FRANKLIN TEMPLETON

Prepared by The Wagner Law Group

WHAT IS REASONABLE?

Practical tips for evaluating fees and expenses of plan investments

All investments involve risk, including possible loss of principal.

IMPORTANT NOTE: The Wagner Law Group has prepared this white paper on behalf of Franklin Templeton, Inc. This paper includes suggested practices that plan sponsors, and the financial professionals who work with plan sponsors, may wish to consider in connection with the management of the plan and its investments.

It is important to note that the suggested practices are not the exclusive means of complying with ERISA's fee-related duties and prudence requirements. Other combinations of practices also may be effective. Plan sponsors and other fiduciaries should consult with their own legal counsel concerning their responsibilities under ERISA in the administration and management of their respective plans.

Future legislative or regulatory developments may significantly impact these suggested practices and the related matters discussed in this paper. Please be sure to consult with your own legal counsel concerning the application of ERISA to the selection of plan investments and any related future developments.

This white paper is intended for general informational purposes only, and it does not constitute legal, tax or investment advice on the part of The Wagner Law Group or Franklin Templeton, Inc. and its affiliates. Plan sponsors and other fiduciaries should consult with their own legal counsel to understand the nature and scope of their responsibilities under ERISA and other applicable law.

The content of this whitepaper was updated in September 2020 and is subject to change.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

What's inside

Introduction	3
ERISA's fee-related duties	4
Meeting your fiduciary responsibilities	5
Fiduciary considerations for share class selection	6
Increasing availability of CITs	7
Cost implications of TDF structure	9
Conclusions	10
Exhibit A – Fiduciary Checklist for Plan Investment Expenses	11

INTRODUCTION

Plan sponsors have a general duty to ensure that the plan's investment fees and expenses are reasonable under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

If the plan's investment fees and expenses are excessive, the plan sponsor may be subject to significant fiduciary liability, as highlighted in the 2015 Supreme Court case, *Tibble v. Edison International*.[1]

As a result of this high-profile case and other 401(k) fee-related litigation, many plan sponsors are now paying even more attention to investment fees and expenses. But even if plan sponsors fully appreciate their legal responsibility to ensure that the plan's investment fees and expenses are reasonable, they may still be left asking themselves, "What is reasonable?" By the same token, Department of Labor ("DOL") regulations do not define "reasonable," adding to the uncertainty.

In this paper, we will be offering practical tips and suggestions that are designed to help 401(k) plan sponsors[2] demonstrate that they are evaluating the reasonableness of the plan's investment fees in a proper manner. As discussed below, plan sponsors may be able to significantly reduce and mitigate their fiduciary risk by considering the following in their fiduciary deliberations:

- The importance of share class selection and the availability of alternative share classes
- The increasing availability of collective investment trusts ("CITs")
- How the structure and form of target date funds ("TDFs") may have cost implications

[1] *Tibble v. Edison Int'l*, 575 U.S. 523, 135 S. Ct. 1823, 191 L. Ed. 2d 795 (2015).

[2] Our references to 401(k) plans in this paper should be interpreted broadly to apply to all defined contribution plans with participant-directed investments, including but not limited to ERISA 403(b) plans.

ERISA's FEE-RELATED DUTIES

Plan sponsors have a fiduciary duty under ERISA to ensure that the plan's investment fees and other operational expenses are reasonable (the "Reasonable Expenses Rule").[3]

They are also subject to a "duty of prudence," which requires them to act with the care, skill, prudence and diligence that a prudent person familiar with plan investment matters would use.[4]

The courts have interpreted this duty of prudence as requiring plan fiduciaries to make the same investment decisions that prudent and experienced investors acting for their own account would make in similar circumstances.[5] Therefore, before an investment may be approved, the plan sponsor must conduct a "prudence test" to see if hypothetical prudent investors acting for their own personal account would also approve of the investment.

In evaluating prudence, the focus is on process. Both the DOL and the courts have stated that plan sponsors should, before selecting a service provider, conduct a comparative analysis in order to make a prudent decision. One way that a comparison can be made is through a request for proposal, although a more common approach is benchmarking. Courts analyze a fiduciary's *process* to determine prudence, not outcomes.[6] As a decision by the Eighth Circuit[7] stated, it is important to select a meaningful benchmark. While there is no fiduciary obligation to select the least expensive fund,[8] in general the fund selected should be within a range of what other service providers have charged. Equally important, the plan fiduciary must also take into account both the quantity and quality of the services that it is receiving.

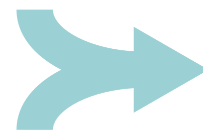
When applied to 401(k) plans, the Reasonable Expenses Rule requires the plan sponsor to choose investment menu options that are reasonably priced. This determination must be made in accordance with the duty of prudence. Thus, the plan sponsor would need to choose investment options with fees and expenses that are comparable to those options that prudent and experienced investors acting for their own account would choose in similar circumstances. Instead of focusing on lowest cost, plan sponsors are required to ensure that fees are reasonable given the investment and its features. To put it another way, the investment options may not be offered to plan participants unless prudent and experienced investors would similarly conclude that the investment fees and expenses are reasonable under the circumstances.

Fiduciaries are cautioned to remember that they can be held personally liable for their poor decisions, including making up any losses suffered by the plan.[9] In the event that the fees and expenses for any investment option included in the plan's menu are deemed to be excessive, the plan sponsor who approved such investment would be in breach of its fiduciary duties under ERISA. The penalties for a fiduciary breach can be severe. In addition to fiduciary liability for any harm caused to plan participants, a plan sponsor can be subject to various sanctions under ERISA, including a 20% civil penalty.[10]

[3] ERISA Sections 403, 404(a)(1) and 408(b)(2).
[4] ERISA Section 404(a)(1)(B).
[5] *In re Unisys Savings Plan Litig.*, 74 F.3d 420 (3d Cir. 1996).
[6] *Ferguson v. Ruane Cunniff & Goldfarb Inc.*, No. 17-CV-6685 (ALC), 2019 WL 4466714 (S.D.N.Y. Sept. 18, 2019).
[7] *Meiners v. Wells Fargo & Company*, 898 F.3d 82 (8th Cir. 2018).
[8] *Sacerdote v. New York Univ.*, No. 16-CV-6284 (KBF), 2017 WL 4736740 (S.D.N.Y. Oct. 19, 2017).
[9] ERISA Section 409, 29 USC Section 1109.
[10] ERISA Section 502, 29 USC Section 1132.

MEETING YOUR FIDUCIARY RESPONSIBILITIES

Whether a plan sponsor's investment decision has been made in accordance with the duty of prudence is determined by the plan sponsor's actions in making the investment decision, and not on whether the investment ultimately succeeds or fails.[11]



If a plan sponsor's investment decision is one that a prudent person would have made under similar circumstances, a fiduciary breach does not arise even if the investment ultimately fails.[12]

To meet the duty of prudence, plan sponsors and other fiduciaries should conduct due diligence reviews of all proposed investments.[13] As a result, before 401(k) plan sponsors approve any investment options, they should conduct a due diligence review of the proposed investments, including their fees and expenses.

If plan sponsors lack the experience or skill required to properly conduct the due diligence review, ERISA's duty of prudence obliges them to consult an expert.[14] While reliance on outside experts may be necessary, it does not completely eliminate fiduciary responsibility. A fiduciary may not be a mere "rubber stamp." Thus, when performing a due diligence review of an investment option's fees and expenses, 401(k) plan sponsors should consult an investment expert, such as a qualified financial advisor, if they do not have the necessary experience or skill to properly conduct this type of investment fee review. Financial advisors may be able to provide valuable guidance, such as fee and expense benchmarking information for comparable investment options. After all relevant fee and expense information has been reviewed, a proposed investment option should be approved only if the plan sponsor is able to conclude that prudent investors would find the investment fees and expenses to be reasonable.

Of course, although they are an important factor, fees and expenses should not be the exclusive factor considered when selecting a plan's investment options. Before a prospective investment option is approved, the plan sponsor should consider all relevant facts and circumstances, such as the option's investment objectives, risk and return characteristics, performance, and the extent to which it would improve the level of diversification within the plan's investment menu.

It is a best practice for plan sponsors to adopt an investment policy statement ("IPS") to guide them as well as their advisors. The IPS should define the plan's investment criteria and provide a framework for how to select funds and monitor their performance. Like the plan document itself, the IPS is considered a document that governs the operation of the plan, and all fiduciaries have an obligation to follow it.[15]

[11] *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983).
[12] *In re Unisys Savings Plan Litig.*, 74 F.3d 420 (3d Cir. 1996).
[13] *Fink v. National Savings and Trust Co.*, 772 F.2d 951 (D.C. Cir. 1985).
[14] *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982).
[15] 29 U.S. Code § 1104(a)(1)(D).

FIDUCIARY CONSIDERATIONS **FOR SHARE CLASS SELECTION**

Mutual funds are routinely used as investment options in 401(k) plans, and it is customary for a mutual fund to offer multiple share classes to its investors.

Share class selection is an important cost consideration for plan fiduciaries since different fees and expenses may be charged to shareholders based on the particular share class that is held. The different retail share classes of a mutual fund typically feature different 12b-1 fees, while the institutional share class of a fund typically does not charge any 12b-1 fee and has lower overall expenses.

Plan sponsors that approve the use of mutual funds as investment options should pay careful attention to share class selection. Selecting the wrong share class could potentially trigger a fiduciary breach in violation of ERISA. The 2015 Supreme Court case *Tibble v. Edison* involved a plan sponsor that was deemed to have breached its fee-related duties under ERISA by selecting a retail share class for its mutual funds, without even investigating the possibility of using a less expensive share class.

The various share classes in a mutual fund represent identical interests in the mutual fund's underlying investment portfolio, except that different fees and expenses are allocable to the different share classes. Thus, all else being equal, it would be prudent for plan sponsors to select the least expensive share class that is available from the fund. Smaller plans may, however, be ineligible to invest in a fund's cheapest share classes. The fund itself may impose eligibility requirements based on plan size or investment minimums as disclosed in the fund's prospectus. Furthermore, recordkeeping platforms may impose their own share class restrictions. For example, institutional shares may not be accessible through a recordkeeper that administers micro-sized plans.

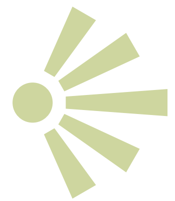
Even if a plan is able to access a mutual fund's institutional share class, it may be prudent to utilize a more costly retail share class if there is a corresponding benefit for participants. The Eighth Circuit explained that a fiduciary might "have chosen funds with higher fees for any number of reasons, including potential for higher return, lower financial risk, more services offered, or greater management flexibility").[16] Unlike institutional shares, retail shares may generate revenue sharing payments that are paid from the fund to the plan's recordkeeper, which in turn may reduce the administrative fee that would otherwise be charged to participant accounts. Although a retail share class may be more expensive, the reduction in administrative charges may confer a valuable benefit to participants that offsets the additional cost.

Based on the above analysis, when plan sponsors conduct their due diligence review of a mutual fund's fees and expenses, they should investigate the possibility of using less expensive share classes to the extent they are accessible by the plan. If the plan intends to use a fund's retail shares, the plan sponsor may consider the extent to which participants would benefit from any revenue sharing payments paid from the fund to the plan's recordkeeper, reducing their administrative fees. Courts have found that a fiduciary does not breach its fiduciary duty by allowing revenue sharing to be used to offset the costs of its recordkeeping service, so long as this is appropriately disclosed and authorized by the plan documents.[17] The emphasis is instead placed on the process the fiduciary uses to evaluate and monitor fee arrangements.

If a plan sponsor encounters difficulty determining which share classes are accessible or whether it would be worthwhile to access cheaper share classes through a different recordkeeper, the plan sponsor should consider consulting a qualified financial advisor to assist with its due diligence review.

[16] *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585 (8th Cir. 2009).
[17] *Tibble v. Edison Intern.*, 729 F.3d 1110 (9th Cir, 2013); *Tussey v. ABB, Inc.*, 746 F.3d 327 (8th Cir. 2014).

INCREASING AVAILABILITY OF CITs



In addition to offering mutual fund options to participants, 401(k) plans can also offer collective investment trusts, or CITs, as investment options.[18]

As a formal matter, CITs are trusts with investment funds that are maintained by a bank trustee,[19] but they are very similar to mutual funds in operation. A CIT may offer a large-cap growth fund or an intermediate bond fund, for example. Similar to mutual fund families, it is common for CITs to offer a family of investment funds with different investment strategies. CITs were historically designed as investment vehicles for defined benefit plans, but they have evolved over the years. Many CITs are now valued and traded on a daily basis just like mutual funds and are accessible through 401(k) recordkeeping platforms.

But unlike mutual funds, CITs are not subject to regulation by the U.S. Securities and Exchange Commission (the "SEC"). Mutual funds are registered with the SEC and are subject to numerous SEC reporting requirements, including prospectuses, Statements of Additional Information, shareholder reports and quarterly reports with portfolio holdings information.[20] CITs, on the other hand, are subject to the oversight of banking regulators, whose reporting requirements are substantially less burdensome.[21] Therefore, CITs generally have lower regulatory costs in comparison to those for mutual funds. In addition, CITs generally have lower advertising and distribution expenses.

CITs can only be accessed by retirement plans and cannot be sold to the "retail" public or individual investors. Thus, in contrast to many mutual funds, CITs do not incur any costs for advertising or distributing to retail investors.

CITs also have greater fee flexibility than mutual funds. The transactional costs associated with CITs tend to be lower than mutual funds because participants trade less frequently. As required under SEC rules, when a mutual fund offers multiple share classes, the investment advisory fee charged to shareholders in different classes must be the same percentage amount.[22] For example, when a large plan and a small retail investor invest in the same mutual fund, even if they are investing in different share classes, all fund investors will be charged the same advisory fee.[23] Alternatively, a CIT is permitted to offer multiple classes of unit ownership[24] in the same fund, where fund investors who are eligible to invest in a less expensive unit class may pay a significantly lower advisory fee. Many CITs offer flexible pricing for retirement plans, featuring different advisory fees that vary based on plan size or investment minimums.

Given the fact that CITs are generally less expensive than mutual funds and that flexible pricing may be available,

[18] Legal restrictions may limit the ability of 403(b) plans to utilize CITs as investment options.

[19] For securities law purposes, CITs generally must be "maintained by a bank" under Section 3(a)(2) of the Securities Act of 1933 and Section 3(c)(11) of the Investment Company Act of 1940. For federal income tax purposes, CITs are organized as "group trusts" under Revenue Ruling 81-100 as modified by Revenue Ruling 2014-24, which generally requires a bank trustee.

[20] These documents must be filed with the SEC in accordance with the requirements of the Investment Company Act of 1940 (the "Company Act").

[21] Under Section 9.18 of OCC regulations, national banks must prepare annual reports for their CITs based on audited financial statements. State-chartered banks are subject to similar reporting requirements under state law.

[22] Rule 18f-3 under the Company Act.

[23] Although the advisory fee generally must be the same, different mutual fund shareholders may be charged different amounts for distribution- and service-related expenses based on share class as provided under Rule 18f-3.

[24] Ownership interests in funds offered through CITs are customarily designated as "units" rather than "shares."

plan sponsors may be able to significantly reduce and mitigate their fiduciary risk by exploring the possibility of utilizing CITs. Under ERISA, plan sponsors have a fiduciary obligation to offer reasonably priced investment alternatives, and exploring the possibility of using CITs would be consistent with this duty. In the Supreme Court case discussed above, *Tibble v. Edison*, the plan sponsor was deemed to have breached its fiduciary duty by failing to investigate the possibility of using a less expensive share class. Under this line of reasoning, the mere fact that a plan sponsor is prudently looking into the possibility of using CITs can help demonstrate that it is acting with the appropriate level of care as a fiduciary. Thus, from a fiduciary perspective, it may be prudent for plan sponsors to investigate the possibility of utilizing CITs as investment options for their participants. Conversely, failure to offer CITs should not, standing alone, be considered a breach of fiduciary responsibility.[25] The plan's IPS should specify what types of investments can be made by the plan.

Although CITs may have certain cost advantages over mutual funds, plan sponsors should also consider the other potential advantages that mutual funds may have over CITs. Because CITs are not subject to the numerous reporting requirements that are imposed on mutual funds by the SEC, additional due diligence by investors is required. More information will generally be available for mutual funds, resulting in greater transparency for mutual fund investors. Participants may also be less familiar with CITs, which are not accessible to the retail public and do not have ticker symbols which would allow them to be searched online. Additionally, CITs are not required to be valued on a daily basis. Furthermore, plan participants who take rollover distributions generally must first liquidate any CIT holdings.

This is because participants who leave the plan will cease to have access to the plan's CITs, since CITs are generally not available to retail investors, including those investing through rollover IRAs.[26]

In light of these potential comparative advantages for mutual funds, when evaluating CITs, plan sponsors may wish to consider CITs advised by fund managers that also advise well-established mutual funds. Since the mutual funds of these managers would be subject to SEC reporting requirements, additional information relating to the fund managers themselves would be publicly available, increasing transparency.[27] Participants who may not be as familiar with CITs may appreciate the fact that the CIT is advised by a "name brand" fund manager with a known track record for advising mutual funds. Lastly, even though participants who take rollover distributions may cease to have access to the plan's CITs, their rollover IRAs may be able to access mutual funds that are advised by the same fund managers.

In sum, looking into CITs as potential investment options for participants may offer valuable protection from a fiduciary liability perspective, even if the plan sponsor ultimately decides against utilizing CITs. If the plan is currently using mutual funds as investment options, the plan sponsor should at least consider whether more favorably priced CITs with comparable investment strategies are readily available to the plan. When considering different CITs, the plan sponsor may also wish to consider choosing CITs that are advised by fund managers with well-established mutual funds. If plan sponsors need assistance with this type of due diligence, they should consider working with a qualified financial advisor to help them make this fiduciary determination.

[25] *Larson v. Allina Health Sys.*, 350 F. Supp. 3d 780 (D. Minn. 2018).

[26] If the plan's mutual funds are also available to IRA investors, participants who take rollover distributions may use the cash in their rollover IRAs to purchase shares in the same funds. However, the same share class may be not be available to IRA investors, and different sales loads and 12b-1 fees may apply.

[27] Of course, this additional information would pertain to the relevant mutual fund and would not directly relate to any CIT advised by the same fund manager.

COST IMPLICATIONS
OF TDF STRUCTURE

Target date funds, or TDFs, are a popular investment solution for plans. They are frequently offered as standard investment options for participants, and in the case of plans that automatically enroll their participants, they are routinely used as default investment options for participants who fail to make affirmative investment elections.

As a result of their popularity and their routine use as default investments, a substantial portion of a plan's assets may end up being allocated to the plan's TDF investment option. In fact, while the percentage allocation may vary widely from plan to plan, it is possible to find plans that have a majority of their assets invested in the plan's TDF investment option. Accordingly, plan sponsors should pay special attention to the plan's TDF option from a fiduciary perspective. To ensure compliance with their fee-related duties under ERISA, they should conduct a due diligence review of any proposed TDF option's investment expenses before approving it.

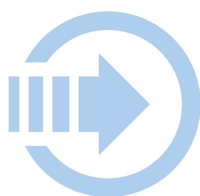
Many TDFs are organized as mutual funds with a "fund of funds" structure, meaning that the TDF is a mutual fund ("target date mutual fund") that invests in other mutual funds. TDFs sponsored by mutual fund families customarily utilize their affiliated funds as underlying investments, and the fees and expenses for these affiliated funds can be significant. To evaluate the target date mutual fund's total investment expenses, plan sponsors would therefore need to examine the fees and expenses at two different levels: those of the underlying mutual funds as well as those of the overlying TDF.

In addition to performing a due diligence review of the target date mutual fund's total investment expenses, plan sponsors should also pay careful attention to share class selection. As discussed above, a plan's investment expenses may vary significantly, depending on the particular share class that is selected for a target date mutual fund. Thus, in addition to investigating the possibility of using different target date mutual funds, plan sponsors should also investigate the possibility of utilizing less expensive share classes to the extent they are readily accessible by the plan.

It would also be prudent for plan sponsors to consider the possibility of using CITs with a target date investment strategy ("target date CITs"). Under ERISA, plan sponsors have a duty to ensure that the plan's TDF investment option has reasonable fees and expenses. Just as CITs are generally less expensive than mutual funds, target date CITs, on the whole, are less expensive than target date mutual funds. Consistent with our discussions above, it would be prudent for plan sponsors to at least explore the possibility of using target date CITs. The mere fact that a plan sponsor is prudently looking into the possibility of using target date CITs can help demonstrate that it is acting with the appropriate level of care as a fiduciary. If plan sponsors need any help performing an investment fee review of target date mutual funds or investigating the possibility of using target date CITs, they should consider contacting a qualified financial advisor for assistance.

CONCLUSIONS

There are several practical actions that plan sponsors can take to help demonstrate that they are reviewing the plan's investment fees with the appropriate level of fiduciary care.



When mutual funds are used as investment options, plan sponsors should consider the possibility of using more inexpensive share classes to the extent they are readily accessible by the plan. They should also consider whether more favorably priced CITs with comparable investment strategies are readily available. When evaluating different CITs, plan sponsors should also consider CITs advised by fund managers that also advise well-established mutual funds. If target date mutual funds are offered as investment options, plan sponsors should also consider the possibility of using more inexpensive share classes, as well as more favorably priced target date CITs.

As is true for all fiduciary decision making, it is important that plan sponsors maintain adequate records of their deliberations so that they may establish that a prudent process has been followed.

Attached is a Fiduciary Checklist for Plan Investment Expenses, with a summary of our practical action items. If plan sponsors encounter any difficulty implementing them, they can always ask a qualified financial advisor for assistance. As required under ERISA, plan sponsors should consult an investment expert if they do not have the necessary experience or skill to properly conduct investment fee reviews on behalf of the plan.

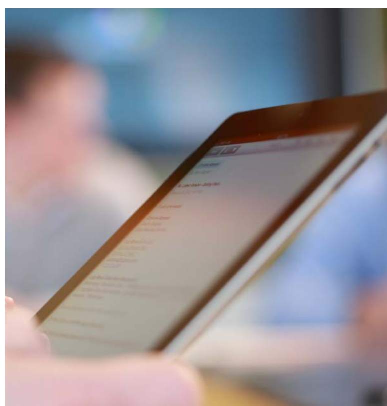


EXHIBIT A

FIDUCIARY CHECKLIST FOR PLAN INVESTMENT EXPENSES

	Practical considerations and action items		Yes	No
1	**ERISA Fee-Related Duties**	**Prudence Test** If prudent and experienced investors were to examine the plan's current or proposed investment options, would they conclude that the investment fees and expenses are reasonable under the circumstances?		
2	**Share Class Selection**	**Investment Fee Reviews** If the plan offers mutual fund options: • Have you considered the possibility of using less expensive share classes (to the extent they are readily accessible by the plan through its current or an alternative recordkeeper)? • If a retail share class is being considered, have you determined if any revenue sharing payments from the fund will favorably reduce the recordkeeper's administrative charge to participant accounts?		
3	**Collective Investment Trusts** (CITs)	**Increasing Availability of CITs** If the plan currently offers mutual fund options: • Have you considered whether more favorably priced CITs with comparable investment strategies are readily accessible by the plan (through its current or an alternative recordkeeper)? • Have you considered using CITs that are advised by fund managers that also advise well-established mutual funds?		
4	**Target Date Funds**	**Cost Implications of TDF Structure** If the plan is currently using target date mutual funds as investment options: • Have you investigated the possibility of utilizing less expensive share classes (to the extent they are readily accessible by the plan through its current or an alternative recordkeeper)? • Have you considered whether more favorably priced target date CITs with comparable investment strategies are readily available to the plan (through its current or an alternative recordkeeper)?		
5	**Investment Expertise**	**Due Diligence Reviews** When investment options are proposed for the plan's investment menu: • Are you conducting due diligence reviews that cover each investment option's fees and expenses? • Are you consulting an expert as necessary, such as a qualified financial advisor, to assist with due diligence reviews?		

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About Marcia Wagner and The Wagner Law Group

Marcia Wagner is the founder of The Wagner Law Group, one of the nation's largest and most highly regarded law firms specializing in ERISA, employee benefits and executive compensation, and has practiced employee benefits law for over 30 years.

She is an authority on qualified and non-qualified plans, fiduciary issues, deferred compensation, and welfare benefit arrangements, with experience in plan design and drafting, compliance, tax planning and consultation on all aspects of ERISA and the Internal Revenue Code. Ms. Wagner also serves as an expert witness in ERISA litigation.

Ms. Wagner specializes in Title I of ERISA, and has obtained advisory opinions, information letters and prohibited transaction exemptions from the DOL. She handles fiduciary matters impacting plan sponsors, investment and other fiduciary committees, investment managers and advisors, recordkeepers, broker-dealers, banks and other financial services firms. Ms. Wagner advises clients on the avoidance and rectification of prohibited transactions, the development of compliance programs, and investment policies. She is a renowned expert in issues concerning pension plan investments and fiduciary issues, and her opinion has been sought by noted authorities in the employee benefits area, including governmental agencies.

She was appointed Chair of the Employee Plans subcommittee of the IRS Tax Exempt & Government Entities Advisory Committee and received that agency's highest honor. She is a Fellow of the American College of Employee Benefits Counsel and is the recipient of more than 50 professional honors.

Ms. Wagner has written hundreds of articles and 15 books. She is a highly sought after lecturer, is widely quoted in financial journals and has been a guest on Fox, CNN, Bloomberg, and NBC.

All investments involve risk, including loss of principal.

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