NEXUS338

Carfora, et al vs. TIAA

Cross-selling Managed Account Services

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On November 3, 2023, a second amendment to the original class action complaint filed by John Carfora, et al ("Plaintiffs") against Teachers Insurance & Annuity Association of America and TIAA-CREF Individual and Institutional Services, LLC (collectively "TIAA" or "Defendant") for self-dealing and a breach of fiduciary duty.

PARTIES TO THE COMPLAINT

A. *Plaintiffs*

John Carfora is a retired professor and a participant in the ERISA-governed Dartmouth College 401(a) Defined Contribution Retirement Plan and Loyola Marymount University Defined Contribution Plan.

Sandra Putnam is a retired senior research scientist and a participant in the ERISA-governed Pacific Institute for Research and Evaluation 401(a) Defined Contribution Plan and the Pacific Institute for Research and Evaluation 403(b) Tax-Deferred Annuity Plan.

Juan Gonzales (aka Gonzalez) is a university professor and a participant in the ERISA-governed Georgetown University Defined Contribution Retirement Plan and Georgetown University Voluntary Contribution Retirement Plan.

All named employer-institutions have their retirement plans administered and recordkept by TIAA and most, if not all, investment options offered under the retirement plans and made available to participants were or are proprietary to TIAA

B. *Defendant*

Teachers Insurance and Annuity Association of America is a legal reserve life insurance company established under the insurance laws of the State of New York in 1918. Its headquarters and principal place of business is in New York, NY. TIAA's clients include thousands of defined contribution plans which utilize TIAA's investment options (annuities and mutual funds) and administrative services such as recordkeeping of participants' accounts.

This commentary represents Nexus338's understanding, and it may be subject to change. This Firm has no obligation or responsibility to update this summary document. The comments and views should not be deemed as Philip Chao, or any member of this Firm, offering regulatory, legal, fiduciary or investment advice. The opinion expressed is informational only and is insufficient to be relied upon to make any legal, regulatory, compliance or investment decisions or to make any changes to your personal or retirement plan financial condition or investments.

TIAA-CREF Individual & Institutional Services, LLC is a wholly owned subsidiary of Teachers Insurance and Annuity Association of America. TIAA Services is a Delaware limited liability company; its headquarters and principal place of business is in New York, NY. TIAA Services is a registered broker-dealer under the Securities Exchange Act of 1934 and an investment advisor under the Investment Advisers Act of 1940 and provides investment advisory services to individuals. Currently TIAA has over 15,000 institutional clients, whose plans have more than five million individual participants. TIAA serves as the plans' recordkeeper and provides TIAA-affiliated investment options in which participants can invest, including fixed and variable annuities and mutual funds.

In 1998, Congress revoked the tax-deductible 501(c)(3) charitable organization status of TIAA because it "competed directly with for-profit insurance companies and mutual fund groups."[1]

ISSUE SUMMARY

TIAA is an insurance company that offers employer-sponsored defined contribution recordkeeping and administration services. Participant-level services and education are part of the service offerings to plan sponsors. TIAA also offers proprietary investment options which tend to dominate the investment lineup or choices for the plans they recordkeep and administer. Typically, the plan sponsor/fiduciary determines what investments would be included. But because of the TIAA contract structure, the investment lineup has, in the past, been limited to TIAA-CREF affiliated only investment options. This is no longer the case today with the adoption of the "open architecture" approach of making most investment options from other asset managers available to all plans. The investment lineup typically includes the TIAA annuity, which would provide a guaranteed lifetime income to participants beginning at their retirement. The services described thus far are deemed non-fiduciary as the decisions are made by the plan sponsor/fiduciary and TIAA should not have any discretion in selections of plan design or investments.

TIAA, since its founding and by charter, serves non-commercial enterprises. This means TIAA's plan sponsor clients are limited to schools and educational institutions, non-profit university- and church-affiliated medical and hospital facilities, as well as non-profit organizations, foundations, and NGOs. There are two clear trends that have worked against TIAA's business model. The first is that TIAA's competitors do not have such limitations and can compete in the TIAA carved-out domains directly. Second is the fee competition in the asset management business that witnessed fund expenses (i.e., revenue shrinkage) plummeting over the past twenty years. And third, as a consequence of the extreme focus on the fiduciary duty to control plan expenses, recordkeeping and plan administration fees have also been under significant pressure (i.e., revenue shrinkage). Over time, the TIAA original model is an existential threat to TIAA.

[1] Reed Abelson, Budget Deal to Cost T.I.A.A.-C.R.E.F. Its Tax Exemption, N.Y. Times (July 30, 2007), http://www.nytimes.com/1997/07/30/business/budget-deal-to-cost-tiaa-cref-its-tax-exemption.html

TIAA also offers financial, estate, and wealth management services to those with a high asset balance, for a fee. Making these services available to participants should also be a plan sponsor fiduciary decision. However, once a participant decides to access these services, TIAA would act as a fiduciary to the participant. The centerpiece to ongoing advice implementation and delivery is the TIAA "Portfolio Advisor". This is a managed account program that places the plan participant in a model portfolio that often includes TIAA-affiliated funds and provides ongoing investment advice that rebalances the assets if the account deviates from the model portfolio allocation by a certain amount. There is an asset-based service fee for the Portfolio Advisor service that is paid to TIAA in addition to the underlying TIAA-CREF affiliated fund expenses also paid to TIAA.

The Complaint suggests (1) the cross-selling of services and (2) the multiple layers of fees are deemed fiduciary violation to ERISA. According to the Complaint that TIAA embarked on an ambitious plan to cross-sell Portfolio Advisor to the participants of TIAA-administered plans, and in doing so to persuade those participants to roll their assets out of the lower-fee employer-sponsored retirement plans in favor of the higher-fee, individually managed Portfolio Advisor. TIAA began its implementation of this strategy by more than tripling the size of its sales force from fewer than 300 "wealth management advisors" ("Advisors") in 2011 to nearly 900 Advisors by 2017. These Advisors utilized a highly structured pitch process called the "Consultative Sales Process," in which the Advisors cold-called participants in TIAA-administered plans, ostensibly under the guise of offering free financial planning services, but with the undisclosed intent of pressuring those participants to switch to Portfolio Advisor. TIAA instructed Advisors to engage in a form of hat switching" in which the Advisors were told to wear "a fiduciary hat when acting as an investment adviser representative and a non-fiduciary hat when acting as a registered broker-dealer representative." This dual-hat system was not only confusing to Advisors and plan participants alike, but was also misleading and fraught with conflicts of interest. This strategy ultimately proved extremely lucrative to TIAA, which allegedly reaped a 20-fold increase in its annual revenues generated from assets rolled over to Portfolio Advisor."

ERISA FIDUCIARY

1. ERISA's three-pronged functional "fiduciary" definition[2] states that "a person is a fiduciary with respect to a plan to the extent:
   (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,
   (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or
   (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

[2] 29 U.S.C. § 1002(21)(A)

2. An ERISA fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan.
3. A fiduciary also must act prudently "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use."[3]

ALLEGATIONS

A. TIAA adopted a company-wide policy of providing fraudulent investment advice for the purpose of enhancing TIAA's revenues and profits at the expense of retirement plan participants.
   1. To combat eroding market share and the imminent decline of its retirement business, TIAA implemented a corporate strategy designed to induce participants to roll assets out of their retirement plans and into TIAA's high-cost non-plan products.
   2. TIAA used fraudulent tactics to induce retirement plan participants to move their assets to TIAA's non-plan products and wealth management.
   3. TIAA created powerful incentives for Advisors to steer participants to Portfolio Advisor and other non-plan products, thereby enriching TIAA at participants' expense.
   4. TIAA fraudulently led participants to believe that it was acting solely in their interests when in reality its investment advice was designed to benefit TIAA at participants' expense.
   5. TIAA fraudulently portrayed the merits of Portfolio Advisor, which charged much higher fees than employer-sponsored plans for worse performance.

B. TIAA and TIAA Services knowingly received ill-gotten profits produced by Plan Sponsors' ERISA violations.
   1. Cross-selling - the "conflicts of interest" that arise when a recordkeeper markets its non-plan products to a plan's participants.
   2. Monitoring all sources of revenue - ERISA explicitly requires that administrative expenses and service provider compensation be "reasonable" for the services provided.
   3. TIAA knew that Plan Sponsors failed to implement restrictions and failed to inquire into TIAA's cross-selling revenues.

C. TIAA and TIAA Services engaged in fraud and concealed their fraudulent conduct.

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[3] 29 U.S.C. § 1104(a)(1)(B)

D. The Plan Sponsors breached their fiduciary duties in at least the following respects:

- failing to protect Plaintiffs and class members' interests and those of their plans by allowing or failing to monitor Defendants' cross-selling efforts and to discover Defendants' fraudulent sales tactics;
- failing to take steps to protect Plaintiffs and class members by preventing Defendants' fraudulent sales tactics and misuse of confidential participant data to benefit themselves;
- failing to protect the interests of Plaintiffs and class members by mandating that TIAA fully disclose conflicts of interest and other information material to the rollover decision;
- failing to inquire into Defendants' revenues derived from cross-selling; and
- failing to monitor and account for the amount of Defendants' revenues derived from cross-selling to evaluate whether Defendants' compensation was reasonable for the services provided to the plans.

CLAIMS

A. As a party-in-interest, Fidelity violated Prohibited Transaction Rules.

B. Fidelity failed to discharge its duties with respect to the Plans solely in the interest of the Plan participants and beneficiaries and (a) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the Plans with (b) the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

C. To the extent that Fidelity is not deemed a fiduciary or co-fiduciary under ERISA, Fidelity is liable to the Plaintiffs for all recoverable damages and relief as a non-fiduciary and party-in-interest that knowingly participated in prohibited transactions and breaches of fiduciary duty in violation of ERISA, as well as knowing breaches of trust.

CONCLUSION

This case was first filed in 2022 which was dismissed by the Court and provided Plaintiffs with leave to file an amended complaint. Plaintiffs have done so in November 2023, and now before the Court is Defendants' motion to dismiss Plaintiffs' Second Amended Complaint. On May 31, 2024, the Court denies Defendants' motion. Defendants shall file their answer to the Amended Complaint on or before June 21, 2024.

The purpose of this summary is to lay out the Plaintiffs' basic case and to examine if (1) there are any issues that a plan sponsor or a plan advisor/consultant should be concerned about regarding underlying Claims; and (2) there is validity that this case sets a new path in future litigations along similar fact pattern pertaining to cross selling and conflicted revenue enhancements.

Plan sponsors, advisors, recordkeepers, and other intermediaries should keep a close eye on the outcome of this case. It not only impacts recordkeepers as to how cross selling is scrutinized but also how plan sponsors should select and monitor service providers and have a clear understanding of "controlling plan expenses" and conflict of interest. Fee compression has been a real positive for plan participants. On the other hand, plan sponsors are expecting more services from service providers. As such, service providers, including plan advisors and consultants, are looking for ways to expand their services, through cross selling, to realize more or to make up lost revenue. These services may be necessary, appropriate, or important, but it is the plan fiduciary's responsibility to develop a prudent process to understand and monitor the services and the service providers in the sole interest of participants.