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Industry Insights

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Another Cybertheft Lawsuit Spotlights 401(k) Record Keeper Procedures

The army of internet thieves doesn't spare retirement plans. Several lawsuits have been filed against plan sponsors and their record keepers, including Estee Lauder, Abbott Laboratories, and record keeper Alight, as a result of theft of plan accounts. Those cases have not resulted in final decisions clearly defining the responsibilities of fiduciaries and service providers, however a newly filed lawsuit against Colgate-Palmolive and Alight provides another opportunity to do so. (Disberry v. Emp. Rels. Comm. of the Colgate-Palmolive Company, S.D.N.Y. No. 22-cv-05778)

While the DOL has not issued regulations defining responsibilities for protecting plan assets from thieves and hackers, it has released a package of best practice recommendations for plan sponsors and record keepers. These recommendations include third party audits of cybersecurity procedures and multi-factor authentication. However, the cases filed make the point that call center employees are a vulnerable part of any record keeper system, and that they must be properly trained to consult managers and/or secure additional identifying information before putting through any suspicious transactions.

THE COLGATE-PALMOLIVE CASE

The Parties: A participant whose entire account worth over $750,000 was stolen by a hacker has sued the plan committee, Alight and custodian Bank of New York Mellon (all of whom are alleged to be fiduciaries) to get the account restored with attorney's fees and costs. The complaint focuses on the specific actions of Alight and its employees. Although the alleged breach did not involve BNY Mellon employees, the complaint also cites provisions of the BNY Mellon agreement requiring BNY Mellon to maintain an information security program and to protect sensitive information against unauthorized access. The participant alleges that the plan committee rejected her benefit claim and will not restore her losses resulting from the fiduciary breach.

401(k) Red Flags: The facts as recited in the complaint read like an example of why record keepers need better employee training and strict identification procedures.

After several unsuccessful attempts to process changes online, a thief called the Alight call center to change the password, e-mail, address and bank account information for the participant's account. No notice of the change was sent to the participant's prior e-mail address or telephone number. The mailing address was not in the same country as the other contacts. A temporary password was mailed to the participant however without notifying the participant by e-mail or text that a temporary password had been requested and mailed out. The mail was intercepted by the thief. Although the Summary Plan Description (SPD) indicated that there would be a 14 day wait before a distribution would be made following an address change, no such waiting period was imposed and an immediate lump sum distribution was quickly made. The participant did not discover the theft until she checked her account balance and alleges that she was told that the loss was unfortunate however that the Plan benefit "was paid in accordance with Plan terms and requirements."

Defined Benefit Plan Procedures Prevented the Theft: Plaintiff alleges that the thief also tried unsuccessfully to access her pension under Colgate-Palmolive's defined benefit plan, which was administered by a different record keeper. That record keeper insisted on a photo ID, which the thief was unable to provide.

Separate Litigation Involving Alight: On a separate front, the Department of Labor (DOL) has been battling Alight in court over its investigation of Alight's cybersecurity procedures. A federal district court has ruled that Alight must respond to the DOL's subpoena seeking documents relating to the unauthorized distribution of plan assets, though Alight has appealed. Alight is also seeking an order preventing the DOL from sharing the information with other federal agencies, which could result in their own enforcement action.

Who Should be Responsible? As of yet, there is no general federal law providing for cybersecurity protections. Who should be responsible for this loss; the criminal authorities who are unlikely to be able to restore-the service providers, the fiduciaries responsible for hiring and monitoring the record keeper or an innocent participant?

ERISA provides that fiduciaries can be personally liable for losses from breaches of their responsibilities. However, trustees, even if fiduciaries for some purposes, do not generally have a duty to inquire into instructions to make distributions. Charges that Alight acted as a discretionary fiduciary here may also present a hurdle, as most record keepers are not fiduciaries. However, the fiduciary committee would appear to have a responsibility to hire plan service providers with adequate cybertheft protections. As the case progresses, the committee's knowledge and monitoring of Alight's procedures and its questionable statement that payment had been made to the thief in accordance with proper procedures are likely to be issues. Whether the plan sponsor maintained insurance or attempted to get indemnification for this loss on behalf of the participant under its service agreements may also be reviewed.

Steps to Provide Better Protection: Plan sponsors can take steps now to reduce the probability a theft like this will harm participants. Here are some practices recommended by the DOL and experts:

+ Require that record keepers maintain cybersecurity insurance and have their procedures audited regularly by outside parties. Put these obligations in service agreements.
+ Thefts can also result from hacking into employee computers at the worksite or when working remotely. Plan sponsors should also maintain cybersecurity insurance and have their procedures audited.
+ Whenever contact information is changed, send texts and e-mails notices immediately using the prior contact information and alerting the participants to contact the record keeper immediately if they did not initiate the changes.
+ Impose a mandatory delay on payment of any distributions requested immediately after a change in contact information.
+ Require confirmation of identity beyond passwords, such as the photo ID requirement imposed by Colgate-Palmolive's defined benefit plan provider or specific personal identifiers.

We need a federal solution to protect participant accounts. Binding DOL guidance on legal liability in this area is sorely needed, however the best solution may be action by Congress to provide for specific participant remedies. Such a provision could even be tacked onto the pension reform legislation currently being considered by Congress.

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The Secretary of Labor Tells Congress He is Open to Regulating Cryptocurrencies

Recently, the Department of Labor has been aggressive in issuing guidance for plan fiduciaries regarding their investment decisions which goes beyond the general fiduciary standards in ERISA. Last March, the Department of Labor issued a Compliance Assistance Release cautioning fiduciaries of defined contribution plans to exercise "extreme caution" in considering cryptocurrencies. This follows on the recently issued proposed regulations regarding ESG investing (Environmental, Social and Governance) and a cautionary letter stating the Department of Labor does not view private equity as an appropriate investment for most defined contribution plans.

The Secretary of Labor, Marty Walsh, has stated he is open to the Department of Labor promulgating rules regulating cryptocurrencies in retirement plans. He made this statement in testimony he gave before the full House Committee on Education and Labor this past June. The Secretary was seeking approval of the Biden administration's 2023 $14.6 billion budget request for the Department of Labor. He offered no details beyond stating the Department of Labor is contemplating a rule making process for cryptocurrencies.

This rule may never come to fruition as investors' interest in cryptocurrencies has waned with the market sell off. Cryptocurrencies have followed the downward trajectory of stock prices. This year, virtually all cryptocurrencies have lost well over half their value with some approaching zero. In June, the total value of all cryptocurrencies fell from just under $3 trillion to below $1 trillion.[1]

Sources:
[1] Cryptocurrency market value slumps under $1 trillion, Reuters, June 13, 2022

The U.S. Court of Appeals Squarely Rejects the Argument that Plan Fiduciaries Must Choose Less Expensive Index Funds Over Actively Managed Products

In this case, the investment lineup included the actively managed version of the Fidelity Freedom Funds. The plaintiffs argued that the fiduciaries violated their various duties under ERISA by failing to utilize the less expensive index version of these funds. The District Court granted CommonSpirit's motion to dismiss. A motion to dismiss is granted only if the court believes there will be no basis to grant relief even if the plaintiffs prove all the facts alleged in the complaint. The District Court's decision was upheld by the Court of Appeals.

This case is yet another example of plaintiffs arguing that a better outcome could have been achieved if the plan fiduciaries had followed their preferences rather than arguing that the fiduciaries utilized a defective process in reaching their decisions. The District Court made it clear that merely pointing to funds with better performance is not sufficient to prove a violation under ERISA.

The Court of Appeals in rejecting the plaintiffs' arguments, stated that "the Employee Retirement Income Security Act does not give the federal courts a broad license to second guess the investment decisions of retirement plans. It instead supplies a cause of action only when retirement plan administrators breach a fiduciary duty by, say, offering imprudent investment options."[1]

The Court was comfortable with the fact that actively managed products are more expensive. The Court stated "Investors today have the option of using index funds, which create a fixed portfolio structured to match the overall market or a preselected part of it, which require little to no judgment, and which have grown in popularity as an alternative to active management. Little surprise, actively managed funds, which require considerable judgment and expertise, charge more than passively managed funds, which require little judgment and expertise." The Court added that it could be imprudent for a plan not to offer active choices.[1]

Source:
[1] Smith v. Commonspirit Health, case text

The Challenges for ESG Investing

ESG investing, sometimes known as socially responsible investing, aims to generate returns by picking stocks based on environmental and social concerns and issues of corporate governance, in addition to looking at the financial metrics of companies. ESG investing has grown rapidly as investors are becoming more interested with these issues. ESG fund growth is expected to exceed $40 trillion this year. Even traditional asset managers, who do not follow an ESG strategy, are feeling pressure to adopt ESG policies that require consideration of factors other than traditional financial criteria in evaluating companies.

ESG investing has some unique investment aspects. "ESG" has no precise legal, or industry, definition. The Securities and Exchange Commission has expressed concern that investment firms are using ESG to market their actively managed products that address issues such as climate change and diversity only superficially. There are certainly some ESG funds which do not appear to lean very far into the concept. It is not unusual for the underlying holdings of an ESG fund to be similar to other funds that invest in the stocks of large U.S. companies.

An example of the Securities and Exchange Commission's growing concern is the investigation it launched into four Goldman Sachs mutual funds which are being marketed as ESG funds. One of these funds, formerly called the "Blue Chip Fund," was renamed "The US Equity ESG Fund" in 2020. After this name change, the top three holdings remained the same. The fund's other top holdings include Bristol-Myers Squibb, Eli Lilly and JP Morgan Chase. In the Fund's prospectus, Goldman reserves the right to invest in some companies without an ESG analysis.

A potential challenge is the ESG factors given priority depends, in large part, on public mood. For example, ESG funds frequently focus on carbon emissions, and many exclude defense stocks. Prior to this year, these criteria had wide appeal. However, the Russian invasion of Ukraine illustrates how quickly public mood can change. The public's focus has shifted to the hardship high energy prices are creating for many. The U.S. government, along with its Western allies, is focused on increasing the global oil supply. Concern about climate change, at least for the time being, has to some extent been temporarily deemphasized. With new geopolitical reality created by Russia's aggression, there is an increased appreciation of the need for national defense, including a nuclear deterrence.

Another challenge is ESG ratings can be subjective. Although the CFA Institute is working on a common standard, none currently exists for measuring ESG elements in the investment industry. Most investment managers do not develop their own ESG ratings. Rather, they rely on the ratings of companies with expertise in ESG metrics. There is little consistency in rating from one scoring system to the next.

A fundamental principle of ESG investing is companies who rank highly on ESG metrics, due to their sustainable business practices, will outperform over the long term. A study conducted last year by the *Wall Street Journal* sorted 492 companies into three groups: ESG leaders, average ESG performers, and ESG laggards based on data provided by three rating companies. The study looked at stock price performance in 2020 and the first part of 2021. The study showed that depending upon the scoring system, this fundamental principle is still unproven.[1]

Add in the fact that recently the Department of Labor issued proposed regulations purporting to insert the consideration of ESG into prudent fiduciary investment processes and the potential complexities of the arena – particularly for ERISA fiduciaries – becomes of considerable importance. At this juncture the prudent fiduciary should either wait to see the outcome of the regulations upon finalization, or if they desire to add ESG at present, to do so with a primary eye towards pecuniary objectives with the ESG being a secondary consideration.[2]

Sources:
[1] How ESG Stocks Perform Depends on Who Ranks Them
[2] US Department of Labor Releases Statement on Enforcement of its Final Rules on ESG Investment, Proxy Voting by Employee Benefit Plans

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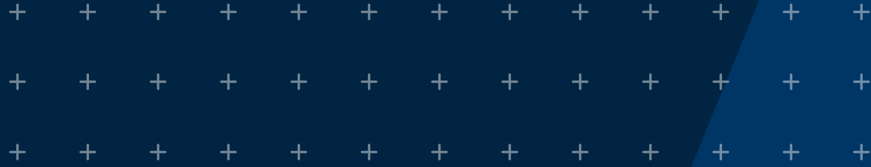

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