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Jerry Schlichter's fee lawsuits have left an indelible mark on the 401(k) industry

After a decade of litigation, fees are lower and retirement plans are more transparent. But have the lawsuits gone too far?

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By **Greg Iacurci**

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Shining a light: Jerome Schlichter says 401(k) plan fees "were in a dark closet" prior to the wave of lawsuits.

At first glance, Sept. 11, 2006, may not stand out as a remarkable date in American history.

But to retirement wonks, it is: That's the day a personal injury lawyer from St. Louis filed a flurry of lawsuits against major corporations, alleging their 401(k) plans had high fees that harmed employees. It's a moment that forever changed the 401(k) plan market.

1 years since ... en masse, branching into new areas, and contributing to lasting change, largely to the benefit of plans and retirement savers.

"It's had a tremendous impact," Sean Deviney, the director of retirement plan consulting at Provenance Wealth Advisors, which oversees $500 million in DC

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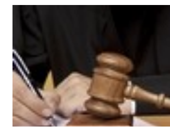

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plan assets, said of the litigation. "It **brought awareness** to the fees being charged in plans and a sense of urgency for [employers'] retirement-plan committees to really take their jobs seriously."

But, observers say the litigation has also contributed to fee hysteria among employers and, following some large monetary settlements, resulted in a plaintiff's bar that seems to be unnecessarily piling on the litigation to score a quick payday.

"Have there been some defendants that have been asleep at the wheel?" asked Matt Gulseth, partner at Channel Financial, which oversees more than $1 billion in retirement plan assets. "Yes. Is it as much as the plaintiff's bar is insinuating with all these lawsuits? Probably not."

'A DARK CLOSET'

Mr. Schlichter's initial tranche of lawsuits, against such companies as Lockheed Martin Corp., Caterpillar, General Dynamics, International Paper and Exelon Corp., alleged workers in those companies' 401(k) plans were paying excessive fees — or, beyond what would be considered reasonable — for plan

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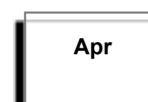

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Broadly, they focused on three areas: companies' use of retail share classes of mutual funds, when identical, less-expensive institutional share classes were available; uncapped, asset-based revenue-sharing fees paid for record-keeping services; and imprudent, historically poor-performing investment options.

These charges constituted breach of fiduciary duty under the Employee Retirement Income Security Act of 1974, according to the lawsuits.

"When we began this journey, there was no attention being given to litigation in this space," said Mr. Schlichter, who successfully litigated the only 401(k) fee case that's ever gone to the U.S. Supreme Court. "Fees were in a dark closet."

While there had been a handful of 401(k) fee cases filed around the year 2000 by different law firms, they focused on plan service providers such as Nationwide and **New York Life Insurance Co.**; Mr. Schlichter's pioneering lawsuits targeted employers in their role as plan sponsors.

All told, there were 31 so-called "excessive fee" suits

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filed by Mr. Schlichter and other firms over 2006-07, according to data from Groom Law Group. Following several large monetary settlements, including **$62 million** from Lockheed Martin, the litigation caught a second wind beginning in 2015.

Last year, there were 29 new cases filed through September, according to Groom Law Group's most up-to-date data. That's the largest annual total to date, and there's no sign the pace is slowing down.

Number of retirement-plan-fee cases filed annually

Note: Includes 401(k) and ERISA-covered 403(b) plans.

*Through September 2016.

Source: InvestmentNews analysis of Groom Law Group data.

The issue is pertinent to the number of advisers who service defined contribution plans, which is estimated **to be about 250,000**, according to The Retirement Advisor University.

"Advisers are building their practices around defending clients against fee litigation," said Michael Montgomery, managing principal at Montgomery Retirement Plan Advisors, which advises on more than $1 billion in DC assets. "None of us wants our client to be the low-hanging fruit for a litigator, and that's something we think about when we come to work every day."

FEE TRANSPARENCY

One result of the litigation has been increased fee transparency.

Before, employers often thought record-keeping services were free of charge, advisers said. Of course, this wasn't the case.Often unbeknowst to them, participants were paying for those services through revenue-sharing fees, which involves directing a portion of a mutual fund's expense to service providers.

"No one quibbled over how much the record keeper was making," Mr. Montgomery said. "Too many plans were sold because they were 'free' prior to that."

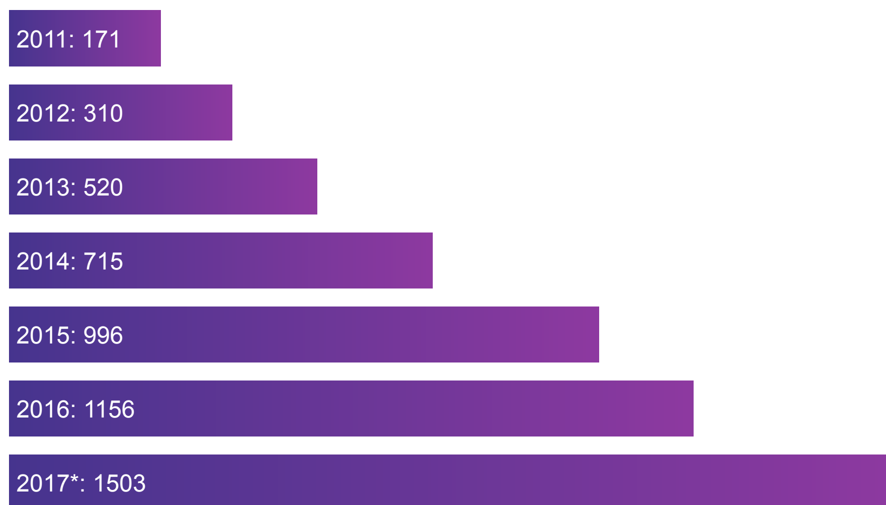
Advisers and employers have since **moved away from revenue sharing** as they've tried to make fees more transparent and better control participant costs.

Nearly 52% of participants paid for DC-plan administration via some form of revenue sharing in 2015, down from 67% in 2012, according to the most recent data from Callan Associates, a consulting firm.

Asset managers have rapidly introduced mutual funds that **strip out revenue-sharing costs** to meet demand. The number of mutual funds offered in a zero-revenue share class is nearly nine times what it was in 2011, according to Sway Research, which studies asset management distribution in DC plans.

In 2017, 79% of assets held in an R share class mutual fund — meant specifically for use in retirement plans — strip out all revenue-sharing payments. That's up from 56% in 2012, according to Sway.

Number of mutual funds without revenue sharing available for DC plans



*Through August 2017.

Source: Sway Research.

"I think back in 2006; if you asked 10 plan sponsors, 'Do you know the specifics on exactly what your plan costs?' I bet nine would say no," said Chad Larsen, president and CEO at MRP, which oversees about $3.5 billion in retirement assets. "Today, I bet eight would say they know it down to the basis point."

Record keepers have updated their technology in response to fee litigation, advisers said. Within the past decade, they've **created mechanisms** such as "expense-recapture accounts" and sophisticated debiting and crediting methods to allocate excess revenue-sharing payments back to the plan and its participants.

'POSITIVE PRACTICES'

Further, record keepers have created "open architecture" investment platforms, allowing plan sponsors to select investments that are not proprietary to the record keeper but based solely on the merit of the investment, advisers said. They've also integrated technology-driven fiduciary investment adviser services, offered by firms such as Morningstar, Envestnet and Mesirow Financial, as awareness of fiduciary issues has grown.

"It's pushed providers to adopt some very positive practices," Mr. Montgomery said.

401(k) advisers have upped their frequency of completing fee benchmarking for plan services, too, to ensure fees are reasonable for services rendered. Mr. Larsen, for example, now completes these exercises with clients once a year, compared with every couple of years in the past.

Fees have **generally declined for all plan services** over the past decade. Total 401(k) plan costs between 2009 and 2014 fell to 0.39% on an asset-weighted

basis, from 0.47%, according to a joint study by BrightScope Inc. and the Investment Company Institute.

This is partly due to a push toward **greater use and prevalence of index funds**, as opposed to actively managed funds, which are generally more expensive. Participant assets held in index funds climbed to 29%, from 17%, between 2006 and 2014, according to the BrightScope-ICI study.

Some advisers say employers push for index funds out of fear rather than for solid fiduciary reasons.

"I've seen some plan sponsors step away from active management just because of the fees," Channel Financial's Mr. Gulseth said. Some perceive using index over active funds as a way of inoculating themselves from fiduciary liability, which may not necessarily be the most prudent course of action, he said.

REGULATION'S EFFECT

Observers point out that the fee lawsuits don't exist in a vacuum — market forces and regulation handed down by the Department of Labor in 2012 requiring disclosure of plan fees have contributed to fee compression and transparency, too.

More recently, the DOL's conflict-of-interest regulation governing investment advice also has placed a focus on plan fees.

But some advisers believe fee lawsuits have had an outsized influence.

Fee disclosure "isn't as impactful as saying XYZ company is getting sued and their name is on the front of the Wall Street Journal," Mr. Deviney said. "That motivates employers to take some action."

Some observers believe there's been overreach from the plaintiff's bar. One frequently derided lawsuit, filed by Mr. Schlichter in 2016, **targeted Anthem Inc.**, whose plan contained several funds offered by **Vanguard Group**, known widely as a low-cost provider. Participants could have had a fund costing 0.02% in place of the Vanguard Group Institutional Index Fund, which cost 0.04%, the lawsuit said.

"I think some of these lawsuits have come too far," William Chetney, founder of Global Retirement Partners, said, adding that he believes employers are focused more on risk aversion than participant outcomes.

Mr. Schlichter, though, doesn't shy away from the allegations in the Anthem lawsuit.

"That argument pre-supposes it's OK to rip off employees and retirees a little bit," said the founder and managing partner at Schlichter Bogard & Denton. "Two basis points is a small amount, but 2 bps over 30 years and over tens of thousands of employees is not a small amount."

Mr. Schlichter made headlines again in a big way last

summer by suing more than 10 prestigious universities, including Yale, Duke, Johns Hopkins and Vanderbilt. They were the **first lawsuits to target fees** in university 403(b) plans, a type of DC plan for nonprofit institutions.

Marcia Wagner, principal at The Wagner Law Group, who's been an expert witness in fee litigation for both plaintiffs and the defense, said these suits have brought rapid change to the 403(b) market. She said she wouldn't be surprised if 457 plans, which encompass governmental institutions, became the next frontier.

"Some of these 457s are huge," Ms. Wagner said. "I haven't seen [a lawsuit] yet. But there's no doubt in my mind there will be some."

And while the suits to date have concentrated primarily on the largest DC plans — those with billions of dollars in assets — there have been a few sprinkled further down market, where most advisers focus their practices.

"This is a new area for the tort bar," Ms. Wagner said. "This can expand or contract. We don't know where it's going to go."

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