

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

American Bar Association Real Property,
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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

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
 - GAO Report (2006)
 - 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
 - Recordkeeper rulings (Adv Ops 1997-16A, 2003-09A & 2005-10A)
 - 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)

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

Alleged ERISA Breaches

	Plan Expense Allegations
1	Failure to capture available revenue sharing
2	Failure to use revenue sharing for benefit of participants
3	Failure to disclose revenue sharing or other fees to participants
4	Failure to understand or monitor revenue sharing or other fees

Alleged Breaches (continued)

	Plan Investment Allegations
5	Improper benchmarks
6	Active fees for passive styles
7	Failure to disclose inappropriate benchmarks and fees
8	Investment options structured in a manner that multiplied and disguised fees
9	Specific misleading statements about fees and benchmarks

ERISA Remedy Allegations

	Relief Sought
10	Determination that Inadequate disclosure makes ERISA §404(c) liability limitation unavailable
11	Recover overpayment for various investment & administration services
12	Recover investment losses due to inadequate information about revenue sharing & other fees, mismatches between fees and style & inappropriate or undisclosed benchmarks or styles (dismissed in <i>Loomis v. Exelon</i> for failure to allege causation)

Litigation Targets

	Defendants
13	Employer/Plan Sponsor (all cases)
14	Committee or other in-house fiduciaries (all cases except <i>Hecker v. Deere</i>)
15	Recordkeeper (<i>Hecker v. Deere</i> & <i>Kennedy v. ABB</i>)

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
 - *Haddock v. Nationwide Financial Services*, 2006 U.S. Dist. LEXIS 10120 (D. Conn. 2006)(claim revenue sharing is prohibited use of ERISA plan assets survived summary judgment challenge)
 - *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