

# 401(k) Plan Fees, Expenses and Revenue Sharing

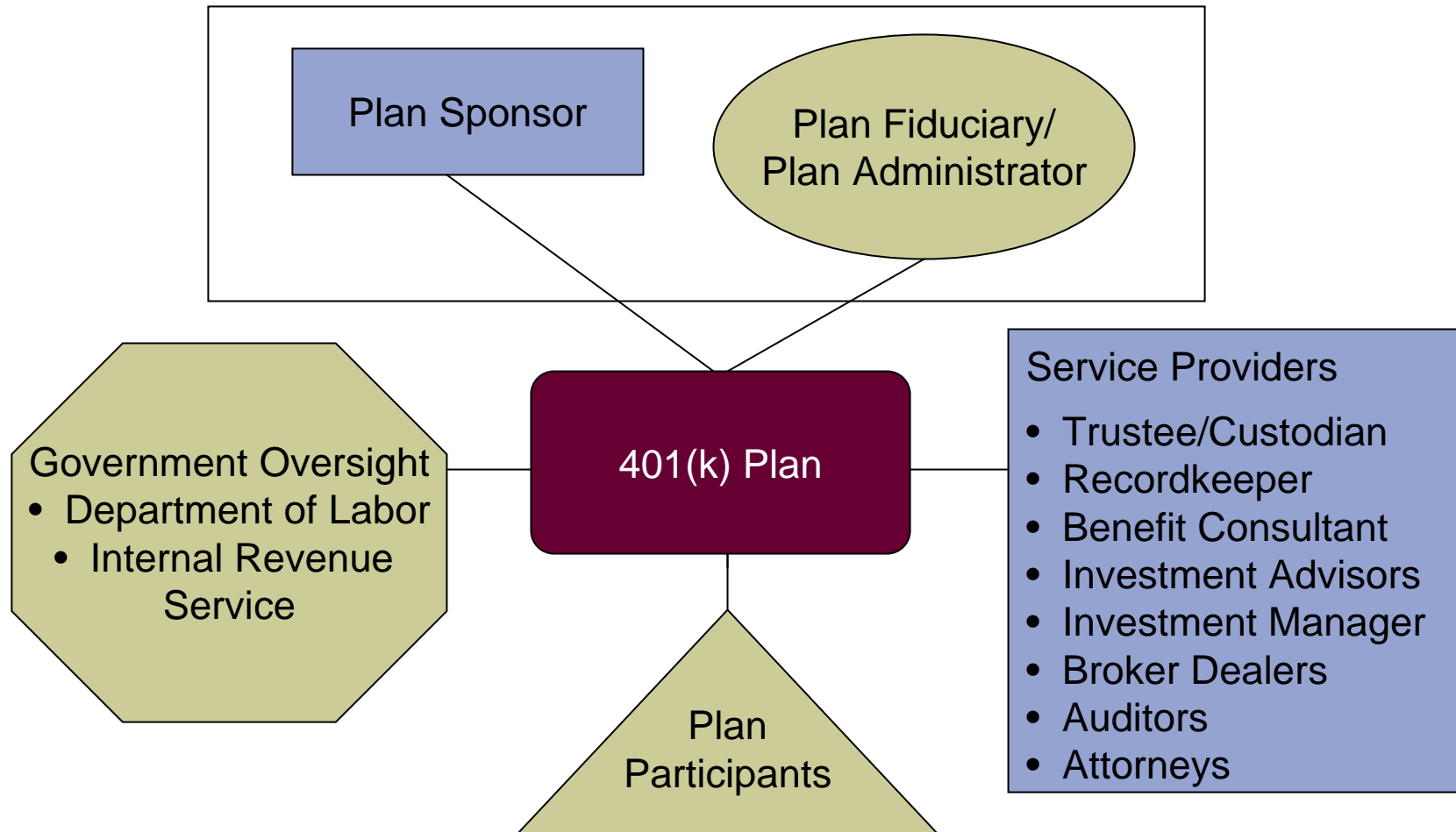
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**RIIA's 3<sup>rd</sup> Annual**  
**Managing Retirement Income**  
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# Overview of Discussion

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- Where have we been?
  - Common 401(k) Plan Traits –Structure, Fees, Participant Communications & Reporting
  - Legal Landscape
- What is happening?
  - DOL & other Governmental Activity
  - Litigation
- Where are we going?
  - Regulatory and Litigation Outlook
  - Suggestions for Sponsors and for Providers

# Common 401(k) Plan Traits – Plan Structure

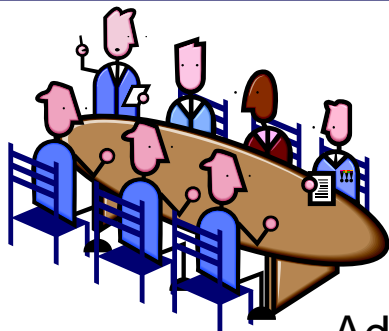


# Common 401(k) Plan Traits – Plan Sponsor Responsibilities

- 401(k) participants may direct their investments, but...
- Plan sponsor still has significant responsibilities:
  - Designing the plan features (contributions, loans)
  - Selecting and monitoring plan service providers
  - Selecting and monitoring investment options
  - Communicating with participants about the plan
  - Regulatory filings (Form 5500)
  - Maintaining plan records



# Common 401(k) Plan Traits – Fiduciary Structure



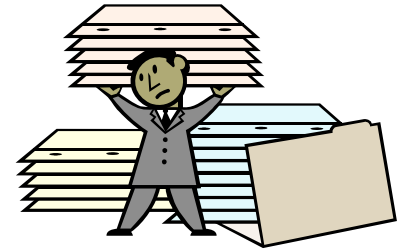
Administrative  
Fiduciary



Investment  
Fiduciary

- Administrative Fiduciary typically selects recordkeeper, negotiates and monitors recordkeeping contract.
- Investment Fiduciary typically selects and monitors plan investment options.
- Revenue Sharing (i.e., payments between investment managers or vehicles and recordkeepers or other plan service providers) is an example of overlap between plan administration and investment of plan assets.

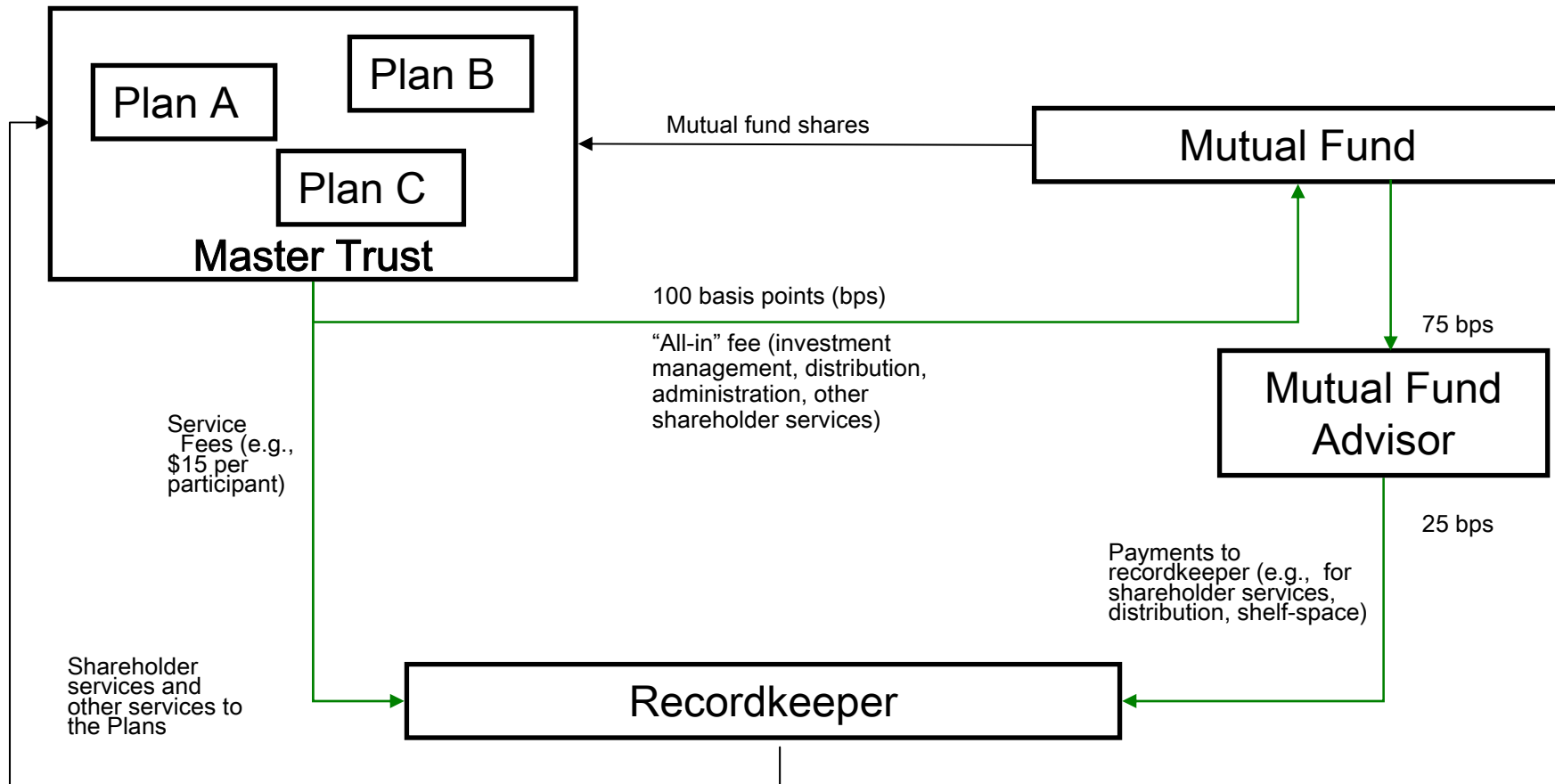
# Common 401(k) Plan Traits - Recordkeeping Arrangement



Typical arrangement might include:

- Third party offers recordkeeping services and platform of investment options
- Mutual funds are typical options
- Sponsor/fiduciary chooses plan's options
- Small or no direct fee to recordkeeper for its services
- Recordkeeper receives payments (revenue sharing) from investment options based on plan investments

# Common 401(k) Plan Traits – Fees

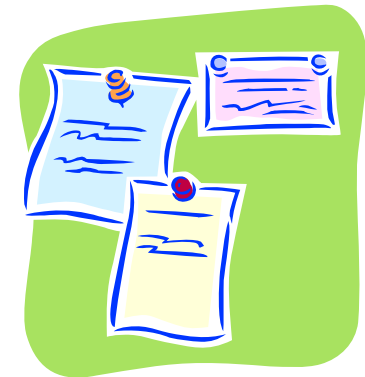


# Common 401(k) Plan Traits – Participant Disclosure

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Disclosure to Participants varies widely:

- Many plans provide mutual fund prospectuses for purposes of meeting 404(c) requirements
- Plans typically do not separately disclose revenue sharing amounts to participants



# Common 401(k) Plan Traits – Form 5500 Reporting

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- Current Form 5500 Schedule C:
  - REQUIRES plans to report some forms of “indirect compensation” received by certain plan service providers for services rendered to the plan (e.g., “finder’s fees”)
  - DOES NOT require reporting of indirect compensation that would have been received if services had not been rendered to the plan and that cannot be reasonably allocated to the services performed for the plan
- Very little current reporting of indirect comp.

# Legal Landscape – Fiduciary Status

- A person or entity is an ERISA fiduciary if:
  - Exercises authority or control re: plan administration
  - Manages or controls plan assets
  - Provides investment advice for a fee
- It's important to understand who is a fiduciary because fiduciary duties are significant.
  - Test is functional – if you are doing these activities, you are a fiduciary.



# Legal Landscape - Fiduciary Duty of Prudence

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- Procedural Prudence
  - identify what information is required
  - obtain it from a competent, independent source
  - give it due consideration
  - make a decision consistent with the information
  - document the decision
  - use experts as appropriate
- Standard is “prudent expert” and not “prudent layman”
- Good intentions not enough: "A pure heart and an empty head are not an acceptable substitute for proper analysis."

# Legal Landscape - Fiduciary Duty of Loyalty

- Fiduciary has a duty of loyalty to the plan's participants and must act for their "exclusive benefit"
- A fiduciary may "wear two hats"
  - Company Hat (when making sponsor decisions)
    - Need not consider plan's interests (e.g., decisions affecting management of Company or plan related but "settlor" functions, like plan design)
  - Fiduciary Hat (when making fiduciary decisions)
    - make decisions "solely in the interest" of Plan participants
    - Example: In choosing a trustee bank, Fiduciary cannot consider positive impact on bank's relationship with Company



# Legal Landscape - Other Fiduciary Duties

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- Comply with plan documents
- Use plan assets only to pay benefits and reasonable expenses of administering the plan
- Avoid conflicts of interest (self-dealing and kickbacks)
- Avoid party-in-interest transactions

# Legal Landscape - Plan Sponsor Duties

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- A fiduciary must “*engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. . . such process should be designed to avoid self-dealing, conflicts of interest or other improper influence.*” - Field Assistance Bulletin 2002-3 (Nov. 5, 2002).
- If services to plan and third party overlap, plan might reasonably request to pay less for services.

# Legal Landscape – Service Provider Duties

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- A Provider can not exercise fiduciary authority or provide advice “causing” a plan’s investment that results in the payment of compensation to such Provider.
  - E.g., 401(k) plan recordkeeper/investment provider with fiduciary authority to select plan investment options generally must rebate or offset fees received from mutual funds.
  - Certain exemptions allow provider to retain commissions/management fees.

# Legal Landscape – Service Provider Duties

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- A Provider may accept payments from third parties, if the payment is not caused by a fiduciary act.
  - E.g., plan recordkeeper/investment provider who merely offers a "platform" of investments from which plan sponsor choose, are not plan fiduciaries and may retain fees from mutual funds.
    - See DOL Adv. Ops. 2003-09A (Aug. 25, 2005) and 1997-16A (May 22, 1997)
  - The opinions recognize that offering a typical 401(k) investment platform doesn't make a recordkeeper a fiduciary.

# Legal Landscape - Service Provider Disclosure Duties

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- Currently, a non-fiduciary Provider has no affirmative ERISA duty to disclose its compensation from third parties.
  - DOL has "encouraged" disclosure in guidance on mutual fund fees and "float."
  - A key consideration is what will need to be disclosed to plan sponsors compared to what will need to be disclosed to participants.

# Legal Landscape – Synopsis of DOL Authority

## DOL Authority – Duties of Plan Sponsors and Recordkeepers re: Revenue Sharing

	Plan Sponsor Duties	Recordkeeper Duties
If <u>non-fiduciary</u> recordkeeper receives revenue sharing compensation	DOL requires plan fiduciaries to obtain “sufficient information” about compensation service providers receive from third parties in connection with plan investments to make “informed decisions” about whether the amounts the plan is directly paying to the provider are reasonable. DOL Adv. Ops. 97-15A and 97-16A	DOL has said that non-fiduciary service provider may retain fees, but should disclose to the plan: any fees and other compensation it receives, directly or indirectly, with respect to the plan (i.e. mutual fund payments), basis for determining amounts received, including a rate or range of rates. DOL Adv. Op. 97-16A
If <u>fiduciary</u> recordkeeper receives revenue sharing compensation	DOL requires plan fiduciaries to obtain “sufficient information” about compensation service providers receive from third parties in connection with plan investments to make “informed decisions” about whether the amounts the plan is directly paying to the provider are reasonable. DOL Adv. Ops. 97-15A and 97-16A	Where recordkeeper is a “Fiduciary,” receipt of fees is a potential “kickback.” DOL says OK if recordkeeper discloses amounts received AND credits that amount dollar for dollar against fees plan owes to recordkeeper DOL Adv. Op. 2005-10A

# Recent DOL Activity

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- Three regulatory initiatives likely to require increased disclosure of (and may discourage) revenue sharing arrangements:
  - Amendments to Form 5500 Schedule C
  - Amendments to 408(b)(2) Regulations – the standards for contracting with service providers which must be satisfied to qualify for an exemption from the prohibited transaction rules
  - Participant disclosure guidance under 404(c)

# Recent DOL Activity - Form 5500, Schedule C

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- In July 2006, DOL proposed changes to Schedule C (filed by plan administrator, requires reporting of service provider compensation).
- Proposal would require reporting of virtually all “indirect compensation” (defined as: payments to plan service providers by third parties “in connection with that person’s position with the plan or services rendered to the plan” 71 Fed. Reg. 411616, 41649 (Jul. 21, 2006)).
  - Require some third party payments to be reported on an unallocated basis.
  - Require “float” to be reported in dollars.

# Recent DOL Activity - Form 5500, Schedule C

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- Examples of Indirect Compensation
  - Float
  - 12b-1 Fees
  - Shareholder Services Fees
  - Shelf-space fees from affiliates of mutual funds
  - Soft-Dollar Payments (e.g., research services)
  - Finders' Fees/Placement Fees

# Recent DOL Activity - Form 5500, Schedule C

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- Proposed Schedule C changes are expected to “clarify” reporting requirements and ensure plan officials obtain information necessary to review reasonableness of compensation, taking into account “revenue sharing or other financial relationships” and potential conflicts of interest that might affect services.
- Proposed regulation expected to become final February 2007.

# DOL Activity - 408(b)(2) Regulations

- DOL is developing Provider “Incentive” to disclose
- Because a Provider is a “party in interest,” its provision of services to the plan requires an exemption.
  - As a party in interest, Provider would be liable for excise tax (pension) or section 502(i) penalties (welfare) if the services are not exempt.
- Current 408(b)(2) regulations require —
  - services are “necessary and appropriate,”
  - the arrangement is “reasonable,” and
  - no more than “reasonable compensation” is paid.
    - See 29 CFR § 2550.408b-2.

# DOL Activity - Proposed § 408(b)(2) Reg. Amendments in April 2007?

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- DOL likely to make disclosure a condition of exemption.
- Likely to require disclosure of information sufficient to permit plan fiduciary to consider whether –
  - the plan pays reasonable fees for services,
  - the service provider's total compensation (including third party fees) is “reasonable,” and
  - any conflicts of interest affect the service provider's advice.

*“This amendment will ensure plan fiduciaries are provided or have access to information necessary to determine whether an arrangement is reasonable...this regulation is needed to eliminate the current uncertainty...”*

# DOL Activity - Disclosure to Plan Participants

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- DOL is considering changes to regulations for participant-directed plans under section 404(c).
- DOL says that rulemaking is needed – *“to ensure that the plan participants...are provided the information they need, including information about fees and expenses, to make informed investment decisions. . .”*

# DOL Activity - 404(c) Disclosure to Plan Participants

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- DOL review of 5500 filings of participant directed plans revealed that only 50% identify themselves as "404(c) plans"
  - Currently, DOL is thinking about applying the same disclosure requirements to all participant directed individual account plans, whether or not the plan is a 404(c) plan (requires finding a disclosure duty).
  - New guidance likely to include both automatic and on-request disclosure requirements.
  - DOL exploring possible role for electronic information in new disclosure regime.

# Congressional Activity

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- Congress has indicated a strong interest in reviewing 401(k) fees.
  - GAO issued its 401(k) Fees Report in November 2006
    - DOL does not have sufficient information
    - Additional legislation may be needed
  - Senate Education and Labor Committee likely to hold hearings focusing on 401(k) fees.
  - House Education and Labor Committee also likely to hold hearings.

# Litigation

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- Class Actions against Plan Sponsors
- Class Actions against Service Providers
- Spitzer Actions

# Class Actions - Plan Sponsors

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- Schlichter, Bogard & Denton has filed twelve lawsuits against major corporations alleging that the corporations' 401(k) plans have been charged excessive and improper fees and have failed to disclose these fees and "revenue sharing" payments to participants. The corporations include: Boeing; Lockheed Martin; Exelon; Caterpillar; General Dynamics; United Technologies; Bechtel; International Paper; Kraft; Northrop Grumman; Deere & Co.; and ABB.

# Class Actions - Plan Sponsors

- All the cases hinge on application of Section 404(a) of ERISA. The three issues arising out of that ERISA subsection are —
  - *Procedural Prudence* - Did the plan fiduciaries exercise due diligence in their consideration of the plan's compensation arrangement with service providers, including any revenue sharing component?
  - *Substantive Prudence* – Did the plan fiduciaries cause the plan to pay excessive compensation to service providers because of revenue sharing or other circumstances?
  - *Disclosure* – Did the plan fiduciaries violate ERISA in how and what they disclosed to plan participants about revenue sharing and other fees charged to the plan?

# Class Actions - Plan Sponsors

- Procedural Prudence –
  - Test focuses on the fiduciary's decision making process, not the result of that process.
  - Considerations include (1) thoroughness of the investigation, (2) expertise of those undertaking it, (3) if appropriate issues were considered, and (4) fiduciary's reliance on expert advice.
  - Argument can be made that satisfaction of test is all that is necessary to avoid imposition of liability under ERISA.
- Substantive Prudence –
  - Test focuses objectively on whether a plan fiduciary caused a plan to pay excessive fees.
  - Reasonableness of fees is determined based on industry standards.
- Disclosure –
  - ERISA imposes reporting and disclosure requirements on plan administrator.
  - After *Varity v. Howe Corp.*, 516 S. Ct. 489 (1996), courts have begun to fashion a "duty to disclose" requirement that exceeds obligations imposed under ERISA.
  - Duty to disclose is not open-ended: generally speaking, litigant must show that failure to disclose was (1) intentional, (2) material, and (3) caused a loss to the plan.

# Class Actions - Plan Sponsors

- Some defendants have answered complaints. Others have filed motions to dismiss parts of the complaint or individual defendants. A few defendants have moved to dismiss their cases outright or have sought an expedited trial schedule.
- Defense of the claims beyond the pleading stage will require use of experts to support the investigation undertaken by plan fiduciaries and the objective reasonableness of fees.
- Additional cases are threatened –
  - Schlichter has advertised for additional plaintiffs and continues to seek plan documents on behalf of plaintiffs to which it has been retained.
- Copycat Case -
  - One plaintiffs' firm has filed an additional complaint (*Heidecker v. Northrop Grumman Corp.*, CV 07-00153 (C.D. Cal., Jan 3, 2007)).

# Class Actions - Service Providers

- Shift in Tactics – A new tactic Schlichter has employed is to join service providers as defendants.
  - ABB Complaint; Deere Complaint
  - The addition of service providers may add “sex appeal” to plan sponsor cases because it presents an opportunity to allege self-dealing based on a service provider’s receipt of revenue sharing.

## Other Service Provider Actions:

### *Haddock v. Nationwide Financial Services, Inc.* (D. Conn.)

- Lawsuit by 401(k) plan sponsors relating to Nationwide’s receipt of fees from funds offered as investment options under variable annuity contracts.
- Under typical service arrangement, each plan sponsor chose a group of funds for its plan from those Nationwide made available under its annuity contract.
- Nationwide selected available funds based in part on revenue sharing paid by funds.

# Class Actions – Service Providers

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- Denying Nationwide’s motion for summary judgment, court held –
  - Nationwide was a plan fiduciary because it retained discretion to add/delete fund options.
  - Nationwide may have been a fiduciary in choosing funds for its platform.
  - Revenue sharing payments from funds could constitute “plan assets.”
  - Even if revenue sharing payments are not “plan assets,” Nationwide’s receipt of revenue sharing could have involved prohibited transactions.

# Class Actions – Service Providers

*Ruppert v. Principal Life Ins. Co. (S.D. Ill.)*

- Class action lawsuit against Principal attacking revenue sharing payments Principal allegedly received in connection with the plan's investments.
- Lawsuit alleges that Principal breached Section 404(a) of ERISA by:
  - Failing to disclose that Principal negotiates revenue sharing with, and accepts revenue sharing from, mutual funds that are included in the menu of investment choices Principal offers to sponsoring employers;
  - Failing to disclose the amount of revenue sharing fees that Principal accepts from mutual fund companies or their advisors; and by
  - Keeping revenue sharing “kickbacks” from mutual fund companies or their advisors.

# Class Actions – Service Providers

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- The *Ruppert* suit further alleges that Principal violated ERISA’s prohibited transaction rule against “self-dealing” by:
  - Using the plans’ assets to generate revenue sharing payments to Principal by mutual fund distributors and advisors; and
  - Retaining revenue sharing payments for its own account.
  - In alleging this, the lawsuit claims that revenue sharing received by Principal are “plan assets.”

# Class Actions – Service Providers

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- *Phones Plus, Inc. v. Hartford Financial Services* (D. Conn.)
  - Lawsuit alleges that revenue sharing payments were for services that the Hartford was already obligated to provide to its plan clients.
  - Like *Haddock* and *Ruppert*, lawsuit alleges that revenue sharing payments are plan assets.
- *Beary v. Nationwide Life Ins. Co.* (S.D. Ohio)
  - Lawsuit not brought under ERISA, but state common law, and claims that Nationwide breached its fiduciary duties by keeping revenue sharing payments for services provided to Section 457(b) plans.

# Spitzer Settlement with 403(b) Provider

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## Retirement Product Disclosure – Settlement Agreement

- In a settlement with the New York State Attorney General, a 403(b) provider, ING, agreed to pay restitution and implement a standard format for retirement product disclosure.
  - Settlement relates to Retirement Program endorsed by NY State Teacher's Union. The 403(b) provider and Union did not disclose to teachers expense reimbursements paid by Insurer to Union.
  - Provider's 403(b) Program competed with 403(b) products offered to teachers by other providers.

# Spitzer Settlement with 403(b) Provider

## **NY Attorney General Settlement Agreement**

- "One-Page Disclosure" to 403(b) Participants
  - States "all-in" investment cost, as a percentage of account balance.
  - Chart shows affect of fees on investor account balances over time.
  - Discloses that fund companies may pay 403(b) provider to be included as investment options, and that 403(b) provider and funds are seeking to make a profit.
    - Does not require disclosure of rates or amounts paid by funds to 403(b) provider, individual fund fees, or contract charges.

# Regulatory Outlook

- High profile lawsuits make it more difficult to persuade DOL to take into account Provider concerns.
  - DOL Amicus Brief uncertain.
  - DOL technical guidance on status of revenue sharing payments as “plan assets” possible
  - Other Potential topics for DOL guidance:
    - Revenue sharing payments are not *per se* illegal under ERISA;
    - A service provider is not a fiduciary under ERISA when it develops a platform of investment alternatives available to plan sponsors and when it retains the ability to alter or change that platform upon advance notice to the plan sponsor; and
    - Plan sponsors and providers currently have no affirmative duty to disclose revenue sharing payments to plan participants.

# Litigation Outlook

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- Litigation experts say cases are unlikely to be decided on motions to dismiss.
- More lawsuits, including “copy cat” suits may be filed.
- Service Providers are increasingly being targeted in fee cases.

# Suggestions for Plan Sponsors

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- Review Plan fee arrangements.
  - Identify Providers' direct/indirect compensation
  - Consider benchmarking?
  - Determine if lower cost investment alternatives are available
- Review fiduciary process for legal sufficiency
  - Adequate due diligence?
  - Documentation?
- Review governance/fiduciary structure.
- Review disclosure to participants about how plan fees are paid, especially asset-based charges that support plan administrative costs.

# Suggestions for Service Providers

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- Service Providers
  - Review disclosure to plan sponsors of direct/indirect compensation
    - Consider “plain language” disclosure of third party revenue
  - Review contractual authority and procedures in making changes in "401(k) fund platform" and other fee arrangements.