UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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ANDREW SNITZER and PAUL LIVANT,
et al.,

Plaintiffs,

v. 17 Civ. 5361 (VEC)

THE BOARD OF TRUSTEES OF THE
AMERICAN FEDERATION OF MUSICIANS
and EMPLOYERS' PENSION FUND,
et al.,

Defendants.

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New York, N.Y.
April 26, 2018
10:00 a.m.

Before:

HON. VALERIE E. CAPRONI

District Judge

APPEARANCES

CHIMICLES & TIKELLIS LLP
Attorneys for Plaintiffs
BY: STEVEN A. SCHWARTZ

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BY: DEIDRE A. GROSSMAN
STEVEN A. SUTRO

(Case called)

(In open court)

MR. SCHWARTZ: Good morning, your Honor. Steve Schwartz from Chimicles & Tikellis for the plaintiffs.

THE COURT: Good morning.

MR. KRINER: Your Honor, Robert Kriner from Chimicles & Tikellis for the plaintiffs.

THE COURT: Good morning.

MS. RUBINOW: Good morning, your Honor. Laurie Rubinow, Shepherd Finkelman Miller & Shah, for the plaintiffs.

THE COURT: Are you all with the same firm? I wasn't listening to the firm.

MR. KRINER: Mr. Schwartz and I are with Chimicles & Tikellis.

MS. RUBINOW: And Shepherd Finkelman Miller & Shah. Thank you.

THE COURT: For the defendants?

MR. LEEDS: Zachary Leeds, Cohen Weiss and Simon.

THE COURT: You all can sit down. Plaintiffs can sit down.

MS. RACHELSON: Jani Rachelson, Cohen Weiss and Simon, same firm.

MR. RUMELD: Myron Rumeld from Proskauer Rose. Good morning.

MS. GROSSMAN: Deidre Grossman, Proskauer Rose. Good morning.

MR. SUTRO: Steven Sutro, Proskauer Rose.

THE COURT: All right. Good morning, everybody. OK. Proskauer, or defendants, this is your motion.

MR. RUMELD: Yes, it is. Can I proceed from here, or do you want me at the lectern?

THE COURT: Wherever you are more comfortable. If you are going to proceed from them, you are going to have to pull a microphone so it's somewhere close to you.

MR. RUMELD: Thank you. Good morning, your Honor. In order to withstand a motion to dismiss, the complaint must allege facts that if proven would support an inference that the plan fiduciaries engaged in an imprudent process.

There are two significant caveats to that general rule that apply in ERISA investment loss cases like this one. First, as the Second Circuit said in Pension Benefit Guaranty Corporation v. Morgan Stanley, the allegations must be evaluated in context; and, second -- and relatedly to this notion of context -- the riskiness of any particular investment shouldn't be evaluated in isolation but, rather, the evaluation should be in the context of all the plan's investments.

THE COURT: Of course.

MR. RUMELD: Agreed, of course. But in this case we have a great deal of contextual facts even at the motion to dismiss stage which really results from the fact that before the original complaint was filed the plaintiffs had access to all the investment reports that were cited in the original complaint, and then in response to our motion to dismiss, the complaint was amended before we moved again; and the amended complaint then made reference to all the minutes that we had produced in the interim.

So, we have all of those contextual facts that are documented, that the court wouldn't normally have access to in a typical motion to dismiss. And, as indicated in our papers, these contextual facts remove any plausible inference of fiduciary breach because they show, first of all, that with respect to each of the principal claims in this case, the challenged decisions were the product of abundant process -- prudence claims are really claims that focus on process -- and that process included detailed consultation with qualified professionals, in particular Makita the investment consultant and Milliman the plan actuary.

This is not a case where one can draw an inference that just because there were losses experienced with certain investments that this means somebody was asleep at the switch.

THE COURT: I don't read the plaintiffs' complaint to be that. The original complaint was close to that, but that's not how I read the current complaint.

I read the current complaint as saying that the fiduciaries were simply acting imprudent in overweighting the fund with risky investments. That's sort of -- I got your claim sort of generally.

MR. RUMELD: OK.

THE COURT: So I guess one question I would have for the defendants is: Is it fair game for me to consider the fact that your plan appears to be out of whack relative to peer plans in terms of how heavily weighted it was in two particularly risky types of investments: Emerging markets and private equity.

MR. RUMELD: So, I think that's one of those areas where the reference to contextual facts comes in. It's certainly fair game for you to consider that.

THE COURT: OK.

MR. RUMELD: But it's also fair game for you to consider that the trustees got contemporaneous advice from their experts that showed that this was not the normal situation. If they continued to seek investment returns of seven and a half percent per year -- which was the investment assumption -- they have a report from their actuary that said this fund is going to be circling the drain eventually for the very simple reason -- which is also well documented -- that the plan's expenses, the cost of paying benefits -- which is something that happens in mature plans where there are a lot of retirees relative to the number of active people -- this plan was going to continue to run a deficit even if it got seven and a half percent returns.

THE COURT: The trustees were in a difficult position with this fund, there is no question about it; and that seems clear from the minutes. And they still I guess are in a difficult position, though maybe it's getting a little better now. But they were in a difficult position.

But even trustees in a difficult position, that doesn't absolve them from all decision making.

MR. RUMELD: I agree. And I think for purposes of evaluating whether they acted prudently, there isn't one answer to the exclusion of others to what to do in a situation like that. Their job is to conduct an evaluation, consult with the appropriate professionals; and if their decision is among the prudent decisions that one could have made in those circumstances, then I think your Honor is supposed to let the case go and realize that there isn't a basis for finding a breach of fiduciary duty.

We have referred in our papers to the stochastic model. I had to get a little bit of education myself on this, but as the report itself says the model runs 10,000 scenarios for each allocation policy there being considered, and after running those 10,000 scenarios with an eight percent rate of return and a seven and a half percent rate of return and a nine percent rate of return it basically says that over an extended period of time -- which is the relevant period of time for a fund like this -- it also said, incidentally, that under any of the models there was no risk of the plan going insolvent in the very short term. There is definitely a greater risk of going down more when more aggressive, but in the short term there was no risk of the plan going insolvent, and in the long term there were many more scenarios under which the seven and a half percent targeted allocation model was going to run the plan under. And, while, yes, it was taking on more risk, there were actually fewer scenarios in which the plan was going to go under if it pursued a nine percent rate of return.

Now, there is no question that we've had some unfortunate circumstances in that the international emerging market equities had a couple of bad years after they put some money in -- though actually after they added more, the recent year has been very, very good, as we indicate in our papers, and that clearly made the situation --

THE COURT: It's very good from a lower level.

MR. RUMELD: From a lower level, yes. But again we're taking --

THE COURT: This is the problem of looking at one year returns. Right? You can have great one year returns, but if you look at it over five years it's horrible.

MR. RUMELD: I completely agree, your Honor. And if you review the paperwork, all of the reports from Makita were focused on 20 year return periods and prepared the allocation model looking at the 20 return period.

And, among other things, if you flip the pages of the report, it's not just the targeted returns. It talks about, for example, the probability of achieving a seven and a half percent rate of return, and it shows that there is a higher probability over a 20 year period of achieving a seven and a half percent rate of return than there is with the models that are targeting a lower level of return, and that's because in longer periods of time aggressive investments tend to do better.

Now, it's also true if we kind of proceed from the overall riskiness of the portfolio to why specifically emerging market equities, there is numerous quotations and references to Makita statements, and it's right in Makita's reports themselves. They endorse these products at the beginning, at the middle, at the end, and they were specifically questioned by the trustees: Are you sure we're supposed to be putting more money in emerging market equities if our two funds haven't been doing well the last couple of years? And their very clear statements and their thought-out statements explain that, if anything, the losses they've experienced in the last year or two makes these securities undervalued by the market right now. And there was a concern that domestic equities may have priced themselves out. You know, there are ways to look at price range ratios; there are objective metrics that consultants use.

But the point is there can't be any question about process here. In the typical case you get a complaint, the complaint points to investment losses. If there are extensive investment losses over a period of time, or there's funds that are offered that charge a lot more than comparable funds that perform better net of those fees, the court is entitled to say, look, it's reasonable to question whether somebody was asleep at the switch here or not doing their job, so we have to send the parties off to discovery.

But here we have the benefit of these reports, and before we all get -- you know, we have done a lot of discovery already somewhat voluntarily. When we met with you last time we told you about that. And we have already produced, I don't know, tens of thousands of documents, and we're on the verge of producing tens of thousands of e-mails, and after that we're going to be doing lots and lots of depositions. And I think if your Honor looks at that PBGC case -- and after the PBGC case that case really got an endorsement from the Supreme Court in the Dudenhoffer case -- there is a legitimate concern by the Second Circuit and Supreme Court that we're not supposed to open the door to this kind of discovery unless at the pleadings stage there is really some there there; I mean you can say that there is a rational inference to be drawn, not that we chose bad investments but that we weren't doing our job in how we chose them.

Now, let me just transition, because although your Honor didn't mention it, I think it's fair to say that the complaint in addition to accusing us of taking on too much risk also accuses us of investing in actively managed funds to the exclusion of the passive index funds.

THE COURT: I was just about to get to that.

MR. RUMELD: OK, so then my timing is good.

THE COURT: Your timing was impeccable.

MR. RUMELD: OK. So here too this is one of those things that if you only look at the reports and you don't have anything else, you can say, hmmm, here are all these actively managed funds, they didn't out perform the index funds. I will say parenthetically that I think it's absurd to be talking about what three index funds would have done. I mean, sure, with the benefit of hindsight we would have all left our money in the stock market the last five years and we would have done very nicely. To compare that to a portfolio, a billion and a half dollar portfolio, with over a dozen different investments vehicles, and to suggest that it could have possibly been more prudent to be just in three; I think that's kind of ridiculous.

But getting back to the question on index versus active, what we see here with this more robust record is, one, there was a movement towards index funds. The fund has substantially more index funds and substantially less money invested in active managers than it did when Makita was first hired. They told them when they got hired this is one of the things we're going to do for you; we focused on the fees; and they acted that way.

On the other hand, we don't see this whole scale shift to index funds, because Makita specifically and repeatedly -- and repeatedly in response to questions from trustees and their counsel specifically on this issue -- said, look, there are some areas of the economy like large cap domestic equities where the market is very efficient and we don't really believe active managers outperform the index funds in the long run so why not save the basis points. But there are other segments of the economy that are less efficient like small cap or international securities where there is a lot of friction, and there is a lot less efficient trading of information, and in these areas you either need to maintain actively managed funds or have some mixture of the two.

So, what you see when you look at the fund's portfolio that with some of these other parts of the economy, some of these other sectors, there is a mixture of actively managed funds and passively managed funds.

You also see -- because there is an accusation that there is an absence of process to review how these guys are doing -- I think we had like a dozen different exhibits cited in our papers where specific investment managers were reviewed, some were replaced. There is this allegation that if we held on to managers for a long period of time we must not be doing our job. But in each of those cases Makita gives an explanation that it sometimes takes a longer period of time in which to evaluate managers, or a certain manager isn't really expected to match the benchmark because he's not just investing the same as the indexes; he's doing something a little differently.

But the point is every one of these managers was vetted, and the decision -- it wasn't the absence of a decision when they kept an investment manager; it was a decision to keep him based on the advices of Makita.

THE COURT: So I read the plaintiffs' argument to be it was standardless, that is, there was no -- aside from what Makita said -- and I read all of the exhibits that you pointed me to on this --

MR. RUMELD: Thank you.

THE COURT: This is an issue of great interest to me personally in term of how you make a decision whether to stay with an investment manager or just go to index funds. I was hoping for some great insight; I did not get that.

What I got was that Makita -- there is no question that there were times when there were trustees who said: Why are we still with this manager? You know, they're way off the benchmark or whatever. And Makita's response was something like you just said. And they would go forward then with it.

But there was no -- at least I couldn't tell from the minutes that you gave me -- that you wanted me to decide on -- what the trustees really were using aside from what Makita said. And it wasn't clear that Makita had a standard either as opposed to kind of a gut feeling that we need to hang in with this manager for a year or two more. But it was not clear to me that there was any kind of standard, leading to the question of whether a fiduciary needs a standard.

MR. RUMELD: So, let me try and respond in a couple of components here. And I don't want to get into a battle of semantics with your Honor, because "standard" could mean a few different things.

So, for example, there is an allegation in the responding papers that Makita said after three to five years we should be making a decision to get rid of the manager if he's not performing well.

If you read what that paragraph says in the minutes, they don't say that. They say in general three to five years is a benchmark you would be looking at, but every single manager you have to evaluate in the context of what is going on, so maybe in three to five years but not necessarily.

I give that as an example, your Honor, because --

THE COURT: I don't know what that means.

MR. RUMELD: Well, the point is that every circumstance has to be evaluated individually so there isn't --

the advice they got from their professional is don't have a hard and fast rule. Historically the biggest mistakes that multi employer funds make is when they bolt from an investment manager because he has two or three years of bad performance, and they exit him right before he rebounds, because the consultants would say you really have to evaluate over a market cycle.

It helps to keep in mind here that Makita comes onboard in 2010 or so; most of these managers that were being criticized in the papers were managers that Makita originally added to this fund so they haven't been there for a long time. If Makita recommended them, that means they were managers that they had already vetted internally and were comfortable with.

Now, if a manager -- if the leading guy passes away or retires and there is an issue whether they are the same smalls in that fund, then that's a reason to get rid of the fund. But if the manager is actually managing consistently with the investment philosophy that Makita endorsed, then Makita's advice sometimes is, look, just because this investment philosophy hasn't panned out for the last year or two doesn't mean that this doesn't make sense. We can't make decisions in the rearview mirror; we have to make decisions going forward.

And, frankly, that's the same point about the emerging market equities. I don't think there is any question that if we evaluated whether to stay in, let alone increase emerging market equities, based on its performance in the first couple of years, everybody would have exited the emerging market equities.

But what Makita says is we are looking at these investments, we are looking at the future, we're looking at the economy, we are looking at the populations of these countries that are growing, they're looking at all of these factors -- which they understand completely much better than I do -- and they're saying, look, if we look into the future, we think this is what we think, and we're not going to be guided by the past. That's the same analysis that's going on with these managers.

So, getting back to your question is there a standard, I would say there is a process, and the process is these folks meet every quarter. By the way, if you sort of look at the various minutes, there isn't just board of trustees minutes. There is board of trustees, there is investment committee, there is strategic planning, there is communication, and there are three or four committees that I don't think would deem sufficiently relevant to this case yet to get involved with.

These are folks that meet extensively on a quarterly basis, and every single quarter Makita prepares one of these reports, and it does report on every single manager broken up by sector. And, if you look at the reports, you will see at the end there is a set of specific recommendations, including recommendations to keep a manager who they call to the trustees' attention and say, yeah, he's not doing well but we think we should let it ride for a while.

And if you look at the history of Artisan, the emerging market manager that performed poorly and was eventually let go, there was a period of time where the trustees were challenging Makita and said what about this, and they said not yet; we don't see anything fundamentally wrong with what they're doing; but if they continue to perform badly, we'll take another look. And that's what happened. With the benefit of hindsight, I'm sure the trustees would say the same thing, gee, we should have gotten rid of these guys a year or two earlier.

But there is a process. And I am a little resistant to use the word "standard," because I think what we're reading Makita to be saying is don't get locked into a hard and fast rule; every single situation needs to be judged by its circumstances.

So, I think the important word here is that there is a process. There is a consistent process of getting reports from Makita, soliciting their advice, and then reacting to their advice in deciding what to do.

I also point out that some of the minutes reflect the fact that the trustees specifically asked for some more reporting from Makita. There is a reference to 2012, 2013. In fact, there is support that the plaintiffs cite for the proposition that the trustees were aware that there wasn't a process. That's not what those minutes say. What the minutes say is the trustees asked Makita to provide additional information about some of the managers and to come in and give their global view about the economy. So they asked for more process. That doesn't mean there wasn't a process before that. We have all those reports before that.

So, you know, obviously we are asking for a lot at a very early stage of a case, and it's a little bit frustrating for me since our two firms represent hundreds of multi-employer plans, so somebody like Jani Rachelson goes to these meetings all the time. So, there is a certain body of information that one has from doing this that we can't possibly capture in the papers.

But I do think that this fund has an extraordinarily robust, documented record of what it did, and we think it really would be a crying shame to put these trustees through what could be years of extensive discovery when we don't really think there is any reason to think that there was something wrong with their process. There may have been something wrong with some of the outcomes, and even there the jury may still be out.

Let me just to close say what you said before is true, this fund is still in trouble. There are some serious issues that have to be decided, whether to support certain pieces of legislation that may allow funds like these to have some other remedy if the investments are doing a little better. They haven't gone into that critical and declining status yet even though we were very close. Maybe we will stay out of it. There is a whole question whether that's a good or bad thing because clinical declining status actually creates an opportunity that some people may think is a good idea. We would just prefer if the trustees could just continue to focus on what their real job is and not be preoccupied by this litigation.

THE COURT: I think we need more musician, young musicians, that's what we need.

OK. Who is arguing for the plaintiff?

MR. SCHWARTZ: Good morning, your Honor. Steve Schwartz. And I agree we do need more young musicians.

Before I get into the EMEs and the private equity and how they took money from domestic equities to fund that, I want to step back to talk about where the problem started. The problem really starts with the target return, the goal of what the return is, because that drives all the investment decisions.

Now, in 2014 defendant Brockmeyer gave an interview to I think it was Allegra Magazine, and he said something that we agree with. He said that he spends a lot more time on investment issues than a lot of the other trustees, and the best return is typically 7.5 percent even though in a few funds we've lowered the investment target to 7.25, and that in seeking returns we've got to protect against a significant downside.

That actually is something we agree with, a statement by one of the key defendants, and it tells you what the metric is. And the problem that started all these problems was that the fund's target return was 7.5 percent; they had the shortfall coming out of the '08 recession because of the '08 recession losses and because of the demographics of the music industry which we don't have to get into even though it's very interesting; and faced with that problem what they decided to do was set a new target return of 8 percent, and it wasn't an analysis that when given the opportunities in the market, given what's available, given the realities of the market -- because the market is the same for someone who is in a hole and someone who is doing really well -- they set the 8 percent number simply because that's the long-term 20-year number they needed to get out of the hole. It was a reverse engineering process. So, they go to Makita and say let's ratchet up the target return from seven and a half to a 8 percent, give us some ideas on how we could get this extra market return.

So it's not just the active managers trying to beat the market. They try to start to beat the market by changing the target return. And all the decisions about EMEs and private equity is really derivative of that attempt to ratchet up the target return. And as we go over time what we will see is when I go through it that when it didn't work initially and they dug the hole even deeper, they just ratchet up the target return from 8 to 9 percent. And going from seven and a half to 9 percent is a massive shift in what you think you're going to get, and that is very much like the gambler who is doubling down or tripling down trying to take riskier and riskier bets.

THE COURT: Is your contention that given historic returns and for purposes of a Taft-Hartley plan, aiming at a nine percent return is just kind of per se too risky, that no fiduciary does that?

MR. SCHWARTZ: Your Honor --

THE COURT: No reasonable fiduciary return is the seven and a half percent that we're all used to, because that's just what you're going to get and aiming at a higher return is necessarily too risky for a pension fund?

MR. SCHWARTZ: No, we are not making a per se argument on the target return. We're also not making a per se argument on can you never use active managers. We're not making per se arguments.

As Mr. Rumeld pointed out in the Pension Benefit Guaranty case and other cases, you have to look at everything in context. And as held in the Sacerdote v. NYU case -- which is about to go to trial -- you can't parse each claim individually.

So, what we have tried to present to your Honor -- I think we have done it -- is present a compelling case giving the reasons why they got into the wrong philosophy and made a mistake, the specific investment decisions that were a mistake given specific warnings about those investments and what would happen if there were short term losses, then doubling down, and then a tripling down, with the overlay of all the active managers which created its own risks all in an attempt to beat the market.

So, we have a comprehensive set of facts or, in the parlance or the lingo of the Pension Benefit Guaranty case, we have all these surrounding circumstances where we think each of them individually is very compelling -- and I do think seven and a half to nine percent, given the statement from one of the key trustees, I think that is a really strong claim. But then they acted on it, and they acted on it like a drunken gambler chasing losses, and those combination of facts to me even under any standard -- whether it's a heightened standard under Pension Benefit Guaranty, under the usual plausibility standard that was used in the Sacerdote v. NYU case, under a summary judgment standard, if we looked at this kind of like summary judgment because we have all these documents, no matter what the standard is, we have a compelling narrative here where all of our claims fit together with various facts, both target returns, specific decisions, next set of decisions where they double down, decisions where they triple down, and to me when you combine all of those and add in some of the questionable disclosures that they made, I think we have a compelling case that there is something wrong here, and what was wrong was while I don't think the process was good at all -- and we do have process allegations here -- I think your Honor did hit the nail on the head, that the decisions themselves are just a combination of risky bet taking that really doesn't make sense. And it's not hindsight that they dug their hole even deeper by making those decisions, because they were told by Makita and by Milliman at the outset that given where the fund is -- and the problems with the fund was going to be funding down the road, not this year or next year -- that if you didn't do well in the short term -- and doing well can mean either making gains or it can mean not having bad losses -- but if you did poorly in the short term, because of the power of compounding over the next ten, 20 years you're not going to dig yourself out of the hole.

So, I appreciate that maybe EMEs did OK during one of the more recent years, but if you take a four year period, if you want to get seven and a half percent and you get zero, zero, seven and a half and seven and a half for each four years, it averages to seven and a half percent per year, but that is a much different result than if it was seven and a half each year because of the power of compounding, and that's how they dug themselves in the hole even more by starting out with the EMEs.

THE COURT: Do I correctly understand your argument about the active managers, that your beef is there did not seem to be from the trustees' perspective -- other than listening to Makita -- and it was not clear to me, are you claiming that Makita had some kind of a conflict, that they shouldn't have been listening to Makita anyway?

MR. SCHWARTZ: Well, I don't say that they shouldn't have listened to Makita anyway. There is a conflict which is not a central part of our litigation but we point it out, that because Makita wanted to get a more lucrative position, there was a financial incentive for Makita to do what the trustees wanted to do and to not push hard against the trustees' desire to ratchet up the target return.

Now we cited in our papers that it was the trustees that directed Makita to raise the target return, and then when Makita makes recommendations they're fitting the recommendations into the target return. It's just like if someone comes to me and says, Steve, try to make $50 million the next two years but not from the practice of law but from investing. Well, if that's what I'm trying to do, I'm not going to do an index fund, I'm not going to do an actively managed Fidelity fund, I'm going to have to start making crazy bets to do that.

So, there is a noncentral but there is something that at least the trustees should have been cognizant of that Makita may have some reasons to not push as hard as they should. And this comes into play where Makita in fact -- along with First Eagle, another one of their advisors -- while the trustees were ratcheting up the EMEs up to 15 percent compared to four and a half percent on the typical fund -- Makita was divesting its portfolio of EMEs, and First Eagle was also doing that and saying we're in a -- I would like to say unusual but it's happened in other cases -- where Makita's so-called advice was the opposite of what Makita was actually doing with its own money, and that to me raises a very serious question. It's one of those --

THE COURT: Well, it raises a question about their advice, but Makita isn't a defendant in this case.

MR. SCHWARTZ: Right. But the defendants knew that Makita made the opposite bet with its own money, because they were told that at the meetings, and the defendants knew that First Eagle made the opposite bet because, they were told that in its meetings, and that's from their notes.

So, what we have is trustees who know Makita is making the opposite bet, and they are taking their EMEs which started at six percent in the initial investment, which was higher than the four and a half of the typical fund, and when they ratcheted it to 11, and they ratchet to 15, but their advisors are making a different bet with their own money, that to me is one of those surrounding circumstances under the Pension Benefit Guaranty case where a decision that looks very reckless if you just look at the decision looks even more reckless when you know that, that the advisers are making the opposite bet. It makes it more reckless when you know from the Brockmeyer interview that they're really stretching the target return.

So, there is a combination of reasons for each of the claims that we raise, all of which interrelate with each other and hold together and provide support for each other which really I think drives home the point that these trustees, no matter what kind of advice they may have gotten, they're making very, very outsized risky bets that made very little context in terms of the position of the fund, when they were told that if you lose money or don't do well in the early years, you're going to never dig out of the hole because the way you dig out of a hole in this context is to have compounding over many years. And with all of the riskier bets necessarily comes a higher degree of volatility, and that's what they got caught in. They got caught in the trap where the volatility of the EMEs and the private equity put them in a bigger hole, and they would be in a better --

THE COURT: I'm sorry, let me interrupt for a second. So your complaint is about both private equity and EME.

MR. SCHWARTZ: Yes.

THE COURT: And what is your complaint relative to firing active managers? Did I correctly understand your complaint that your real complaint seemed to be that the trustees didn't really have a standard for making decisions?

MR. SCHWARTZ: They didn't have a standard. They started with a hundred percent, which I don't even know how someone starts at a hundred percent given the body.

THE COURT: A hundred percent active managers.

MR. SCHWARTZ: Yeah, they start with a hundred, and so while I appreciate they went from a hundred percent to 70 percent beginning to end of the time period that's within the statute of limitations, our case starts at the beginning where it was a hundred percent and stayed at a hundred percent for a while. That decision in and of itself to me is indefensible to have a hundred percent in active management.

Then what you see is that the process -- there is no standard for the process. And there was a case that they cited which I think is very helpful for us where they talked about the process they had in that case, and the gist of it is that for each -- I will pull the case in a second -- for each manager they had a series of five categories of how each active manager was doing, whether it should be a strong hold, weak hold, watch, negative. And the problem.

THE COURT: This is what these trustees did.

MR. SCHWARTZ: No, no, not these trustees. This is in a case, and I will pull the case in a few minutes when I find it. I apologize.

But these trustees the active managers did poorly, and we know from the e-mails from plan counsel they didn't do poorly for one year, three years or five years. The numbers were ugly, and plan counsel acknowledge they were ugly, and if we actually transparently conveyed that information to participants, there would be a riot, and they would get sued just like they have been sued.

What the trustees did was when they were faced with managers who had done poorly over a number of years, the response was, well, we will give them a little more time and we will wait; and then after more years they finally switched, often times from going from one active manager to another active manager, which doesn't make sense.

One good example is for active manager Next Century, there was several years of underperformance from the time they hired Next Century. They actually did I guess a good thing from a process point of view of bringing in the guy from Next Century to give a presentation, and a trustee asked him, well, how much longer should we give you before we can see if your strategy works; and he said one year. Well, they don't ditch Next Century for two years after that.

So, even when the active manager said all I need is one year, if I haven't performed, then, yes, you should get rid of me, after another year of bad performance they didn't get rid of him; they waited around for a whole other year until they ditched Next Century.

And that's kind of an example of what is the process and standards. The standards was basically we will get rid of them when we get around to it, as opposed to stepping back and saying does using active managers really make sense; is there any way that we're ever going to really not only find the rare active manager that can somehow beat the market but we are the ones who are going to be smart enough to identify that smart unicorn active manager.

And when you've made the same mistake not one year or three years but for five or six years, that to me says that there is no really process that's going on there; and we just get into fact questions that just cannot be resolved on a motion to dismiss.

And even with respect to the EMEs, they start out -- they actually made the decision to go into the EMEs based on Makita's recommendation that there were going to be inefficiencies and an active manager can find those inefficiencies and get an above-market return. They made the decision to go to six percent EMEs before they identified these magical active managers.

Then they find the two active managers that start, Dimensional and Artisan. Artisan does poorly, as Mr. Rumeld mentioned, but Dimensional did poorly too. And the response was since Artisan did worse poorly, to ditch Artisan and to send the money from Artisan to Dimensional which had been underperforming, and eventually they sent that piece of the money from Dimensional to Dry House which also did poorly.

So, basically they are doing a whack a mole game from going from one active manager to the other active manager, not really stepping back and saying, well, if all the literature says there are just very few magical active managers that can truly beat the market, maybe the fundamental thing of what we are doing is wrong.

THE COURT: But isn't it the literature more -- it's more sophisticated than that? It's not that -- there clearly are segments where it makes no sense to be in an active managed fund. Blue chip stocks, for example, it's just insane to do that, although there are managers who do that.

I thought the trustees' argument was a little more nuanced than that, it is as to certain segments of the market an index fund doesn't really make sense because there is a lot of variance in terms of how well different advisors do; it's not an efficient, incredibly deep and liquid market; and, therefore, having active managers who could actually do the individual research, etc., is more important in certain markets than in others. And I'm not sure that that is contrary to the accepted body of financial thought relative to index funds.

MR. SCHWARTZ: I disagree but only partially. The literature is very broad based; it's not just the S&P 500. And the place where they got hurt was with the midcap stocks where the literature is just as appropriate as it is with the S&P 500.

And if you take a look at the board minutes -- and I think your Honor identified what the real issue was -- Makita said to them we think this is a sector, midcaps, where we think there are inefficiencies and we think some managers can identify those inefficiencies and do better than the market in good times, and in bad times hedge against even worse losses. And that was basically it. That was the pitch from Makita, and that was it.

There was no elongated discussion, elongated presentation which gave a fair balance of here are the pluses of going active, here are the minuses, this is what the literature shows over many studies over a long period of time, and so when you make a choice be very careful.

And when you step back and say, well, did these particular trustees, did they really understand what they were doing, well, we talked about in paragraph 129 where another one of the key trustees, Gagliardi, he was asked a specific question from one of the plan participants why do you keep on trying to outguess the market with active managers. And I won't read the answer to you. His answer was nonsense, but his answer reflects a complete lack of understanding of what the real choices that you identified.

Is it possible that there could be some specific sector where someone has some real sector-specific and manager-specific information where it might make sense? Warren Buffett says no, but I'm not going to say that you have to make that decision on a motion to dismiss. But these managers did not go into that kind of detail and analysis. And even at the end of the day when they've lost their bets and gotten their clocks cleaned, one of the key members of one of the key subcommittees still has no way to respond to that question from a plan participant, when you think that would be an issue that he was all over and had a complete understanding.

And I don't want to harp too much on plan counsel's e-mail about how the active managers work, but it's not a record where it could have been better; it's an ugly record, and the underperformance you could have said it was an ugly record one, two, three years before they made any moves. And going from a hundred to 70 percent, that is not that big of a shift. If they would have gone from a hundred percent to 30 percent, then I think it would be much harder for me to say, well, at least they were making some reasoned decisions.

But going from a hundred to 70 is basically meaning at some point way too late you're getting rid of the low hanging fruit. But I think that one of the critical parts of the active manager claim is that it's consistent with our claim they're making very risky bets with the emerging markets equities and the private equity, and pretty much everything they did during this time period was one outsized risky bet on top of another outsized risky bet, and they kept on increasing it and ratcheting it up over time.

You don't see those facts in the Pension Benefit Guaranty case. In that case there was one investment mortgage backed securities, there were some rumblings that there were some risks with that, but a lot of people invested in those too. It was not the same kind of inform this is really, really risky. There was no fund specific circumstances about short term returns in that case. And there was one investment decision which started I think at 10 percent, and then it decreased over time. There is no doubling and tripling down in the Pension Benefit Guaranty case. And the loss that occurred was a one-time market crash where everyone got slaughtered in that market crash. In contrast with the EMEs, it was not a one-time market crash. In fact, when they lost initially, they just kept on doubling and tripling down, and they dug deeper holes as they doubled down. And did it have a period where it did well more recently? Yeah, but the volatility can quick right back, but the problem is they've already lost that money and the compounding for that money, and they will never get it back.

THE COURT: That's a little bit backwards.

I mean I hear you, but there is no guaranty in life and definitely not in investments. And the normal view -- which is good advice -- is to try to buy low, right, so as the market -- so as that sector is in trouble, that's the time to buy that sector. Don't buy it when it's high, right?

I mean a rational decision can be made. Now whether that justifies increasing the percentage as opposed to saying let's not bail on the decision to go to eight percent or nine percent or whatever it was in emerging markets. I think your complaint is a little different, which is, far from just investing low, they were saying let's jump in further and further and further into what is an outsized risky bet for a pension fund. It's one thing for your individual IRA.

OK. I think I got your point.

MR. SCHWARTZ: And I agree with that synopsis. And if they had stopped with the six percent and never went to 11 or 15, it might be harder for me and your Honor to discern what was really going on in terms of are they just riverboat gamblers. When they go from the six to the 11 and then to the 15, moving the private equity from three to 18, even though the average fund only has four percent in private equity, and you're taking it from domestic equities -- it would be one thing if they said we're going to take a portion of our high risk portfolio and shift it to another different high risk bet.

What they did is they took the bread-and-butter domestic equities, and they stole from that to fund these two bets, and so it's the combination of factors, and as the cases say, the combination of factors is the way that that courts should review these on a motion to dismiss.

THE COURT: OK, thank you.

MR. RUMELD: Can I just reply very briefly?

THE COURT: Briefly.

MR. RUMELD: I think there is one theme I want to discuss in reply here, which is, there is an essential equivocation in Mr. Schwartz's comments as to whether he is blaming the trustees for following the advice of their consultants or for disregarding the advice of their consultants.

Now, in my book, if you fire an investment manager contrary to the advice of your investment consultant, I think you're much more likely to get into trouble if the investments go in one direction after that, than if you follow the advice of the investment consultant.

What did our consultants say? If you look at this Exhibit 27, the stochastic model I referred to before, on page 13 there is a chart that shows what is going to happen over a long period of time under various annual rates of return. And for the seven and a half percent rate of return it shows that within 20 years, 2034, the fund will be 49 percent funded, meaning it has less than half the money it needs to pay benefits. And a couple of pages earlier they talk about financial measures and they say 80 percent is used as a proxy for a plan headed towards financial health; 50 percent used as proxy for 'plan headed toward financial peril, a/k/a tipping point.'"

THE COURT: 50 percent what?

MR. RUMELD: 50 percent funded. So, they get a report from their actuary that says if we let it ride, if we keep investing consistent with the seven and a half percent assumption, we're telling you that within a 20 year period you will be less than 50 percent funded, and less than 50 percent funded means headed toward financial peril, passing the tipping point.

So I would submit to you, your Honor, that no matter what isolated quotation from Chris Brockmeyer they can refer to, if you are presented from your actuary with a piece of paper that says if you just keep doing what you're doing, your fund is going down the tubes, these are times for extraordinary measures. And that's what happened, OK?

THE COURT: I think the question though is whether the extraordinary measures were too extraordinary for the actions of the fiduciaries.

So, look, I am sympathetic to the situation the trustees found themselves in, but when I hear the emerging markets, they ultimately put how much --

MR. SCHWARTZ: 15 percent.

THE COURT: -- 15 percent, and private equity at 10 percent or nine percent?

MR. SCHWARTZ: 18 percent.

THE COURT: 18 percent. That's just -- I mean again I understand the situation the fund was in, but that is extraordinarily risky. I mean, yes, if the risk pays off, mazel tov, but the reason that it's risky is that you also have a risk that you're not going to get that return, that you're going to lose money. That's why the investment is risky.

MR. RUMELD: Yeah. And with respect, your Honor, that's why we hire professionals who can evaluate risk in the aggregate.

THE COURT: Let me ask you something. If your fund had been 75 percent in emerging markets and 20 percent in private equity because Makita said that will get you fully funded in 15 years, would the plaintiff be able to say that's a breach of fiduciary duty, that is simply too risky, you can't put an ERISA fund in that level of risk?

MR. RUMELD: I think under those circumstances some of the other metrics that appear in those reports, including likelihood of going under in the short term because of a short-term risk would have pointed against doing that, because obviously there is some point at which you are taking on too much risk because you're not going to be there for the long term.

But if you look at these reports, they have probability of achieving seven and a half percent, probability of a negative return over a 20 percent period, probability of what they call those three stigma events, something happening. And actually even if you look at the report where they go to the nine percent target and the 15 percent, the movement on the margin is really relatively small if you look at those risk factors.

At the end of the day I ask that your Honor focus on the process. There is nothing wrong with the process, with taking these extraordinary circumstances, asking your consultant what to do, being presented with four or five choices, and actually picking amongst the more conservative of those choices -- because if you look at that report with the various asset allocation models, yeah, 15 percent sounds extraordinarily high, but the other choices had more risk attached to them. They actually took the more conservative of the nine percent approaches there.

So, we all have our own stigmas about certain investments being risky. Oh, and by the way, the notion pulling away from domestic equities, let's be real here, domestic equities are incredibly volatile. All we have to do is look back the last week or the last month to know that.

Domestic equities aren't the safe investments.

THE COURT: Well, they're volatile in the short term; they're not volatile in the long term.

MR. RUMELD: And also when they move from eight percent to nine percent, they didn't steal from domestic equities, that's false. When they went to eight percent, they moved some of the domestic equities, but they moved from one equity investment to another that their consultant said had a better chance in the long term of getting them the returns they needed.

In any event, my point is it's not imprudent to follow the advice of your consultant. If they want to make a case that Makita didn't know what they were doing, or Milliman didn't know what they were doing, those folks will be happy to defend themselves, I promise. But there is only one instance in these papers that was cited where the trustees did not follow Makita's advice, and that was in 2016 when they suggested derisking -- not just only emerging market equities but all of the equities because of this situation in China -- it was described as a temporary measure. The trustees felt it was too much like market timing and didn't do it, and the truth of the matter is if they had followed Makita's advice they would have been in worse shape because the equities did very well in that period of time.

But if you look at any of the advice before then or after, they're consistently recommending to keep and increase the investments in emerging market equities.

So, it may sound weird to be this heavily invested, but I think the question for your Honor is did these guys follow or not follow the advice of their consultants. And if they followed the advice of their consultants, can I really say there was a breach of fiduciary duty or a breach of the process? Thank you, your Honor.

THE COURT: Thank you.

MR. SCHWARTZ: Can I make one quick point about the stochastic modeling?

THE COURT: No.

OK, I'm prepared to rule on the defendants' motion to dismiss. The motion is granted in part and denied in part. As to Counts One and Two the motion is denied; as to Count Three, the motion is granted.

Much of the defendants' brief reads like a motion for summary judgment, and we're just not at that stage. I reviewed all of the material that the defendant submitted -- based on their argument that the court can consider such materials without converting the motion to a motion for summary judgment if the plaintiff relies on them and if the actual documents contradict plaintiffs' allegations. I do not find that the materials to contradict the complaint, Although I will say that the gestalt of the board minutes is likely to cause the plaintiffs difficulty at trial or at summary judgment.

Plaintiffs' allegations come down to three main complaints: First, the trustees breached their fiduciary duty by investing substantial percentages of the fund in emerging markets equity and private equity, the first of which is very volatile and risky, and the second of which is illiquid; Second, without standards to evaluate the value of active management for various classes of assets within the fund, they opted to use actively managed funds rather than passive index funds which are cheaper, and they failed to take prudent action against underperforming investment managers; and, third, they failed to keep the plan participants fully informed about the fund.

Before shifting to defendants' specific arguments, let me say that I do not find Pension Benefit Guaranty Corp. v. Morgan Stanley to be an impediment to the complaint. Schnitzer has alleged specific information that was available to the fund regarding the near term risk of investing in emerging market equities which, he argues, should have caused a prudent fiduciary to limit the fund's near term exposure to such investments. Far from doing so, he argues, the fund doubled down and increased the percentage of the fund invested in an asset class that was losing money and that a prudent fiduciary would have recognized at the time was likely to continue to do so for the near future.

Defendants argue, in essence, that the decision to invest substantial funds in emerging markets and private equity was not a breach of their fiduciary duty but was instead a reasoned decision by the trustees to increase the probable returns to the fund, even though that meant taking on additional risk to maintain the long term solvency of the fund. As to active management, they argue that many portions of the fund are passively managed and that the decision to use active managers is not per se a breach of fiduciary duty. As to providing plan participants with information about the fund, they argue that much of plaintiffs' complaint is about internal discussions that ultimately were resolved in terms of full transparency and, in any event, plaintiff has neither alleged causation nor harm from the failure THO disclose.

At the motion to dismiss stage, defendants' arguments are not compelling. The court is not unsympathetic to the positions the trustees found themselves in after the 2008 recession. They were highly motivated to adopt an investment strategy that increased the probability that the fund would be solvent in the out years. The question is whether the strategy they adopted was so risky that it is outside the bounds of what a prudent fiduciary would do. In that regard, the fact that this fund was significantly overweighted in volatile and illiquid asset classes (specifically EME and private equity) vis-a-vis it's Taft-Hartley peers, nudges plaintiffs' claim across the line from possible to plausible. Similarly, as to plaintiffs' complaint about active management, it is again clear from the materials presented that the issue of investment management fees was of concern to the trustees. It appears that at many of the investment committee meetings, one or more investment managers came under fire for consistently underperforming the relevant standard. Sometimes, but rarely, the manager was dismissed; more generally, Makita persuaded the board to stay the course and not change managers. There was also discussion at committee meetings which clearly reflects Makita's view of the world -- that active management is worthwhile for certain asset classes where there is a "substantial spread between percentile rankings." That's from Defendant's Exhibit 56. Although, I believe I saw something like that in numerous different meetings. Although the defendants are correct there is nothing per se wrong with active management, plaintiffs' complaint that as fiduciaries the trustees should have some criteria they use to decide whether active management was actually worth the cost and for deciding to fire active managers who were not doing a good job. Plaintiff alleges there were no standards and nothing in the defendants' documents demonstrates that there were.

I'm saying standards. Maybe process would be a better word.

Plaintiffs' argument -- given the financial industry literature that he cites -- is, again, plausible.

Finally, I agree with the defendants that plaintiffs' allegations regarding nondisclosure do not include allegations showing plaintiffs were harmed. I do not view this as fatal because nondisclosure is not a stand-alone claim. Instead, it's just one of three ways in which plaintiff alleges the trustees violated ERISA. Keeping those allegations in Counts One and Two will have no impact on discovery, because regardless of whether it's a stand-alone claim, the evidence of trustees trying to hide the ball from the fund's beneficiaries is relevant to the ERISA claims of breach of fiduciary duty and is therefore a fair target for discovery.

In sum, plaintiff has plausibly alleged an ERISA violation, albeit one that will have a tough row to hoe to get past summary judgment.

As to Count Three of the amended complaint, it is dismissed. Plaintiff responded to defendants' motion relative to that count only in a footnote. That is not adequate to preserve the claim. See In Re Crude Oil Commodity Litigation, 06 Civ. 6677. It appears at 207 WL 1589482 at page 3.

OK. You have a schedule for discovery, correct?

MR. KRINER: We do.

THE COURT: Do you need anything further from me at this stage?

MR. SCHWARTZ: Not from plaintiffs, your Honor.

MR. RUMELD: No, your Honor. Thank you.

THE COURT: Thank you all.

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