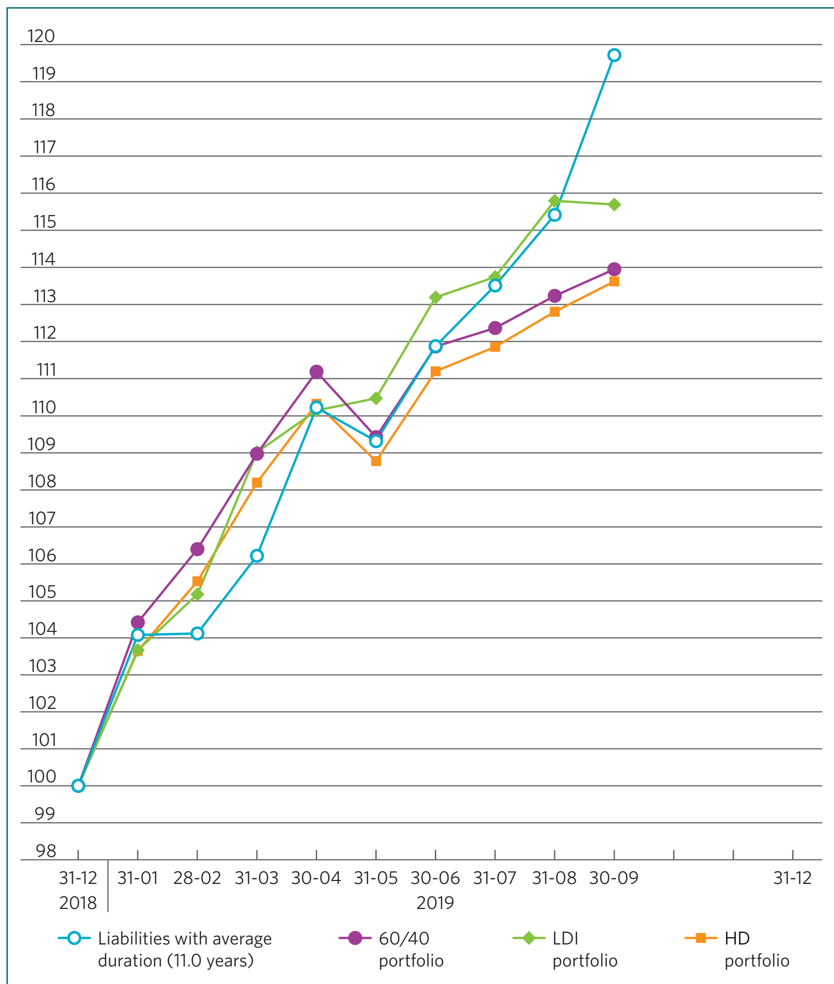
- Base salaries in Canada are expected to increase by an average of 2.7% in 2020, a slight increase over the actual average increase in 2019 of 2.6%.
- Employees' purchasing power is expected to increase, as the anticipated 2.7% salary increase will be more than the projected rate of inflation by the Bank of Canada of 2% in 2020.
- Despite predictions of slowed economic growth in 2020, employers appear to be optimistic as to economic growth.
- Projected base salary increases have risen over the past several years, with actual results equal to or exceeding projections.
- Employers in Newfoundland and Labrador are expecting the highest increases in salaries at 3.1%, mainly due to increased oil production. In 2019 and prior years, British Columbia and Alberta were the provinces with the highest projected increases.
- Employers in British Columbia are expecting salary increases slightly higher than the projected average at 2.8%, while employers in Alberta, Ontario and Quebec are expecting the projected average of 2.7%. The projected increases in salaries range from 2.5 to 2.9% in the other provinces.

The Survey is available for download on Morneau Shepell's website.

Tracking the funded status of pension plans as at September 30, 2019

This graph shows the changes in the financial position of a typical defined benefit plan with an average duration since December 31, 2018. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2018. The estimate of the solvency liabilities reflects the new CIA guidance for valuations effective June 30, 2019 or later. The following graph shows the impact of three typical portfolios on plan assets and the effect of interest rate changes on solvency liabilities of medium duration.

The evolution of the financial situation of pension plans since December 31, 2018



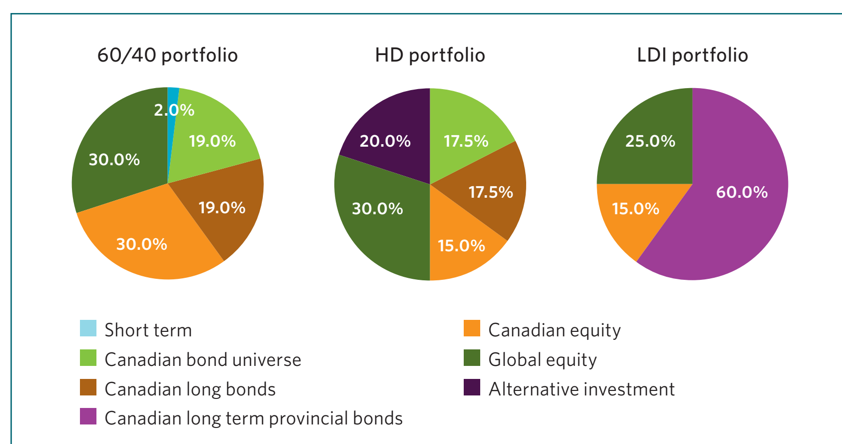
During the month of September, Canadian equity markets, global equity markets (CAD) as well as alternative investments showed positive returns. However, Canadian universe bonds, Canadian long-term bonds and Canadian long-term provincial bonds showed negative returns. With a return of 0.7%, the highly diversified portfolio (HD) outperformed the 60/40 portfolio (0.6%) and the low volatility portfolio (LDI[1]) (-0.1%).

[1] Liability driven investment

The prescribed CIA annuity purchase rates increased while the commuted value rates used in the calculation of solvency liabilities decreased during the month. As a result, the solvency liabilities increased by 3.7% for a medium duration plan. For this type of plan, an investment in the 60/40, in the HD or in the LDI portfolio resulted in a decrease of the solvency ratio.

The table shows the impact of past returns on plan assets and the effect of interest rate changes on solvency liabilities of a medium duration plan, based on the plan's initial solvency ratio as at December 31, 2018.
The graph shows the asset allocation of the three typical portfolios.

Initial solvency ratio as at December 31, 2018	Evolution of the solvency ratio as at Septembre 30, 2019 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	95.2%	96.6%	94.9%
90%	85.6%	87.0%	85.4%
80%	76.1%	77.3%	75.9%
70%	66.6%	67.6%	66.4%
60%	57.1%	58.0%	56.9%



Since the beginning of the year, driven by strong positive returns in the Canadian equity markets, global equity markets as well as the alternative investments, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 14.0%, 15.7% and 13.6% respectively. The solvency liabilities fluctuated over that same period from 19.0% to 20.5% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at September 30, 2019 stands between -5.1% and -2.0%.

Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

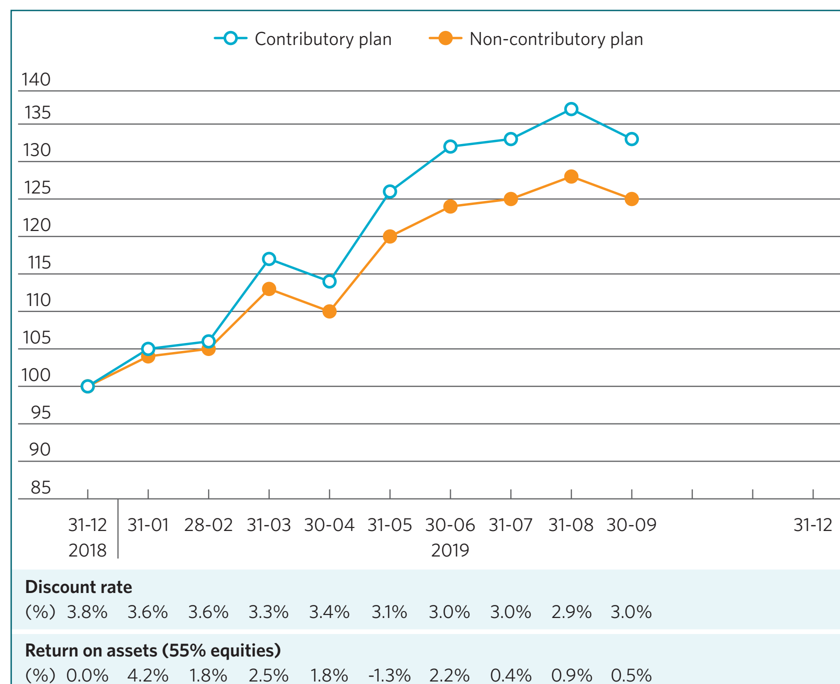
Comments

1. No consideration has been made for contributions paid to the plan or for benefits paid out of the plan.
2. Solvency liabilities are projected using the rates prescribed by the CIA for the purpose of determining pension commuted values.
3. The underlying typical defined benefit plan is a final average plan with no pension indexing, including active and inactive participants representing 60% and 40% of liabilities, respectively.
4. Assets are shown at full market value. Returns on assets are based on three typical benchmark portfolios.

Impact on pension expense under international accounting as at September 30, 2019

Every year, companies must establish an expense for their defined benefit pension plans. The graph shows the expense impact for a typical pension plan that starts the year at an arbitrary value of 100 (expense index). The expense is influenced by changes in the discount rate based on high-quality corporate and provincial (adjusted) bonds and the median return of pension fund assets.

Expense Index from December 31, 2018



The table below shows the discount rates for varying durations and the change since the beginning of the year. A plan's duration generally varies between 10 (mature plan) and 20 (young plan).

Discount rate

Duration	December 2018	September 2019	Change in 2019
11	3.72%	2.89%	-83 bps
14	3.81%	2.97%	-84 bps
17	3.87%	3.02%	-85 bps
20	3.90%	3.05%	-85 bps

Since the beginning of the year, the pension expense has increased by 33 % (for a contributory plan) due to the decrease in the discount rates, despite the good returns on assets (relative to the discount rate).

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Comments

1. The expense is established as at December 31, 2018, based on the average financial position of the pension plans used in our 2018 *Survey of Economic Assumptions in Accounting for Pensions and Other Post-Retirement Benefits report* (i.e. a ratio of assets to obligation value of 95% as at December 31, 2017).
2. The return on assets corresponds to the return on the Morneau Shepell benchmark portfolio (55% equities and 45% fixed income), which reflects the average asset mix in our 2018 Survey.
3. The actuarial obligation is that of a final average earnings plan, without indexing (two scenarios: with and without employee contributions).

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