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Cause and Effect

The influence of 401(k) fee litigation

FOR BETTER OR WORSE, the proliferation during the last five years of class-action litigation challenging the fees and expenses paid by 401(k) plans is not only the industry's most serious challenge but also a spur to greater prudence and reform.

Class Actions Thus Far

The targets of these cases have been very large plan sponsors and related plan committees, managers, and investment providers. Typically, the plaintiffs in the more than three dozen lawsuits that have been brought so far complain that the plan sponsor defendants breached their fiduciary duties by failing to negotiate reasonable fees for administrative and investment services. In support of such complaints, the plaintiffs allege that the defendants failed to understand, monitor, and control hard-dollar and revenue-sharing payments made directly or indirectly by plans, that they failed to establish and implement procedures to determine properly whether such expenses were reasonable and incurred solely for the benefit of participants, and that they failed to disclose such fees and expenses adequately to participants. Frequently allied to such allegations is the claim that the selection of retail-class mutual funds as a plan investment option is inappropriate because they are more expensive than institutional class funds.

The complaints challenging investment and service provider fees were filed in several waves that reflected evolving and broadening theories of liability as the plaintiffs' bar became more familiar with the nature of its target. The largest group of claims was filed in September and October of 2006 by a law firm from St. Louis, Missouri, but it is sometimes overlooked that this was not the start of these cases. In 2006, similar claims by plan fiduciaries against service and investment providers in cases such as *Haddock v. Nationwide Financial Services, Ruppert v. Principal Life* and *Phones Plus, Inc. v. Hartford Financial Services* were already pending. These cases illustrate latent dissatisfaction with investment providers, which the plaintiffs' bar identified and set out to exploit.

Trial courts have been cautious in dismissing these lawsuits at an early stage via motion to dismiss or summary judgment, sometimes going to great lengths to allow participants to articulate their claims and conduct expensive discovery that might establish the facts necessary to support a claim. A notable exception to this trend was *Hecker v. Deere* which granted the employer's motion to dismiss and ultimately was affirmed in a landmark decision by the 7th Circuit Court of Appeals.[1] The powerful influence of the *Deere* case, which essentially holds that the marketplace works to regulate service providers, appears to have slowed the pace of new lawsuits, but the ability to survive motions to dismiss and summary judgments, as well as recoveries in several settlements seems to have encouraged the plaintiffs' bar to soldier on with existing cases. This should come as no surprise, since this type of litigation has the potential to generate enormous legal fees.

To date, the focus of the fee litigation has been on very large plans and employers. If plaintiffs were ever to achieve a modicum of success through legal judgments, it would be only a matter of time before medium and smaller plans became targets. Nevertheless, other forces are at work motivating a response by the 401(k) industry. As a matter of self-preservation, plan sponsors are taking proactive steps to identify and monitor plan fees and expenses. Other changes are coming about because of regulatory initiatives responding to the perceived abuses in the current system that led to the spate of 401(k) fee cases.

Enhanced Transparency

Common to the complaints in class actions over 401(k) fees is the argument that expenses were not disclosed adequately. Improving the transparency of services and fees in the 401(k) market has been a primary goal of the Department of Labor (DoL) since it released its first report on 401(k) fees and expenses in April 2008. More recently, the DoL revised Form 5500 and Schedule C to require more detailed disclosure of fee information, including direct and indirect compensation of more than $5,000. The enhanced reporting on Schedule C was effective for plan years beginning on or after January 1, 2009. However, there was still an issue as to whether providers would produce the necessary information.

In December 2007, the DoL proposed the amendment of regulations under Section 408(b)(2) of ERISA to redefine the meaning of a reasonable contract. The objective of these rules, which recently have been finalized and are scheduled to become effective on April 1, 2012, is to

require service providers to deliver notices to their existing plan sponsor clients that describe the services provided, as well as the compensation directly or indirectly received by the provider. Once the initial disclosures have been made, additional fee disclosures will need to be furnished whenever a provider agrees to renew or extend its services or whenever it enters into a new service arrangement with a plan client. The DoL intends that these disclosures will assist plan fiduciaries in considering a plan service provider's compensation from all sources when determining whether fee arrangements are reasonable, as well as enabling fiduciaries to identify any conflicts of interest.

Providers of the following services would be required to make such disclosures: accounting, actuarial, appraisal, banking, consulting, custodial, insurance, investment, legal, brokerage, and administrative, as well as record-keeping platforms and fiduciary advisers. Plan advisers can provide valuable assistance to plan sponsors by monitoring and evaluating the information obtained from these providers so that sponsors can fulfill their obligation to determine whether the quality and scope of the services are worth the amounts paid for them.

The new rules also will enable sponsors of plans with participant-directed investments to fulfill their new fiduciary obligation, effective for plan years beginning after November 1, 2011, to provide disclosures to participants regarding both plan investments and administrative service fees. The fee information that sponsors provide to participants must be furnished on an annual and a quarterly basis with the quarterly statements showing the actual dollar amount charged to participant accounts.

Adviser Accountability

The DoL's October 2010 proposal to expand the situations in which fiduciary status under ERISA may be conferred as a result of providing investment advice will further affect how many advisers conduct their business, including RIAs and broker/dealers. Under the proposal, a person can be deemed to provide investment advice if there is an understanding (written or otherwise) that the advice may be considered in connection with making an investment or management decision with respect to plan assets and will be individualized to the needs of the plan. To be considered investment advice under the proposal, recommendations need only be provided on a one-time basis, in contrast to the current rule where advice must be given on a regular basis in order to confer fiduciary status. Investment advisers within the meaning of Section 202(a)(11) of the Investment Advisers Act of 1940 also are deemed to be ERISA fiduciaries.

Being a fiduciary with respect to a 401(k) plan requires complete loyalty to the interests of the plan and its participants. For some advisers, this duty may alter radically permissible business relationships and compensation practices. ERISA prohibits fiduciaries who provide investment advice from receiving variable compensation (e.g., 12b-1 fees) due to the conflict arising from the incentive to recommend investments that generate the highest fees. If adopted, the proposal to expand fiduciary status could present many broker/dealers with the choice of accepting such status and its restrictions on compensation or attempting to avoid it by either reducing the level of offered services or, as permitted by the proposal, making awkward disclosures to the effect that their advice is not impartial.

Many advisers serving plans as RIAs, on the other hand, already do so in a fiduciary capacity for which they receive level fee compensation, thereby eliminating potential conflicts of interest. If the proposed rule expanding the definition of the term fiduciary is adopted, it can be expected that certain broker/dealers will seek to become dually registered as RIAs so that they will be allowed to receive this form of compensation.

Investment Advice

The DoL has stated consistently that it does not object to advisers' receipt of indirect compensation, provided that it is disclosed adequately. However, the fee initiatives discussed above will do little good if participants fail to understand the information that is delivered to them. For this, participants may require the guidance of investment professionals who are likely to be plan advisers.

ERISA makes it unlawful for fiduciary advisers to provide participant-level investment advice that is conflicted. Therefore, advisers that receive variable compensation generally are prohibited from offering such advice. The current version of the DoL's proposed regulation of investment advice conditions the ability to offer such advice to participants on the receipt of level compensation by the plan's individual financial adviser and any related advisory firm, so that compensation cannot vary with the investment decisions made by participants. Alternatively, an adviser could earn variable compensation if the investment advice is based on an objective computer model.

It remains to be seen whether the investment advice proposal will be modified to eliminate perceived advantages under the level-fee model for advisory firms affiliated with mutual fund complexes. Under the proposal, an affiliate of such an advisory firm, i.e., the mutual fund complex, has the ability to receive additional compensation, representing an exception to the level-fee model.

401(k) fees, which are paid primarily by plan participants, are the biggest policy issue currently affecting retirement plans. However, most plan participants are unaware that they pay any plan fees. The class actions over fees undoubtedly will cause plan sponsors to monitor plan and fund expenses to ensure that they have negotiated the best deal. In the end, however, the regulatory mandate requiring full disclosure of plan fees has the potential to modify participant behavior and fundamentally change the retirement industry as we know it.

[1] *2007 WL 1874367 (W.D. Wisc. 2007), aff'd. 556 F.3d 575 (7th Cir.2009), aff'd on rehearing 569 F.3d 708 (7th Cir.2009)*