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Davis vs. Stadion Money Management, LLC + United of Omaha Life – a First Look

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On January 25, 2019, a class action complaint[1] was filed in the U.S. District Court Middle District of North Carolina by Kimberly Davis, representing a class (Plaintiffs), against Stadion Money Management, LLC, and United of Omaha Life Insurance Company (collectively Defendents) for: 1) breach of loyalty and prudence[2], 2) knowingly profiting from a fiduciary breach[3], 3) prohibited transactions with a party in interest[4], and 4) prohibited transactions with a fiduciary[5].

I. Stadion Money Management, LLC.[6] (Stadion)

Stadion is a privately owned money management firm based in Georgia and has been in business since 1993. TA Associates, LP, a private equity firm, has a 54.4% interest, with the remaining 45.6% owned by Stadion Money Management Inc. controlled by Timothy Chapman.

Among other discretionary and non-discretionary money management services, Stadion is the adviser to a family of open-end mutual funds (Stadion Funds) comprising the Stadion Investment Trust.

II. Managed Account Services to Retirement Plan

According to Stadion's March 29, 2018, Form ADV Part 2[7] and under Part 4 – Advisory Business, it discloses that Stadion offers discretionary money management services under its Retirement Account Management Program, a Managed Account solution, to participants in certain 401(k) and similar retirement plans under three approaches, in addition to offering three series of target date funds (TDFs) – TargetFit[i]. On its website, Stadion states that it "acts as

[1] https://chaoco.com/wp-content/uploads/2019/02/Davis-vs-Stadion-Footnote-1.pdf
[2] 29 U.S.C. § 1104(a)(1)(A)-(B)
[3] 29 U.S.C. § 1132(a)(3)
[4] 29 U.S.C. § 1106(a)(1)
[5] 29 U.S.C. § 1106(b)
[6] https://stadionmoney.com/
[7] https://adviserinfo.sec.gov/IAPD/Content/Common/crd_iapd_Brochure.aspx?BRCHR_VRSN_ID=527915

an ERISA 3(38)[8] investment manager with discretionary control over participant accounts" under each Retirement Account Management Program.

1) *Plan Based Opt-Out Managed Account Solution – Using Stadion Proprietary Investments*
Structured to meet the requirements of a Qualified Default Investment Alternative (QDIA), this Managed Account solution is then made available through various 401(k) recordkeeping and administration firms ("Recordkeepers"). These Recordkeepers (United of Omaha Life is an example) may enter into an arrangement with Stadion to make Stadion's money management services available to participants, subject to the agreement of the plan sponsor or fiduciary. In these cases, Stadion enters into an agreement with the plan's sponsor or fiduciary to permit Stadion to manage participants' personal 401(k) or similar accounts. The annual asset-based fees for such services generally range from 0.35% to 0.75% and is typical a plan expense.

2) *Individual based Opt-In Management Account Solution – Using Stadion Proprietary Investments*
Certain sponsors of 401(k) and similar retirement plans may make Stadion's services available to participants in their plans (regardless if the opt-in Managed Account is also serving as the plan's QDIA). In these cases, participants may elect to directly engage Stadion to manage their personal 401(k) or similar accounts by entering into a Stadion advisory agreement. The annual asset-based fee for opt-in Managed Account services to individual participants typically ranges from 0.50% to 1.50% (depending on certain factors, such as plan size) and payable by the participants.

3) *StoryLine – Investment Open Architecture*
This is a customizable glidepath based opt-out Managed Account service as a plan's QDIA. The party engaging Stadion is required to select, for the plan, the platform of available investment options that Stadion will use in each participant's Managed Account. While this platform is expected to consist primarily of mutual funds and/or collective investment funds of trust companies ("CIFs"), it may also include third party products or proprietary products sponsored by the Recordkeeper[9] - e.g. insurance company general account products.

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[8] https://stadionmoney.com/retirement/for-advisors/managed-accounts#investment-approach

[9] As so stated in its Form ADV Part 2, conflicts of interests may arise where Stadion recommends that clients invest in guaranteed income contracts or stable value accounts ("GIC/SVA") issued by a plan provider sponsor where Stadion's Retirement Account Management Program services are offered. To minimize these conflicts, Stadion conducts an analysis on the prudence of the investment, the credit quality of the issuer and an arm's length, independence analysis for assets invested in GIC/SVA. Stadion does not receive any additional compensation from assets invested in GIC/SVA.

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The "StoryLine Built with SPDR ETFs[ii]" is a proprietary product[10] that requires the responsible party (recordkeeper, plan fiduciary or adviser) to select a platform that consists primarily of CIFs that invest in SPDR ETFs.

Fees for services offered under StoryLine are expected to generally range from 0.35% to 0.75%. Under agreement State Street pays Stadion (1) an annual payment, (2) reimbursement for certain marketing and educational services, (3) marketing and distribution assistance and (4) other benefits.

In certain circumstances, Stadion may offer StoryLine services at different fee rates through the same plan provider in an effort to accommodate the plan providers' different arrangements for administrative and marketing support services (i.e. Stadion's gross fee will vary because different portions of the fee are redirected to cover administrative and marketing support service costs of the plan provider). This is often referred to as revenue sharing. Stadion implements all Storyline solutions using only the investment options made available on the selected platform, and the party engaging Stadion to provide StoryLine reserves the sole right to change these investment options. Further, under the StoryLine Managed Account program, Stadion can and does recommend allocating participant managed accounts into guaranteed income contracts or stable value accounts ("GIC/SVA") issued by or an entity affiliated with the recordkeeper where the recordkeeper or a related party benefit.

Stadion proprietary mutual funds[iii], CITs[iv] or any other underlying investment options deployed under the Retirement Account Management Program charge their own investment management fees. This is separate from and in addition to the asset-based fee assessed by Stadion for the Retirement Account Management Program.

According to its current website, "Stadion has more than 100,000 retirement accounts and is the fifth-largest provider of 401(k) managed accounts" citing Cerulli, as of 12/31/14. According to its current Form ADV Part 2, Stadion's regulatory assets under discretionary management as of December 31, 2017, were $ 3.35 billion.

[10] According to its Form ADV Part 2, Stadion has entered into an agreement with State Street Global Advisors, a division of State Street Bank & Trust Company, and certain affiliates ("State Street") that obligates Stadion, among other things, to utilize within the "StoryLine Built with SPDR ETFs" product (with certain exceptions) only ETFs that bear the SPDR trademark and to market the StoryLine product as "StoryLine Built with SPDR ETFs" (the "SSGA Agreement"). Under the SSGA Agreement, Stadion is entitled to receive from State Street an annual payment, reimbursement for certain marketing and educational services, marketing and distribution assistance, and other benefits. These payments and other benefits create conflicts of interests when Stadion recommends that clients engage Stadion to provide the StoryLine product. These conflicts may be mitigated, however, by the fact that, the party engaging Stadion to provide the StoryLine product will select and continuously monitor the platform of investments.

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THE COMPLAINT

Background

(1) The Plaintiff was an employee and participant under the Palace Entertainment 401(k) Plan. United of Omaha serves as the Plan's recordkeeper and offered investments under its group variable annuity contract, which included Stadion's managed account service.

(2) Insurance companies like United of Omaha have the largest share of the small plan market. Insurance companies and their agents typically market group variable annuity contracts to small plans with an array (typically 15-60) of annuity "subaccounts" as investment options for participants.

(3) Group variable annuities is a bundled service solution to a plan sponsor's retirement plan needs. In addition to the underlying investments, these products often include services such as recordkeeping, custodial services, annual reporting, discrimination testing, preparation of required performance and fee disclosures, employee enrollment and education, and a secure website for employee account management.

(4) Stadion manages thousands of participant accounts in United of Omaha administered plans through its managed account program. In the capacity of a 3(38) fiduciary investment manager, Stadion has complete discretion to manage and dispose of the assets in the participant's account by selecting which of the plan's options to invest in, the amount of existing assets to invest in each option, and the investments to which future contributions are directed.

(5) Stadion does <u>not</u> create a custom portfolio for each individual participant. Instead, each participant is assigned to one of six risk-based portfolios: Capital Preservation, Conservative, Balanced, Moderate Growth, Growth, and Maximum Growth. Risk assignments may be based on a participant's age <u>or</u> responses to a questionnaire. Stadion invests each portfolio the same way for all participants assigned to that portfolio (an age-based risk model.)

(6) Stadion uses a core/flex approach to manage each portfolio. The "core" component consists of a permanent allocation to equity securities and another permanent allocation in fixed income securities. To express this core portfolio, Stadion allocates account assets in several different subaccounts, <u>including its own proprietary products</u>. The remainder of each portfolio is the "flex" component which relies on Stadion's asset allocation strategy with Stadion adjusting the asset allocation based on its assessment of market conditions. Stadion <u>exclusively used its own proprietary subaccounts</u> to execute the flex portion of each portfolio.

(7) The Guaranteed Account is a special, interest-bearing subaccount managed by United of Omaha. There is no explicit expense ratio for this subaccount. Instead, United of Omaha retains investment earnings that exceed the interest credited to participants. United of Omaha refers to its retained earnings as "implicit fees". These fees are separate from, and in addition to, the managed account fee.

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ERISA Fiduciary Standard & Prohibition

(1) Duty of Loyalty - requires Stadion, a discretionary fiduciary investment manager, to act solely in the interest of the participant account holders and must exclude all selfish interest and all consideration of the interests of third persons.
(2) Duty of Prudence and Due Care – requires Stadion to meet the prudent person standard by which fiduciaries' investment decisions and disposition of assets are assessed. Further, Stadion has a continuing duty to monitor plan investments and remove imprudent ones within a reasonable time.
(3) Prohibited Transaction –ERISA §406(a)[11] prohibits fiduciaries from allowing or causing a direct or indirect transaction involving plan assets that have the potential for conflicts of interest. These include any transactions with "parties in interest" (such as a service provider) and fiduciary self-dealing".

Allegations

(1) Stadion's use of its own subaccounts to invest the core equity portion of each Managed Account added extra costs for participants even though comparable investments in subaccounts from United of Omaha were available at a lower cost. The product charge paid from Stadion's own subaccounts to United of Omaha was about 50% higher than other comparable arrangements. (United of Omaha charges higher product charges in Stadion-affiliated subaccounts than any other subaccount within these plans.)
(2) Stadion also benefits from allocating monies to the Stadion-affiliated subaccounts. These allocations boost Stadion's reportable assets under management, improving its attractiveness within the marketplace. The higher level of Stadion's core equity investments allowed it to enter into a joint marketing venture with the investment manager of the exchange-traded funds that Stadion used to invest the core equity assets in its subaccount. Also, the higher assets under management lowered Stadion's trading costs, benefiting Stadion's other customers and thus Stadion's standing in the marketplace.
(3) Stadion used United of Omaha's Guaranteed Account to invest in the core fixed income component of participant managed account portfolios. The Guaranteed Account guarantees principal amounts invested and provides a stated rate of return. United of Omaha generally sets the stated return rate at a level that is 1.00% to 2.00% lower than the income, or spread, it expects to earn by investing the underlying assets. United of Omaha refers to its spread as "implicit fees" of the Guaranteed Account while comparable, principal-guaranteed, fixed income investments are available at a much narrower spread. This implies an understanding between United of Omaha and Stadion that Stadion would direct managed account assets to United of Omaha's Guaranteed Account instead of other fixed income options, allowing United of Omaha to invest those monies and earn spread.

[11] https://www.law.cornell.edu/uscode/text/29/1106

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(4) United of Omaha and its affiliates issue an agreement to employers that allows them to add Stadion's services to their plan. This agreement requires employers to make the United of Omaha Guaranteed Account available as an investment option in their plan in order for the Stadion services to be offered. This benefits United of Omaha and Stadion, as United of Omaha receives a steady flow of assets to generate "implicit fees" for itself and Stadion maintains security with its marketing partner.
(5) The same set of circumstances exits when Stadion allocates for the flex portion of a managed account portfolio. Stadion uses Stadion-managed, asset allocation subaccounts comprised of index tracking funds. However, they are charged at a higher cost and producing poorer performance as a consequence. Stadion has no incentive to move managed account investments to other subaccounts with lower product charges because this would reduce United of Omaha's revenue, threaten Stadion's ongoing marketing relationship with United of Omaha, and eliminate the indirect financial benefits Stadion accrued from the use of Stadion-affiliated subaccounts.
(6) United of Omaha received significant additional revenue as a result of Stadion's breaches of its fiduciary duties and other violations of ERISA. These monies were transferred from participant accounts held in United of Omaha's client plans to United of Omaha at Stadion's direction.
(7) United of Omaha also had sufficient knowledge of Stadion's imprudence and disloyalty in regard to Stadion-managed subaccounts to render its receipt of higher product charges in connection with those subaccounts improper. United of Omaha was aware that sometimes identical investments with lower product charges were available to Stadion through other subaccounts. Likewise, United of Omaha was aware of Stadion's dependence on United of Omaha and its desire to maintain favor with its host. In addition, United of Omaha was aware of Stadion's performance deficiencies relative to other subaccounts available to its client plans. Under these circumstances, United of Omaha knew that Stadion's direction of managed account assets to Stadion-managed subaccounts was an ongoing breach of Stadion's fiduciary duties.

CONCLUSION

This class action lawsuit shines a light onto the revenue sharing (or possible self-dealing and prohibited transactions) relationship between a recordkeeper and a managed account provider. Although it is premature to suggest who will prevail in this suit, it is fair to suggest that the plaintiff bar is constantly seeking the next excessive fee opportunity set. The significance of this complaint is that Stadion is a Managed Account "add-on" service provider to many other recordkeepers, and if the Court finds in favor of the Plaintiff, it could potentially increase the likelihood of such other recordkeepers with Stadion relationship being named in future complaints.

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First things first, according to the June 2014 GAO report[12], "Managed Accounts are defined as investment services under which providers make investment decisions for specific participants to allocate their retirement savings among a mix of assets they have determined to be appropriate for the participant based on their personal information." Managed Accounts may consider personalized factors such as a participant's date of birth, risk tolerance, gender, assets, contributions and state of residence even though they are not required to do so. Managed Accounts are generally considered to be an investment service—not one of the plan's investment options. The role of the participant is to elect in (Opt-In) the Managed Account service and be engaged in the financial and investment process or, when serving as a plan's QDIA, be defaulted into it (Opt-Out), generally relinquishing their ability to make investment decisions unless they disenroll from, or opt out of, the Managed Account.

As the cost of technology continues to plummet, the speed and ease of use continues to escalate, and the power of computing exponentially increases, IT driven portfolio construction and management in the form of Managed Accounts has significantly improved and democratized. The race now is for existing and new Managed Account providers to offer the obvious value at a cost that is competitive with TDFs as the go-to QDIA in DC plans.

In a fee compressed world, recordkeepers are seeking ways to stay in business while remaining competitive. Managed Account is a new revenue source to put recordkeeping back in the driver's seat. The natural partners are asset managers (especially those without a TDF) and existing or new Managed Account (i.e. robo) technologists. The recordkeepers has the freedom to set the parameters and invite the parties for a proprietary Managed Account solution and make this a new distribution conveyor belt for asset managers at a variety of combinations and revenue sharing breakpoints. The flexibility is only limited by technology and their existing systems. This allows the recordkeeper a meaningful way to compete with other recordkeepers with an asset manager parent and to also retain assets. As compared to the old Opt-In Managed Account system, the Opt-Out approach captures a significantly greater portion of the plan assets as it serves as the plan's QDIA while requiring less support, since a default investment is, by definition, used by unengaged or unwilling-to-engage participants. Thus, the per-account cost for providing Opt-Out Managed Account solution should be significantly lower while profitable for the recordkeeper and the asset managers.

So, what would be the problem? For starters, it is greed. Under ERISA, greed is the antithesis of meeting the duty of loyalty and the duty of prudence. In building a Managed Account solution, the architect should view all the components and their inter-relationships from an ERISA fiduciary lens. Even though a technology based Managed Account solution may be fairly new (since the1990s) to the investment world, too many hands in the cookie jar has been around since the beginning of time.

[12] https://www.gao.gov/assets/670/664391.pdf

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This class action suit reminds us that transparency and disclosure is insufficient in meeting one's fiduciary duty under the ERISA framework. We need to support a solution that does not involve layers of fees among related parties. At the end, an ERISA 3(38) is a serious position and should not be considered a *quid pro quo* marketing tactic to win business. The system functions because it relies on honest and participant centric gatekeepers and referees. Companies and individuals in charge of seeking, vetting and appointing a 3(38) discretionary portfolio manager are equally responsible as the 3(38) in making certain that, on an ongoing basis, loyalty and prudence are enforced solely in the interest of the participants, Opt-In or Opt-Out.

Endnotes

[i] TargetFit. Stadion's TargetFit product is a group of three target date fund series – the Stadion TargetFit Conservative Strategies, the Stadion TargetFit Moderate Strategies, and the Stadion TargetFit Growth Strategies. TargetFit was designed to offer multiple target date fund options based on a particular risk objective. Each TargetFit target date fund is a CIF. As such, TargetFit is only available to certain 401(k) and similar retirement plans through open-architecture platforms.

[ii] StoryLine Strategies: Stadion will seek to implement StoryLine's customizable glide paths by utilizing a strategic equity strategy ("Core Equity"), strategic fixed income strategy ("Core Fixed Income") and Flex in varying allocations; however, in implementing such strategies, Stadion will be limited in its investable universe to the platform of particular investments selected by the applicable Recordkeeper, employer or plan sponsor engaging Stadion to provide the StoryLine product. While this platform is expected to consist primarily of mutual funds and/or CIFs, it may also include third party products or proprietary products sponsored by the Recordkeeper. Alternatively, a party engaging Stadion to provide the "StoryLine. Built with SPDR ETFs" product will be required to select a platform that consist primarily of CIFs that invest in exchange traded funds ("ETFs") that bear the SPDR® trademark. In either case, Stadion will implement Storyline using only the investment options available on the platform, and only the party engaging Stadion to provide StoryLine (and not Stadion itself) will be permitted to change these investment options. Each StoryLine allocation will generally be comprised of five sub-components: Domestic Equity, International Equity, Short Duration Fixed Income, Long Duration Fixed Income, and Flex. The Domestic Equity and International Equity sub-components (collectively "Core Equity") will be strategically allocated to provide broad market exposure amongst domestic equity and international equity investments, respectively. The Short Duration Fixed Income and Long Duration Fixed Income subcomponents ("collectively Core Fixed Income") will be strategically allocated to provide exposure to short and long duration securities, respectively. In some cases, Stadion may utilize guaranteed investment contracts offered by the Recordkeeper in lieu of or in addition to the Short Duration Fixed Income subcomponent. The Flex sub-component will be allocated amongst equity, fixed income and cash positions as determined by a combination of the Tactical Unconstrained Strategy focusing on shorter term technical measures to determine market risk and the Core Satellite Strategy focusing on intermediate to longer-term technical measures to determine market risk. Stadion will periodically (e.g., annually) review the relevant benchmarks for each sub-component and make allocation adjustments among the sub-components as necessary.

[iii] Stadion Funds. Stadion charges the Stadion Alternative Income Fund an annualized management fee of 0.85% of the Fund's net asset value. Stadion charges all other Stadion Funds an annualized management fee of 1.25% of the Fund's net asset value up to $150 million, 1.00% of assets over $150 million and 0.85% for assets over $500 million. The management fees paid by each Stadion Fund are more fully described in each Fund's prospectus.

[iv] Investors Master Trust for Employee Benefit Trusts. Fees are 0.00%, 0.27%, 0.35%, 0.40% and 0.55%, depending on share class.

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