401(k) Fees & Expenses
Class Actions: What’s a Fiduciary to Do?

American Bar Association Real Property, Probate & Trust Law Section:
Employee Benefits Group Briefing
April 27, 2007
401(k) Fees Issue

- 401(k) Fees class actions
  - Focused attention on risk to fiduciaries who select & monitor investment managers, investment fund options & recordkeepers
  - Court decisions are likely to be a mixed bag:
    - Should both expand the scope of fiduciary duties & identify limitations on such duties
    - Retroactive change unlikely; prospective change quite likely
- Fiduciaries must deal with 401(k) fee issue even if they never face a 401(k) fee class action

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Additional Drivers of 401(k) Fees Issue

- Department of Labor activity
  - Expanded Form 5500 disclosure requirements (May?)
  - Regulatory reinterpretation of necessary services exemption “reasonable contract/arrangement” requirement (Summer?)
  - Stricter §404(c) requirements
  - PPA quarterly statement guidance (already in effect)
  - DOL enforcement initiatives (underway)

- Annual Plan Audits
  - AICPA/Foundation for Fiduciary Studies ERISA investment practice standards
  - Growing auditor concern over 401(k) fees & disclosures

- Other Governmental Efforts
  - Congressional hearing will likely lead to legislation
  - SEC pressure on mutual funds (ongoing)
History of Revenue Sharing

- Revenue sharing has been an ERISA plan mutual fund investment fact of life for 30 years

- ERISA prohibited transaction exemptions
  - Requires informed independent fiduciary oversight
  - Fiduciary determination that fees (e.g., revenue sharing) are reasonable

- DOL guidance mapped out bundled recordkeeping
  - Soft Dollars guidance
    - Concession to SEC interpretations based on preemptive securities law
    - Outlined choice: waive 12b-1 fees or apply fees to plan expenses
    - non-fiduciary status of recordkeepers
    - Bundled providers can keep mutual fund fees
    - Even fiduciary can keep revenue sharing if applies to expenses

- Expanded Disclosure even before PPA
  - DOL rulings required disclosure (Adv Ops 97-15A, 97-16A)
  - §404(c) protection contingent on disclosure
  - Alternative protection under Jenkins v. Yager also depends on disclosure
### Cases Assuming Revenue Sharing can be Appropriate/ Desirable (Schlichter Cases)

<table>
<thead>
<tr>
<th>Federal District Court</th>
<th>Case</th>
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<tbody>
<tr>
<td>Northern Illinois</td>
<td><em>Loomis v. Exelon</em> (Darrah); <em>George v. Kraft Foods</em></td>
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<tr>
<td>Southern Illinois</td>
<td><em>Will v. General Dynamics</em> (Murphy); <em>Abbott v. Lockheed Martin</em> (Reagan); <em>Beesley v. International Paper</em> (Herndon); <em>Spano v. Boeing</em> (Herndon)</td>
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<tr>
<td>Central Illinois</td>
<td><em>Martin v. Caterpillar</em> (McDade)</td>
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<tr>
<td>Northern California</td>
<td><em>Kanawi v. Bechtel</em> (Breyer)</td>
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<tr>
<td>Central California</td>
<td><em>In Re Northrop Grumman Corp ERISA Litigation</em> (Real); <em>Renfro v. Unisys</em> (Cooper)</td>
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<tr>
<td>Western Missouri</td>
<td><em>Kennedy v. ABB Inc.</em> (Laughrey)</td>
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<tr>
<td>Connecticut</td>
<td><em>Taylor v. United Technologies</em> (Eginton)</td>
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<tr>
<td>Western Wisconsin</td>
<td><em>Hecker v. Deere</em> (Shabaz)</td>
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## Alleged ERISA Breaches

<table>
<thead>
<tr>
<th></th>
<th>Plan Expense Allegations</th>
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<tbody>
<tr>
<td>1</td>
<td>Failure to capture available revenue sharing</td>
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<tr>
<td>2</td>
<td>Failure to use revenue sharing for benefit of participants</td>
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<tr>
<td>3</td>
<td>Failure to disclose revenue sharing or other fees to participants</td>
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<tr>
<td>4</td>
<td>Failure to understand or monitor revenue sharing or other fees</td>
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## Alleged Breaches (continued)

<table>
<thead>
<tr>
<th></th>
<th>Plan Investment Allegations</th>
</tr>
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<tbody>
<tr>
<td>5</td>
<td>Improper benchmarks</td>
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<tr>
<td>6</td>
<td>Active fees for passive styles</td>
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<tr>
<td>7</td>
<td>Failure to disclose inappropriate benchmarks and fees</td>
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<tr>
<td>8</td>
<td>Investment options structured in a manner that multiplied and disguised fees</td>
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<tr>
<td>9</td>
<td>Specific misleading statements about fees and benchmarks</td>
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## ERISA Remedy Allegations

<table>
<thead>
<tr>
<th></th>
<th>Relief Sought</th>
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<tbody>
<tr>
<td>10</td>
<td>Determination that Inadequate disclosure makes ERISA §404(c) liability limitation unavailable</td>
</tr>
<tr>
<td>11</td>
<td>Recover overpayment for various investment &amp; administration services</td>
</tr>
<tr>
<td>12</td>
<td>Recover investment losses due to inadequate information about revenue sharing &amp; other fees, mismatches between fees and style &amp; inappropriate or undisclosed benchmarks or styles (dismissed in <em>Loomis v. Exelon</em> for failure to allege causation)</td>
</tr>
<tr>
<td></td>
<td>Defendants</td>
</tr>
<tr>
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<td>------------------------------------------------</td>
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<tr>
<td>13</td>
<td>Employer/Plan Sponsor (all cases)</td>
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<tr>
<td>14</td>
<td>Committee or other in-house fiduciaries (all cases except <em>Hecker v. Deere</em>)</td>
</tr>
<tr>
<td>15</td>
<td>Recordkeeper (<em>Hecker v. Deere &amp; Kennedy v. ABB</em>)</td>
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Cases Asserting Revenue Sharing is Improper

- Southern District Illinois
  - *Ruppert v. Principal Life Insurance* (Herndon)

- Southern District Ohio
  - *Beary v Nationwide Life Insurance* (Sargus) (457 plan not subject to ERISA, conflict of interest not protected by ERISA exemption)

- District Connecticut
  - *Beary v. ING Life Insurance & Annuity* (Kravitz) (457 plan not subject to ERISA, conflict of interest not protected by ERISA exemption)
  - *Phones Plus v. Hartford Financial* (Covello) (dismissal motion pending)
Cases Asserting Revenue Sharing is Improper (continued)

- **Parties**
  - Two cases are brought on behalf of non-ERISA governmental plans
  - Primary targets in these cases are the recordkeepers/investment fiduciaries

- **Specific Allegation**
  - Allege revenue sharing is a prohibited “kickback”
What’s a Fiduciary to Do? (reasonable fees)

- Assess reasonableness of fees & expenses
  - Competitive RFP process
  - Use Investment consultant to review recordkeeper’s administrative costs/profit
  - Perform fee benchmarking study

- Recordkeeping Agreement safeguards
  - Build in disclosure obligations
  - Seek fee representations & warranties
What’s a Fiduciary to Do? (investments)

- Assess whether investing in appropriate mutual fund share classes
- Performance reviews & searches should consider reasonableness of fees
- Performance reviews should highlight whether value added (i.e., has performance exceeded benchmarks when expressed net of fees)
- Maintain up to date Investment Policy Statements
- Perform regular performance evaluations
  - Should include assessment of benchmarks/styles
Fee Disclosure

- Annual report (Form 5500)

- Fiduciaries should insist on receiving full revenue sharing & administrative expenses disclosure

- Participant Disclosure
  - SPD, benefit statements & investment communications should disclose fees that are charged & explain how participants can obtain detailed, up-to-date fee information
  - Recordkeeper should have disclosure obligations under Recordkeeping Agreements
    - Prospectus distribution by Recordkeeper
    - Transaction fees should be disclosed in detail as integral part of each transaction
    - Additional communications from Recordkeeper
      - 404(c) communications
      - list of funds with associated fund level fees