Employers and 401(k) Service Providers

The Looming Battles Over Hidden Fees and Costs

By Joel Daniel, Chip Hunt and Chip Hardy

The driving force of potentially high-impact changes in the retirement plan services arena is the significant attention now being focused on the topic of revenue sharing arrangements and fee practices of 401(k) plan service providers. The implications for plan fiduciaries, including employers who sponsor retirement plans, and plan participants can be serious.

Recent media headlines, highly publicized class-action lawsuits, New York Attorney General Elliott Spitzer's high profile settlements and a recently released government report calling for Congressional action all spotlight the problematic issues relating to the unnecessarily complex and confusing 401(k) fee practices so prevalent within the retirement plan services sector. The problem for unsuspecting plan fiduciaries is that liability for inattention may rest on them. Accordingly, investment and retirement committee members, human resource professionals, corporate senior management teams and other plan fiduciaries need to be informed of the issues and consider a prudent course of action to take now in order to maintain the retirement plan's integrity, protect themselves and, most importantly, to preserve employee confidence in the plan. Attorneys representing employers that sponsor 401(k) and similar plans should advise their clients to review the plan service fees to help avoid unwanted breach of fiduciary duty claims.

Plan sponsors should be diligent

Plan sponsors should review all plan service provider fee arrangements. There will likely be resistance from service providers; therefore, actually *executing* the prudent course of action may not be easy, but is necessary to mitigate the risk of liability. In the quest for executing a prudent course of action, plan fiduciaries must understand one crucial point—following a prudent process in selecting and monitoring plan service providers and related fees is the key to avoiding fiduciary liability. In other words, the focus of any fiduciary inquiry is on the procedures followed, not results achieved. The exercise of a routine and disciplined process for managing plan-related decisions significantly improves the plan's chances for avoiding fiduciary liability and obtaining success over the long term.

Generally, plan fiduciaries do not have the knowledge, skills and resources to independently complete these tasks. ERISA explicitly authorizes plan fiduciaries to hire competent experts to assist in this task. Further, courts have ruled that ERISA fiduciaries have a duty to seek the advice of an *independent expert* in circumstances where committee members feel they lack the knowledge and ability to implement these review processes. *See, e.g. Bussian v. RJR Nabisco, Inc.,* 223 F.3d 286 (5th Cir. 2000); *Katsaros v. Cody*, 744 F.2d 270 (2d Cir. 1984); *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982).

Historical perspective on plan fees offers insight

The fee practices of service providers, which are so commonplace today within the retirement plans service arena, are a relatively new phenomena, having only *evolved* over the past 20 years. The evolution of today's fee practices is directly related to the proliferation of 401(k) plans and the corresponding growth of the mutual fund industry.

Traditionally, the employer (or the plan trust) paid service fees directly to each respective service provider. These services typically included: trust/custodial, administration and recordkeeping, actuarial, investment management, legal and accounting. Even brokerage service arrangements typically included a separately negotiated commission structure.

Beginning in the mid to late 1980s, retirement plan designers began to favor "participant-directed" 401(k) plans over traditional "trustee-directed" plans. As 401(k) plans grew in popularity, so did the innovations.

By the late 1980s to early 1990s, most of the routine "bells and whistles" (e.g., daily-valued participant accounts, interactive telephone systems, live operators, online elections and investment

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transfer capabilities, brokerage-window accounts) had been developed. As one might expect, because of their very nature, daily-valued mutual funds became the perfect fit as the investment funding vehicle of choice for 401(k) plans.

Recognizing the trends and flow of new dollars into 401(k) plans, banks, brokerage firms and insurance companies scrambled to enter the 401(k) arena and capture its share of this promising market. Simultaneous to the market entry of these financial service providers, traditional third-party administrative firms saw their market share dwindling. Competition among all parties for the development of new business became fierce.

Mutual fund companies recognized and seized on the opportunity to uniquely position themselves with each of these service provider segments. To mutual fund companies, the respective sales forces of service provider intermediaries would, in turn, operate as a distribution venue for the benefit of the mutual fund companies.

To add to their appeal in each of these distribution channels, mutual fund companies began to develop business arrangements (known as revenue sharing), whereby the mutual fund company would share a portion of its fees with the service provider for providing certain services. The logic behind these arrangements was that service providers were now fulfilling participant investor services, which the mutual fund company would no longer have to provide. Fund prospectuses, for example, were being delivered by 401(k) vendors, relieving the mutual fund company of the obligation. This arrangement caused service providers to rapidly develop bundled service sets in order to tap into the hidden revenue flowing from mutual fund companies.

Within the context of an intensely competitive market environment, this revenue sharing practice was an incredibly appealing marketing tool that created the illusion that some service providers' fees were significantly more attractive than the fees of other firms that continued to fully disclose their fees. Such firms quickly found themselves at a huge "pricing" disadvantage and turned to such "pricing" practices for business survival purposes. By the early to mid 1990s, the common sales pitch within the industry was "we can provide you a 401(k) plan for free."

However, a problem has been quietly developing for ERISA fiduciaries. The hidden fees and lack of disclosure relating to these bundled service and revenue sharing arrangements have blurred the lines of association between the services provided and the costs incurred. This has made it nearly impossible to evaluate or compare the reasonableness of fees in accordance with fiduciary obligations.

Stimulus for change

Class Action Lawsuits Filed—In September 2006, a number of class action lawsuits were filed against 10 major employers on behalf of participants of their 401(k) plans. The companies sued include International Paper Co., Lockheed Martin Corp., Boeing Co., Kraft Foods, Inc., Bechtel Group, Inc., Caterpillar, Inc., John Deere & Co., General Dynamics

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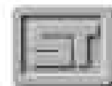

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Corp., United Technologies, Inc. and Exelon Corp. *See, e.g., Spans v. Boeing Co.*, No. 3:06-CV-00743-JLF-DGW (S.D. Ill. 2006).

The basic theme in these cases is that the fiduciaries have caused or allowed their 401(k) plans (and participants) to be charged excessive fees by virtue of revenue sharing arrangements for plan services. It is reasonable to assume that, depending upon the outcomes of these cases, "copy-cat" cases may become troublesome for smaller employers and their respective fiduciary committees. One could even argue that, although the payoff for plaintiffs' attorneys is less rewarding, smaller employers are nonetheless easy prey because they are less likely to have methodically followed the prudent processes with respect to their plans and therefore proving liability would generally be easier.

ERISA Background for the Claims—The Employee Retirement Income Security Act (ERISA) requires fiduciaries and plan trustees to perform their duties "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of … providing benefits to participants and their beneficiaries [and] defraying reasonable expenses of administering the plan." ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

Additionally, fiduciaries are held to a very high standard in the discharge of these duties, acting "with the care, skill, prudence and diligence" that a prudent expert familiar with such matters would use. *See* ERISA § 404(a)(1)(B), 29 USC § 1104(a)(1)(B). As such, causing or allowing the plan or participants to pay more than necessary for plan expenses (thus reducing retirement account balances) without adequate documentation or justification is arguably a breach of fiduciary duty.

Loss of § 404(c) Protection—In a related point and potentially devastating for plan fiduciaries is the challenge to the investment liability protection offered under ERISA § 404(c) and 29 C.F.R. § 2550.404C-1. Among other things, § 404(c) and the related regulations require plan fiduciaries to provide participants with a description of any transaction fees and expenses that affect the participant's account balances. Also, *upon request*, plan fiduciaries must provide a description of the annual operating expenses of each designated investment option.

How can fiduciaries reasonably be expected to meet this disclosure requirement to participants when, in turn, such information may not have been clearly disclosed to them by plan service providers? Yet § 404(c) protection requires full compliance … partial compliance still results in failure and loss of protection.

New Government Report on 401(k) Fees —Another stimulus for reform is the report by the U.S. Government Accountability Office entitled *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees* released in November 2006, GAO-07-21, *available at* www.gao.gov/new.items/d0721.pdf [hereafter GAO Report]. The GAO Report was commissioned by Rep. George Miller, D-California, who is the incoming chairman of the House Education and Workforce Committee. Rep. Miller said he would call hearings on this issue early in the new Congressional session.

The findings of the GAO Report reveal much that was expected as noted by the following excerpts:

- "Concerns have been raised that employers sponsoring the plans and plan participants may not be aware of all of the fees being charged to them or whether companies providing services to the plan have undisclosed business arrangements with other service providers that could negatively affect participants."
- "Without disclosing these arrangements, service providers may steer plan sponsors toward investment products or services that may not be in the best interest of participants and may cause them to pay higher fees."
- [The Department of] Labor has authority under ERISA to oversee 401(k) plan fees and certain types of business arrangements that could affect fees, but lacks the information it needs to provide effective oversight."
- "Investment fees, which are usually charged as a fixed percentage of assets and deducted from investment returns, are typically borne by participants."
- "Over the course of the employee's career, fees may significantly decrease retirement savings."
- "A 1-percentage point difference in fees can … reduce the amount of money saved for retirement … by about 17 percent."

Considering the above findings, the GAO Report recommends that Congress take action by amending ERISA to require:

- employers to provide disclosure of plan-related fees to workers,
- 401(k) service providers to disclose to employers the compensation they receive from other service providers (banks, mutual fund and insurance companies, etc.) and
- investment consultants to disclose potential conflict of interest problems relating to the compensation they receive from the investment companies they are recommending to plan sponsors.

Finally, to better enable the Department of Labor to effectively oversee 401(k) plan fees, the GAO Report recommends that the Secretary of Labor require plan sponsors to report a summary of all fees that are paid out of plan assets or by participants on a revised Form 5500. The Labor Department has indicated it plans to release finalized new rules in this area this spring.

Five steps to take now to mitigate risk of fiduciary liability

1) Engage competent experts to assist in the process. This will provide the prudent expertise of a person familiar with such matters in acting with the "care, skill, prudence and diligence" required. The Department of Labor and the SEC have jointly developed a set of 10 questions in a publication, *Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries, available at* www.dol.gov/ebsa/newsroom/fs053105.html. If the plan currently retains the services of an investment advisor or consultant, he should answer the

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same 10 questions recommended by the DOL and SEC.

2) Review and gather documentation of specific expense and revenue sharing fee arrangements for every fund in the plan. Ensuring parity on a fund by fund basis is important since not all participants invest in the same funds. The Department of Labor has useful tools on its Web site that may be useful in this effort, including the publication *Understanding Retirement Plan Fees and Expenses,* May 2004, *available at* www.dol.gov/ebsa/publications/undrstndgrtrmnt.html.
3) Identify and segregate, by category, all plan-related expenses, then benchmark to industry averages to test reasonableness given the size of the plan by number of participants and total amount of plan assets. Be sure to identify the total expenses being paid, both directly and indirectly, whether by the plan, by the participants or the employer. The DOL's online model publication, *401(k) Plan Fees Disclosure Form,* is a useful tool for this step and can be found at www.dol.gov/ebsa/pdf/401kfefm.pdf.
4) Use the lowest cost mutual fund *share class* available to minimize or eliminate revenue sharing. This is beneficial to the plan by removing much of the uncertainty regarding fee issues. Substituting a cheaper share class may not produce immediate cost savings as the plan's recordkeeper may seek an equivalent hard-dollar fee to make up for the lost revenue. However, from a fiduciary governance point of view, fiduciaries would be much better off with an identifiable, fixed, hard-dollar fee arrangement than with a hidden, variable, soft-dollar fee arrangement.

Industry insiders acknowledge that recordkeeping fees charged on a "percentage of assets" basis do not always correlate to the level of work involved for producing such services. The same idea was recently expressed in the *Wall Street Journal* quoting a suit involving mutual fund giant Fidelity Investments: "As the years pass, and as participant's retirement savings grow, the amount of money available for revenue-sharing payments increases, even though no additional services may be provided to the plan." Tom Lauricella, *Fidelity is Sued Over 401(k) Fees,* WALL STREET JOURNAL, Dec. 14, 2006, at C13.

5) Examine plan communications to be sure that all fees are clearly reported to plan fiduciaries and participants. This will aid in the efforts to otherwise comply with 404(c) and preserve the fiduciary protections offered.

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