

**PLUS**  
**Employment Practices &**  
**Fiduciary Liability Symposium**

**401(k) FEES: RISKS AND EXPOSURE**

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## I. The Administration and Monitoring of 401(k) Plan Fees.

A. **401(k) Plans Increasingly Displace Defined Benefit Plans.** 401(k) and similar defined contribution plans<sup>1</sup> are displacing defined benefit plans as the key retirement planning vehicle for most Americans.

1. The Department of Labor recently estimated that there were over 41 million participants in 401(k) plans.

*Source:* Fee and Expense Disclosures to Participants in Individual Account Plans, 72 Fed. Reg. 20,457 (proposed April 25, 2007).

2. Between 1995 and 2005, defined contribution (“DC”) plan assets more than doubled while defined benefit (“DB”) plan assets increased by 25%. DC plans now represent 60% of all corporate pension assets. In 1995 DC plan assets were \$1.4 Trillion DB plan assets were 1.5 trillion. In 2005 DC plan assets were \$2.9 Trillion DB plan assets were 1.9 trillion.

*Source:* *Flow of Funds Accounts of the United States, June 2006*

3. In 1980, 60% of workers were covered by DB plans, 15% by DC plans. 2003 15% of workers were covered by DB plans, 60% by DC plans.

*Source:* *The Center for Retirement Research at Boston College, February 2006*

4. The average 401k balance \$56,878, the median \$19,926.

*Source:* *Investment Company Institute, September 2005*

B. **As 401(k) Plans Grow, Consequences of Excessive Plan Fees Grow Too.**

1. Numerous fees and expenses are associated with the administration of 401(k) plans, including fees for managing and administering the various mutual fund investments, as well as for recordkeeping, trustee, and other administrative services. In many cases participants pay for these services either directly or indirectly. Although participants are notified of the expense ratio of each mutual fund, the details of how plan fees and expenses are paid, such as through “revenue sharing” between the mutual fund and the service provider, are not typically disclosed.

-- “Study of 401(k) Plan Fees and Expenses,” Final Report by Pension and Welfare Benefits Administration § 5 (Submitted to DOL April 13, 1998)

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<sup>1</sup> For ease of reference, “401(k) plans” is shorthand for all eligible individual account plans that allow participants to hold shares of mutual funds in individual accounts.

2. The average cost of DB plans is 25-55 basis points. The average cost for 401(k) plans is 110 basis points.

*Source: Greenwich and 401(k) Averages Book DC survey.*

3. According to the DOL, over the long term, fees that are excessive in even minor increments can dramatically reduce the value of retirement benefits.

*Source: Fee and Expense Disclosures to Participants in Individual Account Plans, 72 Fed. Reg. 20,457 (proposed April 25, 2007).*

## C. **Recent Government Attention Concerning Defined Contribution Plan Fees.**

### 1. **Department of Labor.**

- a. 2004 Working Report of ERISA Advisory Council:

“The consensus is for additional disclosure of fees in defined contribution plans that seek the protections of ERISA §404(c).”

“To the extent that an annual statement is provided by the record-keeper, the statement must provide the expenses of each investment option expressed as a ratio along with other information provided about the investment options. There must also be an identification of the investment expenses that are paid entirely or in part by the plan sponsor. The investment expenses do not include other expenses for general plan maintenance paid by the plan sponsor, including, but not limited to, legal expenses, consulting expenses and accounting expenses. If such investment expenses were paid in part by the plan sponsor the portion so paid would be identified.”

Available at:

[http://dol.gov/ebsa/publications/AC\\_111704\\_report.html](http://dol.gov/ebsa/publications/AC_111704_report.html)

- b. DOL has proposed changes to the Form 5500 that would require disclosure of indirect fees, including revenue sharing payments.

“Schedule C must be attached to the Form 5500...by large plan filers to report any person who rendered services to the plan that received directly or indirectly \$5,000 or more in compensation from the plan during the plan year.... EBSA’s proposal...would revise the Schedule C and accompanying instructions to clarify the requirements regarding reporting of direct and indirect compensation (i.e. money or anything else of value) received during the plan year in connection with services rendered to the plan or the person’s position with the plan. Also, a new section would be added requiring that the source and nature of

compensation in excess of \$1,000 received from parties other than the plan or the plan sponsor be disclosed for certain key service providers, including, among others, investment managers, consultants, brokers, and trustees, as well as all other fiduciaries.”

Annual Reporting and Disclosure, 71 Fed. Reg. 41,392, 41,394 (proposed Jul. 21, 2006)

- c. DOL is considering changes to the statutory exemption that allows parties-in-interest to provide services to plans. The changes would attempt to clarify a plan fiduciary’s duty to determine whether a service provider arrangement, including compensation, is reasonable. On April 25, 2007, the Department’s Employee Benefits Security Administration published a “request for information” to assist it in improving information about administrative and investment fees and expenses charged to 401(k) plans.

2. **Securities Exchange Commission.** On May 16, 2005, the SEC identified disclosure of fees by pension consultants as an important issue in a Staff Report Concerning Examinations of Select Pension Consultants.

-- “Staff Report Concerning Examinations of Select Pension Consultants,” The Office of Compliance Inspections and Examinations, Securities and Exchange Commission (May 16, 2005)

Available at: <http://www.sec.gov/news/studies/pensionexamstudy.pdf>

3. **Congress.** In early March 2007, the House Education and Labor Committee held hearings and its chair, Rep. George Miller (D. Cal.), indicated an interest in requiring greater disclosure of plan fees.

#### D. **ERISA 401(k) Litigation.**

1. **Key Statutory Provisions.**

- a. *Who May Be A Fiduciary With Respect To Plan Fees?*

- (1) A person who exercises any discretionary authority or control respecting the management or disposition of a plan’s assets or its administration.
- (2) A person who renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan or has responsibility in connection therewith. *See* ERISA § 3(21).

(3) The plan administrator (usually the employer) and designated officers, directors, and committee members will ordinarily be plan fiduciaries. Depending on what authority they have, outside consultants, service providers and others may be deemed to be fiduciaries as well. *See, infra*, § II(D)(1)(b)(3).

b. *Fiduciary Duties Regarding Fees.* Plan fiduciaries:

(1) “[s]hall discharge [their] duties with respect to a plan solely in the interest of the participants and beneficiaries;”

(2) For “the exclusive purpose of providing benefits to participants and their beneficiaries and defraying *reasonable* expenses of administering the plan;”

(3) With “the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use.”

*See* ERISA § 404(a)(1) (A) & (B). *See also* ERISA § 403(c)(1) (assets of plan shall be held for the exclusive purposes of providing benefits to participants and their beneficiaries and *defraying reasonable expenses of administering the plan*).

c. *Prohibited Transactions Regarding Fees.* ERISA also *prohibits* a fiduciary from acting for its own benefit in plan transactions, or from receiving consideration from a third party in connection with a transaction involving the plan. ERISA § 406(b).

d. ERISA § 404(c), 29 U.S.C. § 1104(c) provides a defense to plan fiduciaries from liability for losses that participants suffer in their 401(k) account to the extent the participant exercises control over the assets. According to DOL regulations, a participant does not have the opportunity to exercise “control” over his or her assets unless he or she has sufficient information to make informed decisions. The DOL regulations therefore require the plan sponsor to affirmatively disclose information regarding certain transaction fees and expenses related to an investment alternative, and if requested by the participant, the plan sponsor must also provide a description of the annual operating expenses for an investment alternative.

2. **Historical Application Of Fiduciary Principles With Respect To Plan Fees.**

- a. *Brock v. Robbins*, 830 F.2d 640, 648 (7<sup>th</sup> Cir. 1987) (where trustees violated procedural prudence by approving over \$10 million in fees without study after ten minute discussion, ordering injunctive relief but no damages because fee objectively reasonable).
- b. *Whitfield v Tomasso*, 682 F. Supp. 1287 (E.D. N.Y. 1998) (plaintiff states viable claims for breach of ERISA fiduciary duties by alleging fiduciaries allowed a plan to pay annual administrative expenses amounting to 17 % to 50 % of the plan's annual income over a 7-year period; also states viable fiduciary claims against recipient of fees by alleging that firm had no experience performing plan services and provided kickbacks to fund fiduciaries).
- c. *3M Employees' Benefit Trust Assn. v. Connecticut General Life Ins. Co.*, 2003 WL 124027 (D. Minn.) (Plaintiff states claim against insurer for fiduciary breach associated with excessive reserve for welfare benefits under ERISA plan); *Ed Miniat, Inc. v. Globe Life Ins. Co.*, 805 F.2d 732 (7<sup>th</sup> Cir. 1986) (when insurer exercises discretion in providing insurance that funds an ERISA plan, it is a fiduciary with respect to that insurance).
- d. *Guardsmark, Inc. v. Bluecross and Blueshield*, 169 F. Supp.2d 794 (W.D. Tenn. 2001) (by alleging the provider failed to provide reports on administrative fees, and by alleging the provider overcharged for administrative fees, plaintiff states viable claims against a plan's administrative service provider for breach of ERISA fiduciary duty and for prohibited transaction).
- e. *Haddock v. Nationwide Fin. Svcs., Inc.*, 419 F.Supp.2d 156 (D.Conn. 2006). Trustees of employer-sponsored profit-sharing retirement plans sued the plans' service provider, Nationwide, claiming it had some discretion with respect to the mutual funds that were ultimately selected for the plan and that the undisclosed "revenue sharing payments" it received from the plans funds were thus a violation of ERISA's fiduciary and prohibited transaction provisions. The "revenue sharing payments" were not part of Nationwide's contract with the retirement plans, but rather a separately negotiated fee paid by mutual funds to Nationwide. Nationwide argued the fees were reasonable payments for services rendered, but the Trustees argued the fees were kickbacks. The district court denied Nationwide's motion to dismiss, noting that there were factual questions with respect to

- (1) Whether Nationwide might be a fiduciary under 29 U.S.C. § 1002(21)(A)(i)-(iii) because it controlled selection of mutual funds and therefore exercised some control over the disposition of retirement contributions by participants.
  - (2) Whether revenue-sharing payments might be plan assets because Nationwide (a) may have held or received them as a result of its status as a fiduciary or its exercise of fiduciary authority, and (b) at the expense of plan participants.
  - (3) Whether Nationwide may have engaged in a prohibited transaction in violation of 29 U.S.C. § 1106(b)(1) or (3) by receiving consideration from a party dealing with the Plan in connection with a transaction involving assets of the Plan.
- f. *Midwest Community Health Service v. American United Life Insurance Company*, 255 F.3d 374, 378-79 (7<sup>th</sup> Cir. 2001) (although insurer did not have fiduciary obligation with respect to amount of surrender charge for financial instrument held by plan, fact issue with respect to whether it breached fiduciary obligation by failing to disclose ahead of time what would happen in various liquidation scenarios).
- g. Notably, these breach of fiduciary duty/prohibited transaction claims have historically been brought by plan sponsor (or fiduciaries associated with it), not plan participants. *See generally, The Next ERISA Battleground*, 19 Benefits L.J., No. 4, 60 (2006).

3. **New Wave of Putative Class Actions Regarding Plan Fees Brought by Participants.**

a. ***The Parties.***

- (1) Since September 11, 2006, numerous lawsuits have been filed, predominately in the Southern District of Illinois, alleging that plans sponsors, plan committees and company officials associated with them, who had discretionary control responsibilities with respect to plan fees, failed to investigate, negotiate for, or otherwise disclose excessive fees charged to plans and, ultimately, plan participants. The companies named in the lawsuits, with plan assets ranging from \$2 billion to \$15 billion, are as follows:
  - (a) Lockheed Martin Corp.
  - (b) United Technologies Corp.

- (c) Northrop Grumman Corp.
- (d) Caterpillar, Inc.
- (e) General Dynamics Corp.
- (f) International Paper Co.
- (g) Bechtel Corp.
- (h) Boeing Corp
- (i) Exelon Corp.
- (j) A.G. Edwards
- (k) Kraft Foods
- (l) Deere & Co.
- (m) ABB, Inc.
- (n) CIGNA

- (2) In addition, several cases have named the service provider in addition to the employer and its associated fiduciaries. In *Hecker v. Deere & Co., Fidelity Management Trust Company and Fidelity Management & Research Company*, and *Kennedy v. ABB, Fidelity Management Trust Company, and Fidelity Management & Research Company*, the plaintiffs alleged that the *Fidelity* entities were fiduciaries because the plan investment options were limited to, or otherwise influenced by, the availability of Fidelity retail mutual funds. *See also Montoya v. ING Life Insurance and Annuity Co.* (claiming that fiduciaries of § 403(b) plan breached duties in receiving excessive fees for “endorsements” and in receiving revenue sharing “kickbacks” for selected certain mutual funds).
- (3) In other cases, plan trustees have brought class actions alleging fiduciary and prohibited transaction claims with respect to revenue sharing on behalf of other plans against providers alleged to be fiduciaries. *See Ruppert, on behalf of Fairmont Park Inc. Retirement Savings Plan v. Principal Life Ins. Co. (S.D. Ill.)*; *Phones Plus, Inc. v. Hartford Life Insurance Company and Neuberger Berman Management, Inc.* (D. Conn. Nov. 14, 2006). Note also that on November 15, 2006, Orange County, Florida Sheriff Kevin

Beary filed a class action lawsuit on behalf of 457(b) plans against Nationwide demanding that it pay plan participants the proceeds of undisclosed revenue sharing that the company had received from mutual funds. Pensions & Investments 11/22/06, at 1.

- (4) These lawsuits, together with the *Haddock* decision, suggest that if there is a basis to allege that the service provider had discretion with respect to the selection of funds, even if only insofar as limiting the investment options that were available to the plan, then it may be joined as a fiduciary defendant.
- (5) Another variant of this type of litigation is a putative class action recently filed against Cigna, alleging that fees associated with its plan's default fixed-income investment (CIGNA guaranteed life insurance contract products) and employer stock options (which together comprised 65 percent of plan assets) were unreasonable.

b. ***The Alleged Excessive Fees And Improper Practices.*** Although the putative class actions by participants follow a similar pattern, they challenge different fees and practices.

- (1) Revenue Sharing – the Core Claim. *Haddock*, and most of the recently filed cases, allege that service providers received, did not pass on to the plan, and did not properly disclose “revenue sharing” that they received from mutual funds, resulting in excessive fees being paid. *See, e.g., Taylor v. United Technologies Corporation*, Case No. 06 CV 4895 (N.D. Ill.); *Hecker, supra*, (W.D. Wis.).<sup>2</sup> A common practice in the industry is for plans to pay record-keepers and other service providers reduced or no direct fees or compensation, with the mutual fund compensating service providers for services (such as communications) that the mutual fund might otherwise have to perform. Although the mutual funds ordinarily disclose the expense ratio that they charge, the details of what is remitted to other entities may not be disclosed. These fees can be

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<sup>2</sup> Specifically, in the complaints, revenue sharing is defined as the “transfer of asset-based compensation from brokers or investment management providers” (such as mutual funds, common collective trusts, insurance companies offering general insurance contracts and similar pooled investment vehicles, to administrative providers (such as record-keepers, trustees, administrators and/or consultants).)

substantial, and sometimes larger than a plan's hard payments to its service providers.

These lawsuits ask: Are the revenue sharing fees reasonable compensation for actual services rendered, as defendants contend? Or are the fees "kickbacks" for steering assets to the mutual funds, as plaintiffs might contend?

(2) Employer Stock Fund Practices.

(a) Management And Administrative Fees. Some of the complaints allege that management or administrative fees assessed on employer-stock funds causes those funds to under-perform the employer stock available to investors outside the company. The recent complaints allege these fees are not for actual services but are merely sources of income for plan service providers. *E.g., Will v. General Dynamics Corp.*, Case No. 06-698 (S.D. Ill.) (Sept. 11, 2006 )

(b) Holding Excess Cash. Some of the complaints allege that although employer stock funds must hold some cash for liquidity purposes, some allegedly hold excessive cash (e.g., 4 %) that reduced the fund's overall return. *E.g., Will v. General Dynamics Corp.*, Cause No. 06-698 (S.D. Ill.) (Sept. 11, 2006)

(3) Multiplication of Investment Trusts and Related Fees. Some complaints allege that plans hold different funds in separate master trusts that each separately charge fees that are redundant and that related disclosures are confusing or otherwise incomplete. *E.g., Beesley v. International Paper Co.*, Case No. 06-703 (S.D. Ill.) (Sept. 11, 2006)

(4) Shadow Index Funds: Actively-Managed Fees for Passively-Managed Stocks.

(a) Some complaints allege that certain funds unnecessarily charge high expense ratios because they are "shadow index funds, namely, they purport to be "actively managed" by investment specialists but are in reality "passively managed," lower cost index funds. *E.g., Waldbuesser v. Northrop Grumman*, No. 06CV4897, (N.D.Ill.) (Sept. 11,

2006) (alleging that 6 of 11 plan funds had been “shadow index funds” for most of previous 6 years).

- (b) Unnecessarily investing in Retail Funds. In *Boeckman v. A.G. Edwards & Sons, Inc.*, Case No. 05-758 (S.D. Ill. 2006), plaintiffs allege that the fiduciaries breached duties by failing to retain private, cheaper money managers, which would have enabled them to avoid shareholder service fees, transfer agent fees, rule 12 b-1 fees, administrative fees, registration and reporting fees, expenses for reports to shareholders, postage and stationery fees, audit and legal fees, custodian fees, and state and local taxes. Plaintiffs also allege that defendants breached fiduciary duties by investing in retail mutual funds instead of purchasing institutional funds, thus incurring unnecessary expenses.
- (c) Misleading Benchmarks.
  - i. Misrepresenting Fund Performance. Some complaints allege that plan fiduciaries used, or allowed to be used, improper benchmarks of plan funds in communications to participants. The improper benchmarks effectively made funds’ costs appear lower and returns higher than they actually were. See *Beesley v. International Paper Co.*, Cause No. 06-703 (S.D. Ill.) (Sept. 11, 2006), *Waldbuesser v. Northrop Grumman*, No. 06CV4897, (N.D.Ill.) (Sept. 11, 2006)
  - ii. Undisclosed Risk. At least one complaint turns the misrepresentation argument around and argues that the fund itself improperly invested in riskier securities than its benchmark class permitted, resulting in an increased and undisclosed risk to participants. The allegation implies that plan fiduciaries either had reason to know the fund was doing this or had a duty to investigate the fund to determine whether it was doing this. See *Waldbuesser v. Northrop Grumman*, No. 06CV4897, (N.D.Ill.) (Sept. 11, 2006).

- c. **The Claims.** The participant class actions allege breaches of fiduciary duty in violation of ERISA § 502(a)(2), 29 U.S.C. § 1132(a)(2) and (3).
- (1) **Unreasonable Fees Fiduciary Claim.** All of the complaints allege that the fees and expenses outlined above are excessive and unreasonable for the respective services provided, and that accordingly defendants breached their fiduciary duties in failing to investigate, identify, negotiate and monitor the charging of such fees.
  - (2) **Disclosure Fiduciary Claim.** Drawing on regulations requiring that fiduciaries seeking the protections of ERISA § 404(c) provide participants upon request “sufficient investment information” about “transaction fees and expenses which affect [their] account balances,” 29 C.F.R. § 2550.404c-1(b)(2)(i)(B), as well as an alleged duty to affirmatively disclose material information pertinent to benefits, the complaints also allege that defendants breached a fiduciary duty by failing to properly disclose revenue sharing and other fees and expenses. *Cf., Varity Corp. v. Howe*, 516 U.S. 489 (1996); *Griggs v. E.I. DuPont De Nemours*, 237 F.3d 371, 381 (4th Cir. 2001); *Shea v. Esensten*, 107 F.3d 625 (8th Cir. 1997).
  - (3) **Prohibited Transaction Claim.** Although most of the participant class action complaints do not specifically assert a prohibited transaction claim, they allege, as in *Haddock*, that the alleged improper fees constituted prohibited transactions in violation of 29 U.S.C. § 1106.
  - (4) **Relief Requested.** For relief, plaintiffs seek monetary damages under ERISA § 502(a)(2) on behalf of the plan. Consistent with recent decisions limiting the scope of “appropriate equitable relief” under section 502(a)(3) for individual breach of fiduciary duty claims, *see id.*, the complaints attempt to obtain equitable relief with respect to “excess fees and expenses,” and assert that revenue sharing payments are “specifically identifiable funds.” *See Kennedy, supra.*
  - (5) **Potential Damages.** Although the participant-plaintiffs have not alleged specific damages, according to the Department of Labor, “[f]ees and expenses can have a significant impact on worker’s retirement savings.” *See Fee and Expense Disclosures to Participants in Individual Account Plans*, 72 Fed. Reg. 20,457 (proposed April 25,

2007). Notably, however, the court in *Exelon* recently dismissed insufficiently plead claims for investment losses.

- (6) **Potential Defenses.** Although not all can be asserted on a motion to dismiss, potential defenses include:
- (a) Allegations in the Complaint of unreasonable fees, failure to observe procedural prudence, loss causation, and fiduciary status, are too conclusory, even under the lenient pleading standards of Fed. R. Civ. P. 8, to state a claim. *See Custer v. Sweeney*, 89 F.3d 1156, 1163 (4<sup>th</sup> Cir. 1996); *In re Reliant Energy ERISA Litigation*, 336 F. Supp.2d 646 (S.D. Tex. 2004).
  - (b) The fees are in fact reasonable. *Cf. Fink v. National Savings*, 772 F.2d 951, 962 (D.C. Cir. 1985) (Scalia, J.) (concurring) (no fiduciary liability for failure to investigate when investment objectively prudent); *Robbins, supra*.
  - (c) Even if the fees are deemed in retrospect to have been excessive the fiduciaries observed procedural prudence (which may not, given historical standards, have required consideration of revenue sharing details). *See Bussian v. R.J.R. Nabisco, Inc.*, 223 F.3d 286, 299 (5<sup>th</sup> Cir. 2000) (*test is conduct not results*).
  - (d) Under ERISA's comprehensive disclosure scheme, there is no obligation to communicate revenue sharing and similar fees to participants. *See infra*, § II(E)(8)(c).
  - (e) Because the amounts participants ultimately pay are determined by the mutual funds' expense ratios and are not affected by revenue sharing, excessive payments for a service imbedded within aggregate fees--or the failure to disclose them--was not the cause of any loss. *See Silverman v. Mutual Benefit Life Ins. Co.*, 138 F.3d 98, 104 (2<sup>nd</sup> Cir. 1998).

d. **Early Decisions.**

- (1) **Fiduciary Claims.** Although one court dismissed an excessive fees claim without comment, *see Waldbuesser v. Northrup Grumman Corp.*, Case No. 06-CV-06213 R (JCx) (Feb. 28, 2007), and claims for insufficiently plead

damages have also been dismissed, *see Loomis v. Exelon Corp.*, N.D. Ill. No. 06-C-4908 (2/21/07), claims alleging that fiduciaries breached their duties by allowing excessive fees to be charged have survived motions to dismiss and have been allowed to proceed to discovery. *See Spano v. Boeing Co.*, S.D. Ill. No. 06-cv-743-DRH, 4/18/07, *George v. Kraft Foods Global, Inc.*, S.D. Ill., No. 06-cv-798-DRH, 3/16/07. These rulings rejected arguments by defendants that the plaintiffs had not sufficiently alleged their fiduciary status; that they had not adequately plead non-compliance with section 404(c); and that they had failed to plead entitlement to an accounting and other relief and ERISA § 502(a)(3).

- (2) **Prohibited Transactions Claims.** In *Boeckman v. A.G. Edwards, Inc.*, Civil No. 05-658-GPM (S.D. Ill. Sept. 26, 2006), the court ruled that plaintiffs stated a claim by alleging that a plan sponsor's payment of excessive fees to a mutual fund constituted a prohibited transaction to a "party in interest." Although recognizing that the claim was "weak," the court observed that while the statutory exemption of mutual funds from the "party in interest" provisions was "broad, it is not absolute," and that a transaction between a mutual fund and a third party service provider (presumably with respect to revenue sharing) may be an indirect prohibited transaction.
- (3) **Change Of Venue.** Motions for changes in venue to more convenient locations have been granted, *see, e.g., Kraft, supra*, and denied. *See Lockheed.*
- (4) **Jury Trial.** In *Boeing, supra*, the court ruled that fiduciary claims involving plan fees must be tried to the court, not a jury.

E. **Ten steps 401(k) Fiduciaries Can Take to Reduce Exposure to Fiduciary Claims.**<sup>3</sup> As revenue sharing and other fees become better understood and standards develop with respect to the monitoring of plan fees, fiduciaries (and their insurers) can limit exposure if the following steps are taken:

1. **Determine Who Is A Fiduciary.** Liability can be limited if sponsors identify who has the discretion and responsibility to make decisions (i.e.

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<sup>3</sup> The contributions of Diane Berthel, Berthel Schutter, St. Paul, Minnesota, in the preparation of these materials, are gratefully acknowledged.

selection of recordkeeper and mutual funds with different expense ratios) that affect plan fees.

- a. *Qualifications.* Are the company officials charged with responsibility for administering the plan knowledgeable and qualified? Have they retained qualified advisors? Have they exercised independent judgment in reviewing the expert's advice? *In re Unisys Savings Plan Litigation*, 74 F.3d 420, 434 (3<sup>rd</sup> Cir.) (*expert recommendations cannot be "rubber-stamped"*). *cert.denied*, 117 S.Ct. 56 (1996).
- b. *Service Provider As Fiduciary.* Assess whether parties providing services might also be deemed fiduciaries with responsibility for selecting funds. Notably, the provider found in *Haddock v. Nationwide Fin. Svcs., Inc.*, 419 F.Supp.2d 156 (D. Conn. 2006), was alleged to have had discretionary responsibility with respect to selecting the mutual funds and thus was allegedly a fiduciary, creating additional duties and obligations. *See, infra*, § II(D)(4)(c).
- c. *Directors and Officers.* Do directors and officers who are not meaningfully involved in plan administration have appointment and removal authority over fiduciaries who are making the pertinent decisions? If so, consider removing them from the "fiduciary chain" or ensure that they receive information sufficient to fulfill their monitoring function. *See Crowley v. Corning Inc.*, 234 F. Supp. 2d 222, 229-30 (W.D.N.Y. 2002).

2. **Understand Plan Provider Arrangements.** Fiduciaries can limit exposure if they are attentive to plan provider arrangements. As it has become standard for plans to move to an "open architecture" (the ability to use a variety of funds with a single provider), providers performing services for participants investing in "outside" mutual funds have negotiated fee sharing arrangements with those funds. As a result, the potential exists for a provider to be influenced by the sharing arrangements it is able to negotiate in offering funds. The influence of revenue flow between providers and investment companies creates a unique purchasing challenge for fiduciaries on behalf of their participants. Some plan sponsors choose unbundled services, using multiple vendors to deliver services. The arrangement generally separates the influence of investment fees from plan expenses but introduces plan management complexities.

3. **Understand The Fees And Expenses That Plans And Their Participants Pay.**

- a. *Mutual Fund Fees and Revenue Sharing.* The most common investment options found in defined contribution plans are publicly

traded mutual funds. The fund's owner (the participant) pays an expense ratio. Sources for revenue share imbedded in mutual fund expense ratios are 12b-1 fees and sub-transfer agent (TA) fees. The mutual fund company may also share a portion of their investment management fee, which is the part of the expense ratio intended to pay for research and portfolio management expenses.

- (1) 12b-1 fees. The primary source of mutual fund revenue share is the 12b-1 fee, which typically ranges from .25 to 1.00%. A single mutual fund will typically offer several share classes to purchase. The only difference is the cost of the shares, which relates primarily to the 12b-1 fee, which are distribution fees paid out of fund assets which include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares, and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. Fiduciaries are responsible for selection of the fund *and* its class of shares. *See* <http://sec.gov/answers/mffees.htm#distribution>.
  - (2) Transfer Agent (Sub-TA) Fee. This fee tracks individual shareholder accounts and is a part of the normal operating expense collected by the mutual fund. If the Plan provider is tracking individual participant information, rather than the transfer agent, the mutual fund company is sometimes willing to share all or a portion.
  - (3) Investment Management Fees. For research and portfolio management expenses they are part of the expense ratio and deducted automatically from investors' accounts.
  - (4) Trading and Other Fund Expenses. A part of a fund's operating expenses fund management works to keep expenses low as they detract from performance.
- b. *Mutual Fund Alternatives*. Commingled trusts, separately managed accounts and exchange traded funds are sometimes alternative investment options. Generally less than mutual fund expense ratios, they are attractive alternatives when no revenue share is needed or plan administrative expenses are paid separate from investments.
- c. *Unitization Fees*. Paid to unitize employer stock, separate accounts, mix of funds, etc.; the investment may be mixed with a money market allowing participants to trade every business day like a mutual fund instead of waiting a usual 3-day period in which

stock trades are settled. Unitized funds also allow loans and withdrawals to be processed daily. In the case of a “model portfolio” different asset allocations of the core funds in the plan are mixed and rebalanced on a regular basis. Unitization allows a Net Asset Value (NAV) to be calculated on the portfolio each day.

- d. *Annuity Investment Fees.* Contract charges – generally asset based wrap fees agreed to in the annuity contract.
  - (1) Withdrawal penalties – fee charged to withdraw from a contract prior to expiration.
  - (2) Commissions - Broker/agent's fee for buying or selling securities and insurance products. In the case of annuities it is often tied to the contract penalty.
  - (3) Risk and mortality charges – charge for insurance.
- e. *Directed Brokerage Account Fees.* Although these accounts are managed by participants, the plan sponsor is responsible for negotiating the overall fee arrangement.
- f. *Earnings on Unallocated Assets.* When participant contributions are not immediately allocated to plan accounts, the provider may earn interest on the un-invested assets ‘float.’
- g. *Other fees and Expenses.* Each plan and agreement is different, and other fees and expenses should also be considered.

4. **Investigate and Compare Alternatives.** Fiduciaries should develop a process to investigate how fees are charged or accounted for, who pays them and what options may exist for more favorable arrangements. *See* 29 C.F.R. § 2550.404 a-1 (2006) (fiduciary complies with standard of care if they have “given appropriate consideration” to the pertinent facts and circumstances and have “acted accordingly”).

- a. *Track Fees That Compensate The Providers.*
  - (1) Revenue share fees. When a Plan offers funds that revenue share, Plan fiduciaries should track the amount and the manner in which it flows to the service provider(s).
  - (2) Other fees. For many vendors, certain service costs are incurred on a per capita or per transaction basis and are not related to total assets under management. Identify and track all fees and penalties outlined in the service agreement, trust agreement, annuity contract and any other signed documents. Fees and penalties vary widely.

Similarly, consider “soft dollars” used to pay for investment research.

b. *Understand How The Economics Of Revenue Share Affect The Plan.*

(1) Economies of scale. Fees impact returns and economies of scale impact fees. The question of reasonable revenue share is affected by total plan assets and the average participant account balance. Balancing services received with a fair flow of revenue requires ongoing analysis and periodic negotiation on the part of plan fiduciaries. When negotiating, fiduciaries should consider total plan size, average account balance, expected cash flows and any other pertinent plan activity.

(2) Cost shifting. Consider whether cost shifting leaves some participants contributing more to revenue share. A plan may have funds that are in-house managed funds where all revenue goes to the provider, outside funds with no revenue share and outside funds that revenue share with the provider. In this scenario it is possible for a participant to invest in funds that do not revenue share and avoid contributing to overall plan expenses.

c. *Ensure That Service Providers That May Be Deemed To Be Fiduciaries Make Proper Disclosures.*

(1) If a plan fiduciary has authority to cause a plan to invest in a mutual fund, either because the fiduciary is an investment manager or because the fiduciary provides investment advice to the plan, the fiduciary must either remit such fees to the plan or offset the fees dollar-for-dollar against the overall management or wrap fee it charges to the plan. *See DOL Advisory Opinion, 97-15A (Frost Letter)*. If the fiduciary does not exercise any authority or control to “cause” a plan to invest in a mutual fund, the fiduciary will not violate the anti-kickback prohibition under ERISA § 406(b)(3) by receiving fees from mutual funds in connection with plan investments, but some disclosure of the fees is required; the fiduciary must disclose (i) the fact that mutual funds pay fees, (ii) the services provided for the fees, and (iii) the range of rates at which the fees are calculated. *See DOL Advisory Opinion 97-16A (Aetna Letter)*.

- (2) In assessing the level of independence of entities with responsibility for selecting funds, fiduciaries may review part D of their SEC Form ADV to confirm their level of independence.

[http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd\\_OrgSearch.aspx](http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_OrgSearch.aspx)

- d. *Evaluate Bundled Arrangements.* Provider fee agreements generally bundle a full course of services. Some services may not be delivered, desired or may be provided by an outside source. Be aware of any fees redundant of other fees. Ensure that all fees link to legitimate services. Negotiate the service agreement to ensure participants are not paying for unnecessary services.

Fiduciaries may consider unbundling or moving to an approach with low cost investment management such as commingled trust or separate accounts to pay for recordkeeping and administrative services separate from investment management. However, “unbundling” services may create issues with daily pricing and availability of information for record-keepers and plan sponsors and may also involve limitations that make them impractical (e.g., minimum investments). Also, consider whether paying a recordkeeper separately rather than through revenue sharing actually saves money.

- e. *Consider Quality As Well As Cost.* Some courts have ruled that, just as inattention to cost may be a fiduciary breach, decisions based on cost alone may constitute a breach as well. *See, e.g., Bussian v. RJR Nabisco, Inc.*, 223 F. 3d 286 (5<sup>th</sup> Cir. 2000).
- f. *Active v. Passive Management Fees.* Fiduciaries should ensure that they are not paying “active management” fees for funds that are better characterized as index funds.
- g. *Employer Stock.* If employer stock is unitized, is the fee reasonable? If the plan uses share accounting, is the commission for trades reasonable? Are any fees unnecessarily devoted to “asset management” that does not actually occur?
- h. *Directed Brokerage Account Fees.* Annual account fees and the commission schedule should be reasonable for an institutional arrangement.
- i. *Participant Advice and Managed Account Fees.* Selecting and monitoring an advice provider is a fiduciary responsibility. Plan sponsors must exercise the same prudence in selecting, negotiating,

monitoring and communicating when using the provider's option(s).

j. *Evaluate Fees In Light Of Plan Documents And The Plan's Investment Policy.*

- (1) Do the terms of the Plan or SPD address fees?
- (2) Is there a clearly defined investment policy statement (IPS) to guide fiduciary investment decisions? Is its intent with regard to cost and quality of investments clear? Does it link to appropriate benchmarks and consistent practices to select and monitor investments including fees?
- (3) Is there a policy for benchmarking provider(s) costs and services through an RFP? Is it consistent with overall company policy for vendor selection and negotiation?

k. *Use Credible Benchmarks.* When comparing fees and performance, the integrity of a benchmark depends on the peer group it comprises. Benchmarks using retail versus institutional peer groups can produce significantly different outcomes.

l. *Assess Overall Impact Of Fees On Participants.* After evaluating all fees and expenses identified above, consider whether the aggregate fee that the plan participant pays is reasonable.

5. **Negotiate.** The fiduciary should use its market power to reduce fees or to obtain additional valuable services. The process of negotiating fees may be more important than the results. *See Boeckman v. A.G. Edwards, Inc.*, Civil No. 05-658, (S.D. Ill.) (Sept. 26, 2006) (memorandum and order).

a. *Consider Soliciting Multiple Bids.* The fiduciary should obtain bids from multiple providers to ensure fees are reasonable and to enhance its negotiating position.

b. *Consider Direct Negotiation.* Depending on the provider, harvesting all potential revenue share requires proactive negotiation on the part of the plan sponsor and sometimes direct negotiation with fund and investment management companies.

6. **Meet, Deliberate, and Decide.** The individuals with the responsibility and discretion for choosing mutual funds and service providers should carefully consider, deliberate and exercise independent judgment with respect to the various options. Principles consistent with internally monitored guidelines such as Sarbanes Oxley 404 and compliance with the Plan's investment policy statement should be applied.

7. **Document.** Fiduciaries can reduce exposure if they document the review, investigation, negotiation and deliberations and decision with respect to any decisions regarding plan fees.
8. **Disclose.** In addition to complying with the disclosure requirements of ERISA, *see* 29 C.F.R. § 2520.102-3(1) (a per participant charge must be disclosed in the summary plan description),<sup>4</sup> fiduciaries should consider whether to disclose additional information about plan fees, even though its disclosure may not specifically be required. Notably, because no specific statutory or regulatory requirement mandates that fiduciaries affirmatively disclose to participants revenue sharing arrangements or similar details associated with plan fees, fiduciaries will argue that disclosure of such details is not required. *See Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 83 (1995) (noting that ERISA contains a “comprehensive set of reporting and disclosure requirements,” rejecting arguments that ERISA’s fiduciary duty provisions create a duty to disclose more than that required by these statutes); *DeFelice v. U.S. Airways*, 2005 WL 2674994 (E.D. Va. 2005) (“[A] fiduciary fulfills its duty to disclose information if it complies with ERISA’s disclosure requirement.”) Nevertheless, the law regarding

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<sup>4</sup> Also, “[A] plan may charge participants’ and beneficiaries’ accounts for the reasonable expenses of carrying out investment instructions, provided that procedures are established under the plan to periodically inform such participants and beneficiaries of actual expenses incurred with respect to the respective individual accounts.” 29 C.F.R. § 2550.404c-1(b)(2)(ii)(A).

In addition, to be eligible for the protections of 404(c), which generally relieves plan fiduciaries of liability for plan investment losses that are a direct and necessary result of investment choices made by a participant or beneficiary, plan fiduciaries must also provide “sufficient information” to the participant or beneficiary. 29 C.F.R. § 2550.404c-1(b).

a. “Sufficient information” includes:

1. ERISA requires that summary plan descriptions disclose fees or charges that are imposed in connection with the receipt of plan benefits (e.g., loans, in-service withdrawals or distributions). Reg. 2520.102-3(1). In addition, the DOL has issued guidance stating that specific plan expenses that are allocated solely to a specific participant’s account must be disclosed in the SPD as well (e.g., costs imposed to determine the qualification of a domestic relations order in connection with a participant’s divorce). See DOL Field Assistance Bulletin 2003-3.

2. Upon request, “[a] description of the annual operating expenses of each designated investment alternative (e.g., investment management fees, administrative fees, transaction costs) which reduce the rate of return to participants and beneficiaries, and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative.” 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(2)(i).

the scope of the duty to disclose continues to evolve,<sup>5</sup> and plan fiduciaries may determine that it would be prudent to disclose such information (to the extent available).<sup>6</sup>

9. **Monitor.** As befits significant matters affecting the plan, consider a regular schedule for revisiting and monitoring fee arrangements. Use appropriate institutional peer groups for benchmarking, especially in light of evolving industry practices. Some plans may analyze fees and revenue share quarterly.
10. **Consider The Result.** Although defendants will argue that procedural prudence rather than the ultimate result is the test, fiduciaries will want to be in a position to show that the fees that plan participants in fact pay are reasonable. As in most fiduciary disputes, the substantive prudence of a decision will be difficult to challenge if independent, unconflicted fiduciaries observed procedural prudence and acted in good faith to arrive at a decision.

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<sup>5</sup> In *Varity Corp. v. Howe*, 516 U.S. 489 (1996), the Supreme Court ruled that misrepresentations about benefits delivered in a fiduciary context can serve as the basis for a breach of fiduciary duty claim. Since then, courts have struggled with the exact contours of this duty, including whether fiduciaries have an affirmative duty to disclose information to participants. Compare *Baker v. Kingsley*, 387 F.3d 649, 663 (7th Cir. 2004), with *E.g., Bixler v. Central Pennsylvania Teamsters Health & Welfare Fund*, 12 F.3d 1292 (3rd Cir. 1993).

<sup>6</sup> Revenue sharing arrangements may vary with each transaction, and in some cases may be confidential and subjected to non-disclosure agreements.