BEST PRACTICES EVOLVING FROM 401(K) FEE LITIGATION

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Class action law suits brought against some of the nation's largest employers allege that, as sponsors of 401(k) plans, the targeted employers authorized the payment of excessive fees for the administrative and investment services provided to the plans. The suits claim these plan fiduciaries breached their duties under the Employee Retirement Income Security Act of 1974 ("ERISA"), which imposes a duty to ensure the plan's fees are reasonable in relation to the services provided.

In light of these class action claims, more employers are beginning to adopt "best practices" that involve the monitoring and negotiation of their service providers' fees. An important part of a fiduciary's responsibility includes identifying, understanding, and evaluating the fees and expenses associated with plan investments, investment-related services and administrative services. Thus, when evaluating the plan's investment and service providers, fiduciaries need to consider all hard dollar expenses incurred by the plan as well as any "revenue sharing" and similar payments made between the providers.

When examining the plan's fees, fiduciaries should evaluate them in relation to the quality, nature and scope of the services provided. The selection of an investment or service provider is, in and of itself, a fiduciary decision that is subject to the fiduciary standards under ERISA. The duty to select and monitor these providers, like any other fiduciary duty, must be discharged solely in the interest of plan participants and in accordance with the duty of care and prudence required under ERISA.

To avoid being held hostage by similar legal actions for excessive fees, plan sponsors are taking proactive steps to adopt the best practices and are implementing the following standards. These standards recognize that fiduciaries are judged not on the results they achieve, but on the processes they follow, and that such processes evolve over time.

<u>Identifying Fees</u>. Plan sponsors should make a concerted effort to learn how much the plan and participants are actually paying in fees and expenses. Although the Department of Labor's proposed regulations regarding fee disclosure allow disclosure by formula, many plan sponsors will attempt to determine the actual dollar amount, even if it is an estimate. Moreover, once currently proposed regulatory initiatives have been finalized, the new regime will almost certainly require greater disclosure of fees and compensation and more diligence by sponsors.

<u>Comparing Investment Management Fees or Expense Ratios Against Benchmarks</u>. Plan sponsors should attempt to avoid paying above-average investment management fees or expense ratios unless the investment manager or mutual fund can demonstrate that it is delivering above-average investment performance for the plan participants.

<u>Continuous Monitoring</u>. Continuous monitoring of fee structures to ensure that they are reasonable in comparison with industry standards will become a best practice. In addition to asking a broad range of qualitative and quantitative questions about the plan's funds and service

providers, plan sponsors should review whether the fees are reasonable with respect to the investment performance and services received. Questions directed to service providers, financial advisors and consultants should also seek to reveal conflicts of interest, such as whether such persons receive any indirect compensation from or through the plan's investments.

Documenting Reviews of Investment Vehicles and Fees. Plan sponsors should document their reviews of investment vehicles, including negotiations related to service provider fees paid directly by the plan or plan sponsor or indirectly by the plan participants through a reduction in investment earnings. The documentation should demonstrate a thoughtful process addressing key questions or discussions and decisions made.

Hiring Independent Third Party Investment Experts. More plan sponsors will employ independent third parties (e.g., consultants) to assist with reviewing the investment performance and fees of investment managers and related service providers. While these vendors typically provide reports and recommendations for analysis by the plan sponsor, there is an inherent conflict of interest when vendors report on proprietary funds or even nonproprietary funds where long-term business relationships and revenue agreements may influence the reports and recommendations.

Replace Funds that Do Not Meet Investment Criteria. Many fiduciaries are reluctant to replace poorly performing funds and often compromise by merely adding funds. This should be avoided, since it could demonstrate unwillingness on the fiduciary's part to perform his or her duties, as required by ERISA.

Conducting Fiduciary Audit. When appropriate, more plan sponsors will be hiring an independent third party to conduct a fiduciary audit of the plan's outside fiduciaries, particularly when vendors fail to adequately disclose fees or fees do not seem reasonable.

Fiduciary Manual. A fiduciary manual that incorporates the standards discussed above can serve as a reference tool or guide for employers. Use of a fiduciary manual is intended to help employers reach a better understanding of their responsibilities, thereby helping them comply with ERISA's fiduciary standards.

By adopting these practices and incorporating them into a prudent review process, plan sponsors can help ensure that the plan's investment and service providers have been properly selected, and that the plan's fees and expenses continue to remain reasonable in light of the services being delivered to the plan.