KEEPING UP WITH THE DOL

401(k) FEE DISCLOSURE, LITIGATION, EVOLVING BEST PRACTICES

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I. 401(k) Fee Disclosure

A. Disclosure by Service Providers to Plan Sponsors.

1. Background.

a. Statute. ERISA §408(b)(2) provides relief from ERISA's prohibited transaction rules for service between a plan and a party in interest (e.g., broker-dealer) if the contract or arrangement:

- is reasonable,
- the services are necessary for the establishment or operation of the plan, and
- no more than reasonable compensation is paid for the services.

b. Current Regulations. In addition to the above requirements in ERISA, the current regulations impose only one other significant additional requirement. The plan must be able to terminate the service contract or arrangement without penalty on reasonably short notice.[1] Neither ERISA nor the current regulations impose a significant administrative burden on service providers nor expose them to significant risk of legal liability.

2. Proposed Regulations.

a. Overview. The U.S. Department of Labor ("DOL") has proposed[2] amending its regulations to require service providers to disclose in writing their fees and conflict of interests. If adopted as proposed, the new regulations will impose significant administrative burden on service providers and expose them to significant risk of legal liability for failure to disclose their fees and conflicts of interest.

DOL's proposed fee and conflict of interest disclosure rules for service providers are the second of three fee-related regulations. The first set applies to a plan's disclosures of fees that it pays on Form 5500, Schedule C. As discussed below, DOL has already issued final regulations on the revised Schedule C[3] and they apply starting with the 2009 plan year. DOL has also proposed the third set of regulations that will apply to the disclosures by the plan to its plan participants.[4]

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[1] 29 CFR 2550.408b-2(c).
[2] 72 Fed. Reg. 70988 (Dec. 13, 2007). If DOL adopts the 408(b)(2) regulations as proposed, the final regulations would take effect 90 days after publication in the Federal Register.
[3] 72 Fed. Reg. 64710 (Nov. 16, 2007).
[4] Proposed 29 C.F.R. 2550.404a-5 published at 73 Fed. Reg. 43013 (Jul. 23, 2008).

b. Rationale for Proposed Regulations**.** The three sets of fee-related disclosure regulations are the current installment in the 401(k) fee saga that began more than ten years ago. In 1997, several consumer magazines published provocatively entitled articles, such as "Protect Yourself against the Great Retirement Rip-off"[5] and "Your 401(k)'s Dirty Little Secret."[6] These articles apparently prompted DOL to launch its 401(k) plan fee initiative. In November 1997, DOL held a hearing on 401(k) fees.[7]

In June 1998, DOL published a 19-page booklet, "A Look At 401(k) Plan Fees," for plan participants[8] and a 72-page report, "Study of 401(k) Fees and Expenses," for plan sponsors.[9] The study appears to have been an attempt to educate plan sponsors about their fiduciary responsibilities regarding fees and expenses for service providers. The booklet appears to have been an attempt to persuade plan participants to put pressure on plan sponsors to pay attention to the fees and expenses that plan participants were paying for investment management and plan administration.

DOL's 10-year educational effort to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees has apparently failed. In light of that failure, DOL is proposing to require service providers to disclose the answers to questions that DOL believes plan sponsors should have been asking.

After the *Hecker v. Deere* decision, the final regulations are more important to DOL than before because the 7th Circuit decided that ERISA's fiduciary responsibility rules do not require plan sponsors or their service providers to disclose revenue sharing arrangements. The proposed regulations require service providers to disclose revenue sharing arrangements.

c. Content Highlights**.** In this overview of the proposed regulation, I will focus on the key concepts and highlights. To begin, let me explain the key concepts:

- Direct compensation: This is compensation received by a service provider directly from the plan sponsor or plan.
- Indirect compensation: This is compensation receive by a service provide from a third party (i.e., not the plan sponsor or the plan). Revenue sharing would be example of indirect compensation.

i. Service Providers Affected. Service providers who are plan fiduciaries (e.g., investment advice fiduciaries) and service providers involved with plan administration or investments are subject to the new disclosure rules, even if they do not receive any indirect compensation. However, accounting, actuarial, legal, and similar professional service providers are subject

[5] April 1997 *Money Magazine*
[6] September 1997 *Bloomberg Personal*
[7] The hearing notice is posted at http://www.dol.gov/ebsa/regs/fedreg/notices/97_27431.htm.
[8] A Look at 401(k) Plan Fees" is posted at http://www.dol.gov/ebsa/publications/401k_employee.html.
[9] The Study of 401(k) Fees and Expenses is posted at: http://www.dol.gov/ebsa/pdf/401kRept.pdf.

to the new disclosure rules only if they receive indirect compensation. According to DOL, the distinction is based on its belief that the service providers subject to the enhanced disclosure requirements are most likely to have conflicts of interest.

ii. Fee Disclosures. An affected service provider must disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, all services to be provided to the plan and, with respect to each such service:

- the fees to be received by the service provider (expressed as a specific monetary amount or formula, percentage of the plan's assets, or per capita charge);
- whether the service provider will bill the plan, deduct fees directly from plan accounts, or reduce the plan's investment earnings to pay the fees, and
- how any prepaid fees will be calculated and refunded when a contract terminates.

iii. Special Fee Disclosure Rule for Bundled Services. If a service provider offers a bundle of services to the plan that is priced as a package, rather than on a service-by-service basis, then only the service provider offering the bundle of services must provide the required disclosures. In addition, the bundled service provider is not required to disclose the fee allocation among the services except for fees separately charged:

- against a plan's investment (e.g., management fees paid to a mutual fund's investment adviser) or
- on a transaction basis (e.g., brokerage commissions).

iv. Conflicts of Interest Disclosures. An affected service provider must also disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, information about different types of relationships or interests that raise conflicts of interests for the service provider in performing plan services.

v. Timing and Format of Disclosures. There is no specified timeframe to disclose the information other than prior to entering into the contract. All of the required disclosures need not be contained in the same document and may be provided in electronic format. The service contract must include a representation by the service provider that, before the contract was entered into, all the required conflicts of interest information was provided to the responsible plan fiduciary. During the term of the contract, any "material" change to the previously furnished information must be disclosed within 30 days of the service provider's knowledge of the change.

d. Curing Disclosure Failures. A service provider's failure to comply with the disclosure obligations under the proposed 408(b)(2) regulations would result in a prohibited transaction. Because the prohibited transaction could adversely affect the plan sponsor or similar plan fiduciary, DOL has also proposed a class exemption[10] that would provide relieve for them. Conspicuous by its absence is any relief to the service provider that fails to comply with the proposed 408(b)(2) regulations.

e. No Conflict of Interest Relief for Fiduciaries. To some extent the proposed regulations are misleading because they require service providers, including fiduciary service providers, to disclose their fees and conflicts of interest. As a result, some fiduciaries—particular investment advisers—have inferred that they can cure conflicts of interest by disclosing them as they do under the Investment Advisers Act of 1940. However, the inference is erroneous.

The regulations provide relief only from the party-in-interest transactions in ERISA section 406(a), and not the conflict of interest rules under ERISA section 406(b). Thus, a fiduciary disclosing conflicts of interest under the proposed 408(b) regulations will not get any relief from ERISA's conflict of interest rules. Essentially, the proposed 408(b) regulations are designed to force non-fiduciary service providers to disclose their conflict of interests, even though they are not subject to the conflicts of interest rules that apply to fiduciaries.

f. Outlook. Assistant Secretary of Labor Phyllis Borzi expects the final regulations, unlike the proposed regulations will be a lot more specific about how service providers must disclose their fees and conflicts of interests. Assistant Secretary Borzi also expects the final regulations to be published within two months.[11] If she is correct, it appears that final regulations will preempt the fee disclosure legislation pending in Congress,[12] rather than vice versa. Thus, the content of the final regulations will be heavily influence by the disclosure standards in the pending legislation.

B. Disclosure by Plan Sponsors on Form 5500.

1. Plan Years before 2009. Fees and expenses paid by the plan are required to be disclosed on the Form 5500 using either the Schedule A to report commissions or related fees paid to insurance companies or the Schedule C to report fees paid to service providers. Service providers, such as insurance companies and mutual funds, have traditionally interpreted their duty to disclose narrowly. For example, investment management fees, soft dollars and internal fund expenses were not disclosed on either Schedules A or C of the Form 5500, and there was little reporting of indirect fees.

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[10] 72 Fed. Reg. 70893 (December 13, 2007). The class exemption would be effective 90 days after its publication in the Federal Register.

[11] Doug Holonen, "Lifting the Fog: Face to Face with Phyllis Borzi", *Pension & Investments*, September 7, 2009.

[12] See H.R. 2989, 401(k) Fair Disclosure and Pension Security Act, approved by the House Education and Labor Committee on June 23, 2009. See June 24, 2009, Press Release posted at http://edlabor.house.gov/newsroom/2009/06/house-committee-approves-bill.shtml.

2. *Regulatory Change for 2009 Plan Year*. The Department of Labor has issued final regulations that revise Schedule C of Form 5500 to require reporting by large plans of virtually all direct and indirect compensation of $5,000 or more to any person. This change will be effective for plan years beginning on or after January 1, 2009. The burden of obtaining such information rests on the plan administrator. By itself, this change would not require the cooperation of service providers. However, such cooperation would be strongly encouraged, if not required, when the proposed regulations under Section 408(b)(2) of ERISA are implemented.

3. *Applicable Only to Large Plans*. The requirement to file Schedule C applies only to plans that cover 100 or more employees.

4. *Definition of Reportable Compensation*. Money and any other thing of value, such as gifts, awards, and trips, received directly or indirectly from the plan, including fees charged as a percentage of assets and deducted from investment returns, must be reported.

a. Direct Compensation. Payments by the plan out of a plan account, charges to plan forfeiture accounts and fee recapture accounts, charges to a plan trust account before allocations are made to individual participant accounts, and direct charges to individual participant accounts.

b. Indirect Compensation. Compensation from sources other than payments made directly from the plan or plan sponsor in connection with services rendered to the plan or the recipient's position with the plan. Examples of reportable indirect compensation include fees and expense reimbursement payments charged against the fund or account in which the plan invests and reflected in the value of the plan's investment. Other examples are finder's fees, float revenue, brokerage commissions, research or other products or services received from a broker-dealer or other third party in connection with securities transactions (i.e., soft dollars), and certain transaction-based fees.

c. Excludible Non-Monetary Compensation. Gifts or meals that are deductible by the payor and not taxable to the recipient, provided that the gift or gratuity is valued at less than $50 and the aggregate value of such gifts from a single source in a calendar year is less than $100. Gifts valued at less than $10 do not need to be counted toward the $100 limit. Gifts received by one person from multiple employees of one entity must be treated as originating from a single source.

d. Special Rule for Payments to Bundled Service Provider. A bundled service arrangement includes a transaction in which the plan receives a range of services either directly from an investment provider, through affiliates or subcontractors or through a combination. Direct payments by a plan under such an arrangement need not be allocated among the affiliates or contractors unless the amount paid to an affiliate or contractor is set on a per transaction basis, such as a brokerage commission. Similarly revenue sharing payments by investment providers need not be so allocated unless they come within one of the exceptions described below.

e. Exceptions. The following compensation arrangements must be reported as separate compensation, even if paid from mutual fund management fees:

i. Fees charged to the plan's investment and reflected in the net value of the investment. Included in this category would be management fees paid by mutual funds to their investment advisers, float revenue, commissions (including soft dollars), finder's fees, 12b-1 distribution fees, and shareholder servicing fees.

ii. Payments of commissions and other transaction based fees, finder's fees, float, soft dollars and other non-monetary compensation to the following recipients: plan fiduciaries, contract administrators, providers of consulting or investment advisory services either at the plan or the participant level, providers of investment management services, brokers, and recordkeepers.

5. *Alternative Reporting Option*. "Eligible indirect compensation" will not be reported on Schedule C. In lieu of reporting on Schedule C, information about eligible indirect compensation will be provided to the plan and only the fact that a service provider received this type of compensation will be reported.

a. Indirect Compensation. Fees or expense reimbursement payments charged to investment funds and reflected in the value of the investment or return on investment of the participating plan or its participants are included in the definition. Also included are finder's fees, soft dollar revenue, float, and/or brokerage commissions or other transaction-based fees for transactions or services involving the plan that were not paid directly by the plan or plan sponsor (whether or not they are capitalized as investment costs).

i. For purposes of the above definition, investment funds include mutual funds, bank common and collective trusts, insurance company pooled separate accounts, and separately managed investment accounts that contain assets of an individual plan.

ii. Indirect compensation may be reported on the basis of the service provider's fiscal year.

iii. The DOL has indicated that fees for compliance services received by a recordkeeper from a mutual fund agent are reportable as indirect compensation but do not qualify for the alternative reporting option.

b. Written Disclosures. For indirect compensation to be eligible indirect compensation, written disclosures must be made to the plan. This disclosure must cover the following matters:

i. the existence of the indirect compensation,

ii. the services provided for the indirect compensation or the purpose of the payment,

iii. the amount (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation,

iv. the identity of the party or parties paying and receiving the compensation,

v. if the compensation relates to a bundled arrangement, a description each element of indirect compensation that would be required to be separately reported if there were no reliance on the alternative reporting option.

c. Recordkeeping. Service providers who use the alternative reporting method will be responsible for maintaining records to demonstrate compliance with these requirements.

C. Disclosure by Plan Sponsors to Plan Participants. On July 23, 2008, the Department of Labor issued proposed regulations which, if adopted, will expand the information which must be disclosed to participants and beneficiaries in participant-directed individual account plans. The DOL proposed that the regulations be effective for plan years beginning on or after January 1, 2009. Four categories of information will have to be disclosed to participants before or when they become eligible to participate in a plan and then annually. The first three are plan-related and the fourth is investment-related. In some cases dollar amounts actually charged against a participant's account will need to be disclosed quarterly after enrollment in the plan.

The four categories of information are:

1. *General Plan Investment Information*. This includes how participants and beneficiaries may give investment instructions. Participants will have to be notified of material changes to the plan within 30 days after the date of adoption of such changes.

2. *Administrative Expenses*. Participants and beneficiaries must be given an explanation of any fees and expenses such as for legal, accounting and recordkeeping services.

3. *Individual Expenses*. Disclosure for information relating to individual expenses such as for qualified domestic relations order, a participant loan or investment advice services.

4. *Investment-Related Information.* Participants and beneficiaries must be furnished with certain basic information regarding the plan's investment options, performance history and any fees and expenses associated with their investments.

These rules will apply to designated investment alternatives offered by a plan but do not apply to brokerage windows or self-directed brokerage accounts.

Certain information which is currently required, such as copies of investment prospectuses or summaries, would only have to be provided upon request.

5. *Outlook*. Assistant Secretary of Labor Phyllis Borzi expects the final regulations for disclosure to participants will not be published until after the service-provider disclosure regulations are finalized.

II. 401(k) Fee Litigation

A. Background. An important part of a fiduciary's responsibility includes identifying, understanding, and evaluating fees and expenses associated with plan investments, investment options and services. When they initially consider a new investment, fiduciaries should be aware of all hard dollar payments made directly by plans as well as "revenue sharing" and similar payments made indirectly by third parties. The latter are sometimes referred to as "indirect fees", since they are ultimately charged back to a participant's account. Fiduciaries should also monitor such payments to determine if they continue to be reasonable in comparison to industry standards. While the reasonableness of fees and expenses is a concern for all qualified plans, it is particularly important for 401(k) plans, because they generally bear a higher proportion of the fees and expenses. Monitoring fees and expenses is an ongoing fiduciary responsibility that has taken on new urgency as defensive tactic to claims raised by the plaintiffs' bar.

As discussed in more detail later, the recent Seventh Circuit Court of Appeals decision in Hecker v. Deere (February 12, 2009) has generated headlines for its holding that revenue-sharing is not prohibited by ERISA and that nothing currently requires that it be disclosed to plan participants. The decision is a significant development with respect to similar litigation which, at bottom, is based on claims of excessive fees. However, it is not an appropriate guide for future conduct and plan administration. The DOL has already issued regulatory proposals that would require plan service providers to furnish plan administrators with written disclosure as to indirect compensation. Additional proposals would require plan fiduciaries to furnish participants with an annual statement providing detail as to administrative, individual and investment related expenses. S.406, as filed by Senators Harkin and Kohl, would codify similar proposals as a statutory enactment.

B. Types of Indirect Fees. There are at least eight kinds of indirect 401(k) plan fees and expenses that fiduciaries should be aware of: (i) SEC Rule 28(e) Soft Dollars, (ii) Sub-transfer Agent Fees, (iii) 12b-1 Fees, (iv) Variable Annuity Wrap Fees, (v) Investment Management Fees, (vi) Sales Charges, (vii) Revenue Sharing Arrangements, and (viii) Float.

1. *SEC Rule 28(e) Soft Dollars*. Brokerage firms may charge extra commission that can be used by investment advisors and others to purchase services, such as,

valuable investment research. Such excess commission must be reasonable with respect to the services provided. Fees that are illegal under Rule 28(e) also violate ERISA Sections 403(c)(1), 404(a)(1) and 406(a)(1)(D). Fiduciaries should know whether they are being charged Rule 28(e) fees._

2. *Sub-transfer Agent Fees*. Brokerage firms and mutual funds often sub-contract recordkeeping and other services related to participant shares to a third party called a sub-transfer agent. Payments to these third parties are sub-transfer agent fees. The problem is not the receipt of such fees by the third parties, but whether the fee fairly represents the value of the services being rendered. The DOL, in its publication A Look at 401(k) Plan Fees, has made it clear that a plan sponsor must understand the value and associated compensation of each company providing services to the plan.

3. *12b-1 Fees*. 12b-1 fees are, in general, distribution expenses paid by mutual funds from fund assets. They may include commissions to brokers, advertising or other marketing expenses, and fees for administrative services provided by third parties to fund shareholders. 12b-1 fees can be as much as 1% of a fund's assets on an annual basis. Fiduciary audits have revealed that plan sponsors who have invested in mutual funds with high 12b-1 fees could have invested in a similar mutual fund without paying any 12b-1 fee or a lower 12(b)-1 fee.

4. *Variable Annuity Wrap Fees*. Variable annuities are insurance products that invest in mutual funds. Internal investment gains in such annuities are tax-deferred but the product is subject to commissions. Therefore, one must ask if it is prudent to invest in a variable annuity and pay for commissions if gains under an ERISA-covered plan are already tax deferred. Also, variable annuities have expenses that may be greater than the costs charged by mutual funds. These are wrapped into a single aggregate fee called a "wrap fee." Wrap fees include investment management fees, surrender charges, mortality and expense risk charges, administrative fees, fees and charges for other features, and bonus credits. Investing in a variable annuity could be considered imprudent if the same underlying mutual funds are available at a lower cost outside of the variable annuity.

5. *Investment Management Fees*. Investment management fees are fees for managing investment assets and they are usually charged as a percentage of the assets invested. These fees are usually deducted directly from the investment return.

6. *Sales Charges*. Sales charges are also known as loads or commissions. These are transaction costs for buying and selling investment products.

7. *Revenue Sharing Arrangements*. Revenue sharing is the practice by mutual funds or other investment providers of paying other plan service providers, e.g., the plan's recordkeeper or other third party administrator, for performing services that the mutual fund might otherwise be required to perform.

8. *Float*. Float refers to earnings retained by a service provider (usually a bank or brokerage company) that result from short-term investments in liquid accounts used to

facilitate cash transactions. Funds held in these accounts could include funds to cover checks issued for benefit payments by benefit plans that are not yet presented for payment by the recipient, or uninvested funds awaiting investment instructions from a plan fiduciary. The Department of Labor requires service providers to inform plan fiduciaries of the existence of float and the circumstances under which it will be earned and retained. See FAB 2002-3.

Comment: There is a classification of mutual funds of which employers should be aware. These are so-called "R funds" which generally offer the same types of mutual funds that can be purchased through normal brokerage systems. These funds are specifically designed as pension plan investments and often carry one or more of the above-referenced indirect fees.

C. Fee Litigation. A not unexpected by-product of the increased public and regulatory interest in 401(k) plan fees and expenses has been the filing of lawsuits against some of the nation's largest employers and investment providers charging that they breached their fiduciary duties by failing to identify and/or monitor indirect fees (as well as hard dollar payments) and to establish and follow procedures to determine whether such payments were reasonable. The complaints filed against plan sponsors allege that the defendants failed to monitor and control, or even to inform themselves, of such payments, failed to establish procedures to determine that they were justified, and also failed to disclose such fees to plan participants.

1. *The First Salvo*. Claims by plan fiduciaries against service providers contending that the providers violated ERISA Section 406(b)(1) (self-dealing) and 406(b)(3) (kickbacks).

a. Haddock v. Nationwide Financial Services, Inc. (D. Conn. 2006). This decision denied a motion for summary judgment by an investment provider that had been sued by the trustees of five employer sponsored retirement plans over the provider's receipt of fees from mutual funds offered as investment options under variable annuity contracts. The Court held that there were triable issues of fact as to the following issues:

i. Whether Nationwide was a plan fiduciary because it retained the discretion to add or delete fund options to the investment mix or whether it was a fiduciary merely as a result of initially choosing funds for its investment platform;

ii. Whether revenue sharing payments made to Nationwide were plan "assets" within the meaning of the prohibited transaction provisions of ERISA, notwithstanding an acknowledgement by the Court that assets held by mutual funds are not plan assets; and

iii. Whether Nationwide's receipt of revenue sharing could have involved prohibited transactions even if revenue sharing payments are not plan "assets." The Court noted that a trier of fact might be able draw the inference that Nationwide provided only nominal services to the plan and that service contracts with mutual funds pursuant to which revenue was shared were merely shelf space arrangements.

A motion to dismiss based on similar arguments was denied in 2007. The parties consumed the first half of 2009 contesting the certification of a class for purposes of allowing plaintiffs to maintain a class action.

b. Ruppert v. Principal Life Insurance Company (S.D. Ill.). The complaint in this case alleges that Principal is a fiduciary by virtue of offering full service 401(k) plans to employers and by maintaining the ability to change plan investment offerings. It also alleges that Principal committed violations of Sections 406(b)(1) and 406(b)(3) of ERISA by receiving revenue sharing payments from mutual funds. The complaint contains additional allegations that Principal's failure to disclose the existence of its revenue sharing arrangements to the plans and to participants was a fiduciary breach.

The plaintiff's motion for class certification was denied on August 27, 2008, because an intense plan by plan inquiry would have been required to evaluate the plaintiff's claim that the defendant insurance company was a fiduciary as to each of the more than 25,000 different plans that plaintiff sought to include in the class. The denial of class status was appealed to the Eighth Circuit Court of Appeals which denied the appeal on procedural grounds. However, the battle over class action status continues as plaintiffs have filed a new motion for class certification based on revenue sharing that the defendant allegedly received from affiliates.

c. Phones Plus, Inc. v. Hartford Financial Services (D. Conn.). The complaint was brought by a 401(k) plan fiduciary against the Hartford alleging that revenue sharing payments were for services that the Hartford was already obligated to provide to its plan clients. As in the Haddock and Ruppert complaints, there is an allegation that revenue sharing payments are plan assets.

In Phones Plus, Inc. v. Hartford Financial Services Group, Inc. 2007 WL 3124733 (D. Conn. 2007), issued on October 23, 2007, the district court denied a motion to dismiss, and in so doing adopted a typically lenient approach to the plaintiff's pleadings.

The plaintiff, a sponsor of a 401(k) plan, alleged that Hartford Life Insurance Company and its holding company parent, as well as the 401(k) plan's investment adviser, had breached their fiduciary duties as a result of revenue sharing agreements that Hartford had entered into with various mutual fund companies. Hartford moved for dismissal on the ground that it was not a fiduciary and that, in any case, revenue sharing payments are not plan assets. The investment adviser also moved for dismissal on the

ground that investigating Hartford's receipt of revenue sharing payments was beyond the limited scope of its fiduciary obligations as an investment adviser and that, in any event, it did not know of and did not receive any of the revenue sharing payments. The motions to dismiss with respect to both defendants were denied.

The most significant aspect of the Phones Plus decision may lie in the court's conclusion that it is possible to allege a set of facts (to be proven in subsequent phases of the case) under which revenue sharing payments are plan assets. The Seventh Circuit in Hecker v. Deere recently ruled to the contrary on this point.

As to Hartford Life's status as a fiduciary, the court in Phones Plus ruled that the company's power to add, delete or substitute mutual funds to or from the plan's menu of funds could render it a fiduciary, notwithstanding Department of Labor Advisory Opinion 1997-16A that reached a contrary conclusion on similar facts. The court noted that the question of fiduciary status is inherently factual and depends on the particular actions or functions performed on behalf of the plan. The advisory opinion was held to be inapplicable, because its facts differed from the facts alleged by the plaintiff. For example, Hartford gave a plan only 30 days' advance notice when it proposed to make a change in its fund lineup, whereas under the advisory opinion the plan had been given 120 days to accept proposed changes or to reject them and terminate the contract.

As to the investment adviser's contention that it had no duty to investigate Hartford's receipt of revenue sharing, the court indicated that the scope of the adviser's fiduciary duties was a matter to be determined by interpreting the terms of the advisory agreement. This enabled the court to conclude that the plaintiff had made allegations as to the adviser's obligation to investigate, discover, and inform the plaintiff of allegedly unlawful or excessive fees that might be substantiated during a trial. The investment adviser (Neuberger) subsequently notified the court that it had reached a potential settlement with the plaintiffs. However, the main action against the Hartford continues and a trial date in 2009 has been set.

2. *The Main Thrust*. Participant claims against plan sponsors and related plan fiduciaries were filed in September and October of 2006 by the law firm of Schlicter, Bogard & Denton, LLP of St. Louis, MO. Defendants include sponsoring employers, plan committees, company officers, directors and employees, but not plan providers. The core allegation is that these defendants breached their fiduciary duties under Section 404(a) of ERISA by causing or allowing plan providers to be paid excessive fees for their services. The alleged excessive payments included hard dollar payments made directly by plans as well as revenue sharing payments made by third parties. A novel aspect of these complaints is the allegation that the plan fiduciaries failed to capture revenue sharing monies embedded in the expense ratios of mutual funds offered under the plans even though these funds were not paid to any service providers. Notwithstanding the fact that the mutual funds themselves were not joined as defendants, this claim is an indirect attack on excessive mutual fund expense ratios based on the contention that plan fiduciaries had a duty to challenge such fees.

a. Partial List of Cases:

i. Abbot v. Lockheed Martin Corp. (S.D. Ill.); on March 31, 2009, the court granted a partial summary judgment for the defendants pursuant to which the plaintiff's revenue sharing claims were dismissed.

ii. Beesley v. International Paper Company (S.D. Ill.); the claims contain the usual revenue sharing allegations with the difference that the investment vehicles consisted of separate accounts rather than mutual funds which are arguably governed by market forces, as argued in Hecker v. Deere. In January 2009, both sides moved for summary judgment.

iii. George v. Kraft Foods Global, Inc. (S.D. Ill.); motion to dismiss denied on March 16, 2007

iv. Kanawi v. Bechtel Corp. (N.D. Cal.); this case was settled on November 20 2008.

v. Loomis v. Exelon Corp. (N.D. Ill.); motion to dismiss granted in part and denied in part on February 21, 2007 and class certification was subsequently granted

vi. Martin v. Caterpillar, Inc. (W.D. Mo.); motion to dismiss second amended complaint denied on September 25, 2008 and class certification was subsequently granted; the defendants' motion for judgment on the pleadings was made in February 2009.

vii Spano v. Boeing Co. (S.D. Ill.); motion to dismiss denied on March 16, 2007; on August 17, 2009, the Seventh Circuit Court of Appeals issued an order consolidating the Boeing and International Paper cases with two other cases for purposes of reviewing class certification.

viii. Taylor v. United Technologies Corp. (D. Conn.); summary judgment in favor of the defendant was granted on March 3, 2009; among other things, the court held that information on revenue sharing was not material and that the defendants did not breach their fiduciary duty in not disclosing its use to reduce the defendant's subsidization of plan expenses.

ix Will v. General Dynamics Corp. (S.D. Ill.); the defendants' motion for summary judgment was denied in March 2009

b. Issues.

i. Whether defendants acted prudently in selecting investment options.

ii. Whether defendants are entitled to protection under Section 404(c) of ERISA.

i. Whether plan fiduciaries have a duty to seek mutual funds with the lowest expense ratios.

ii. Whether the protection of Section 404(c) of ERISA is lost as a result of the failure to fully disclose to participants the amounts and nature of direct as well as indirect fees.

iii. Whether the failure to disclose direct and indirect fees to participants constitutes a fiduciary breach.

3. *New Tactics - Additional Complaints Joining Providers*. In December of 2006, the Schlicter law firm filed new complaints against plan sponsors and related fiduciaries seeking the same relief as in the cases filed earlier. In addition, the new round of complaints made defendants of plan service providers such as Fidelity Management Trust Company and Fidelity Management & Research Company claiming that they had breached their fiduciary duties by (i) causing or allowing plans to pay plan service providers excessive fees either directly or through revenue sharing and (ii) "secretly" charging and retaining revenue sharing payments that should have been used to benefit plans and participants.

a. List of Additional Cases:

i. Hecker v. Deere & Co. (W.D. Wis.); see discussion under II. C. 4.c, below.

ii. Renfro v. Unisys Corp. (C.D. Cal.); the court has not ruled on defendant's motions to dismiss and for summary judgment.

iii. Tussey v. ABB, Inc. (W.D. Mo.); Fidelity's motion to dismiss was denied in February 2008. All parties moved for summary judgment in March 2009.

4. *Courts Show Caution in Denying Motions to Dismiss*. Litigation challenging the fees and expenses paid by 401(k) plans continues to proliferate and represents a major threat to the industry. With the notable exception of Hecker v. Deere, 496 F. Supp. 2d 967 (W.D. Wis. 2007), discussed in c. below, the trial courts have been cautious in dismissing these lawsuits at an early stage. Despite the fact that preliminary rulings are not the same as a judgment on the merits, the lack of early dismissals seems to have encouraged the plaintiffs' bar to file even more class action lawsuits over fees. This should come as no surprise, since this type of litigation has the potential to generate enormous legal fees. This trend seemed to intensify as participants sought to recover 401(k) plan losses exacerbated by the current economic downturn. However, it may have been blunted by recent losses, such as Hecker v. Deere.

a. Favorable Defense Rulings. In the meantime, several courts have joined the Hecker court by granting motions to dismiss in 2008.

In Braden v. Wal-Mart Stores, Inc. (W.D. Mo. 2008), Wal-Mart was charged with breaching its duties of prudence and loyalty by selecting retail class mutual funds as investment options. These funds were generally more expensive than institutional class funds. The plaintiffs' complaint compared the plan's investment options with less expensive funds available in the marketplace. However, the court held that this was not sufficient to allow the action to move forward, because there were no factual allegations that Wal-Mart had failed to investigate the funds. The court reasoned that the mere existence of less expensive funds did not mean that the actual selection of more expensive funds was a breach of fiduciary duty. The court also dismissed claims that Wal-Mart had committed prohibited transactions involving revenue sharing, since this practice is not inherently illegal or unreasonable. Finally, the court dismissed the claim that Wal-Mart had failed to provide participants with complete and accurate information, since there was no duty to disclose revenue sharing and the information the plaintiffs sought was not material.

In Columbia Air Services, Inc. v. Fidelity Management Trust Co., 2008 WL 4457861 (D. Mass. 2008), the court also ruled favorably for the trustee-defendant which, it was claimed, had breached its duty of loyalty by receiving a share of mutual fund fees earned by funds advised by an investment adviser belonging to the same funds family as the trust company. However, the court held that the plaintiffs had failed to allege facts showing that the directed trustee was acting as a fiduciary in negotiating the terms of its engagement, including it compensation. Therefore, the claim was dismissed.

Kanawi v. Bechtel Corp, No. C 06-05566 (CRB) (N.D. Cal 2008) (subsequently settled, as noted above) was also favorable to the defendant in that Bechtel's motion for summary judgment was granted with respect to the plaintiff's claim that it had caused the plan to pay unnecessary mutual fund fees. The court held that the plaintiffs had failed to show that the plan had paid unnecessary layers of fees, because most of the plan-level fees had been paid by the employer rather than the plan. The same reasoning applied to the claim that fees paid to the investment adviser constituted a prohibited transaction. The court also reasoned that since the plan's fiduciaries met regularly to discuss the plan's investments and sought the advice of an outside consultant in such matters, the evidence did not support a conclusion that that the fees were unreasonable. Kanawi was a mixed result, however, since the court denied the defendant's motion for summary judgment with respect to a four month period when the plan paid advisory fees with plan assets. The court also denied defendant's motion for summary judgment based on a Section 404(c) defense, since there were factual issues as to whether the plan met the requirements of this defense.

b. Plaintiffs' Victories. More typical of early stage 401(k) fee litigation than the cases discussed above is the denial of defendant's motion to dismiss in

Martin v. Caterpillar, No. 07-cv-1009 (C.D. Ill. 2008). The plaintiffs' claims in Martin were also typical in that they alleged a breach of fiduciary duty arising from investment options with excessive and unreasonable fees and the failure to make adequate disclosures to plan participants. The court upheld the viability of the central complaint that the defendants had charged excessive fees although it agreed with the defendant and the court in Hecker that ERISA does not require plan fiduciaries to disclose revenue sharing.

c. Failure to State a Claim in Deere. Defendants in fee litigation lawsuits have routinely filed pre-discovery motions to dismiss which have generally been denied. The arguments for dismissal are based on the contention that the complaint fails to set forth facts that could give rise to a breach of fiduciary duty. Courts have been reluctant to dismiss a case before there has been fact finding that could support a claim. A major exception to this trend is Hecker v. Deere, 2007 WL 1874367 (W.D. Wis. 2007), which granted early stage motions to dismiss made by the employer, Deere & Company, and two Fidelity entities that were plan service providers.

Deere sponsored and administered 401(k) plans for its employees. The plans offered at least 20 Fidelity investment options while trustee, recordkeeping, and administrative functions were handled by Fidelity Management Trust Company and Fidelity Management and Research Company. (Significantly, the Deere plan also made available a brokerage window that provided participants with access to more than 2,500 other mutual funds.) The complaint alleged that the defendants violated their fiduciary duties in two ways: first, by providing investment options with excessive and unreasonable fees and costs; and, second, by failing to adequately disclose information about the fees and costs to plan participants. The District Court granted the defendants motion to dismiss which the plaintiffs then appealed to the Seventh Circuit Court of Appeals.

On February 12, 2009, the appellate court, in a landmark opinion, affirmed the dismissal, rejecting the plaintiff's first claim as to excessive fees on the ground that the mutual fund fees could not be excessive because they were offered to the general investing public with the result that expense ratios are set in response to market competition. The court stated that "[N]othing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)." The court also held that Deere's practice of limiting the funds' investment options to those offered by defendant Fidelity Investments was prudent given the diversity of those investment options, which included more than 20 Fidelity mutual funds as well as the brokerage window through which participants could invest in more than 2,500 other funds.

As to the plaintiff's second claim, the Seventh Circuit held that ERISA does not prohibit revenue sharing arrangements or compel their disclosure. The court also held that such payments did not constitute plan assets, because they were made from the assets of the mutual funds in question, not from the plan. The court found that the disclosure of

total aggregate fees in fund prospectuses was adequate, stating that "the total fee, not the internal, post-collection distribution of the fee [to Fidelity affiliates], is the critical figure for someone interested in the cost of including a certain investment in her portfolio and the net value of that investment."

Finally, the Seventh Circuit appeared to hold that, given the array of investment options available through the brokerage window, the safe harbor defense provided by Section 404(c) of ERISA shielded the defendants from liability.

Although the Seventh Circuit quickly dismissed the case, the plaintiffs, supported by briefs from the DOL and other groups filed a petition for a rehearing by the full circuit. On June 24, 2009, the appeals court denied the petition, but, in so doing, it issued an addendum to its original opinion which appears to limit some of the more extreme implications of its analysis.

The DOL has taken a strong position that ERISA fiduciaries are always liable for the imprudent selection of investment options in 401(k) plans and that Section 404(c) is no defense against such liability. Accordingly, it vigorously argued that the Seventh Circuit's original Deere opinion had not give due deference to this point. The addendum responded by noting that the 404(c) issue was not involved in its primary holding that there was "no duty to scour the market to find the fund with the lowest imaginable fees" and that the fees in the particular funds that were the subject of the complaint "could not be deemed imprudent because they were offered at the same prices to the general public." The addendum indicated that these rulings did not necessarily contradict the Department's position with which the court nevertheless refused to agree. The court noted that it had intentionally avoided a broad ruling on the issue of 404(c) protection and that it had left the area open for future development. In the addendum, the court stated that, contrary to the Department's fears, its ruling was not broad enough to immunize from accountability a fiduciary that acts imprudently by selecting an overpriced portfolio of funds.

As to the Department's concern that, under Deere, a fiduciary can insulate itself from liability by the simple expedient of including a very large number of investment alternatives in the plan portfolio, the Seventh Circuit addendum, quoting the Department's brief, observed that the Deere opinion "was not intended to give a green light to such 'obvious, even reckless, imprudence in the selection of investments.'" The court explained that its opinion had been "tethered closely to the facts" that were before it and that the plaintiffs had failed to allege that any of the Deere plan's investment alternatives were unsound or reckless.

Notwithstanding its effort to narrow the Deere holding, when the dust settles, it appears that, in the Seventh Circuit's view, the selection, pursuant to a prudent and reasonable process, of a liberal number of investment options to be made available to plan participants would provide an impregnable defense to assertions of liability by participants.

As noted above, the Deere opinion will have a far-reaching influence on existing litigation, but it is less important as to ongoing conduct because of changes in the law that are already underway. On December 13, 2007, the Department of Labor issued proposed regulations that condition exemption from ERISA's prohibited transaction rules on extensive disclosure by plan service providers to plan fiduciaries. The DOL had previously amended the Form 5500 instructions to require reporting of plan fees by the plan sponsor. This was followed on July 23, 2008 by proposed regulations that would require plan fiduciaries to furnish participants with information as to fees, including a breakdown of fees to various categories of expense. It is possible, however, that certain aspects of the Seventh Circuit' decision, such as its position on the 404(c) defense, will be legislatively overruled.

5. *Class Certifications in 401(k) Fee Litigation*. Most of the lawsuits over 401(k) fees are brought as class actions and, therefore, involve motions for class certification under Rule 23 of the Federal Rules of Civil Procedure. Rule 23(a) requires satisfaction of each of the following requirements: (1) a class of plaintiffs so numerous that joining all the members in the lawsuit is impracticable, (2) legal or factual questions that are common to the class, (3) claims or defenses that are typical of the class members, and (4) the representatives of the class that will fairly and adequately protect the interests of the class. Rule 23(b) contains additional detailed requirements that guard against inconsistent adjudications, provide that the sought after relief will be appropriate for the class as a whole, or ensure that questions of law or fact that are common to the class will predominate over questions only affecting individual members.

Most courts have almost routinely granted class certification in litigation over 401(k) fees, although the Seventh Circuit has recently consolidated several cases for review on this issue. In addition, the Supreme Court's LaRue decision, discussed below, has given rise to the argument that, in view of participants' new ability to bring suits for individualized losses, it is no longer appropriate to certify such claims as class actions.

6. *Implications of Indirect Fee Cases*.

a. Since most of the cases are in the preliminary phases of litigation, it is unclear whether they will result in significant recoveries for the plaintiffs.

b. Since the facts in these cases are very similar to those of many other employer sponsored 401(k) plans, victory by the plaintiffs would mean that these plans would face a significant exposure to liability.

c. Some copycat claims have already been made and additional law suits making similar claims are likely to be filed.

d. Publicity generated by the litigation will increase the pressure to make regulatory as well as legislative changes that will require detailed fee disclosures by plan sponsors. In any event sponsors are, themselves, likely to demand more extensive disclosure from plan providers in order to protect themselves against claims.

III. Evolving Best Practices

A. Practices That Strengthen Defenses against 401(k) Fee Litigation

Class action law suits brought against some of the nation's largest employers allege that, as sponsors of 401(k) plans, the targeted employers have failed to negotiate reasonable fees for administrative and investment services. In light of these class actions, more employers are beginning to adopt best practices that involve monitoring and negotiating service provider fees. To avoid being held hostage by these legal actions, employers have taken proactive steps to adopt 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. Broker-dealers and other financial advisers need to be aware of these best practices as well as the regulatory changes discussed above.

1. *Identifying Fees*. Plan sponsors will be making a more concerted effort to learn how much the plan and participants are actually paying in fees and expenses. Although the proposed 408(b)(2) regulations allow disclosure by formula, many plan sponsors will attempt to determine the actual dollar, even if it is an estimate.

2. *Comparing Investment Management Fees or Expense Ratios against Benchmarks*. Plan sponsors will attempt to avoid paying above-average investment management fees or expense ratios unless the investment manager or mutual fund can demonstrate it is delivering above-average investment performance for the plan participants.

3. *Continuous Monitoring*. Continuous monitoring will become a best practice standard. In addition to a broad range of qualitative and quantitative questions about the investment managers or mutual fund, plan sponsors will be asking whether the fees are reasonable with respect to investment performance and related services plan participants are receiving.

4. Documenting Reviews of Investment Vehicles and Fees. Plan sponsors will be documenting 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.

5. *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.

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

7. *Fiduciary Manual*. Use of a fiduciary manual is intended to help fiduciaries reach a better understanding of their responsibilities and to help them comply with ERISA's fiduciary standards. When properly designed, it serves as a reference tool (i.e., a guide for plan fiduciaries when they have questions, such as identifying fiduciaries or determining the scope of their responsibilities and liabilities). A fiduciary manual can also provide compliance tools that fiduciaries may use to monitor investments and service providers.

B. Practices Relating to Financial Literacy of Plan Participants. In 1995, the U.S. Department of Labor launched a national pension education campaign whose theme was, "Save! Your Retirement Clock is Ticking." As the clock ticks on, the aging U.S. population and the accelerating shift from defined benefit plans to defined contribution plans has made the issue of financial literacy increasingly important in ensuring a secure retirement income. The media, including television, radio, web sites, books, magazines and newspaper columns devote substantial attention to the topic. This has led policy makers to recommend measures that are rapidly evolving into a set of best practices that employers should consider adopting with respect to the administration of 401(k) and other individual account plans that place the responsibility and the risk of investment choice on the employee.

1. *Prior Developments in Closing the Information Gap*. As early as 1996, the Department of Labor acknowledged the importance of closing a so-called information gap by providing plan participants and beneficiaries with information designed to assist them in making investment and retirement-related decisions appropriate to their particular situations. To allay plan sponsor fears that such efforts might be interpreted as giving investment advice for which the plan sponsor could be held liable, the Department issued Interpretive Bulletin 96-1 which describes four "safe harbors" representing examples of the type of information, materials and educational services that can be furnished to participants without constituting investment advice. The Department noted that there could be many more such examples of investment education that did not reach the level of investment advice. Subsequently, the Department's so-called SunAmerica ruling (Advisory Opinion 2001-09A) implicitly recognized the need for advice by allowing investment providers to recommend asset allocation models to plan participants if the source of such advice is independent of the provider.

2. *Pension Protection Act*. In 2006, the U.S. Congress attempted to increase the availability of participant-level investment education and advice by enacting a new prohibited transaction exemption as part of the Pension Protection Act. To qualify for relief, an RIA, broker-dealer or other fiduciary adviser is required to ensure that their fees for providing advice will not vary based on any recommended investment options that are selected by a participant. Alternatively, the investment advice can be provided through the utilization of an objective computer model that is independently certified not to favor investment options that would result in greater fees for the adviser. Unfortunately, the finalization of regulations implementing these provisions has bogged down in political wrangling.

3. *Current Proposals Based on Existing Law*. In the meantime, efforts to address the employee information gap are underway based on regulations that are already in place. While some employers were initially concerned about the risks that offering advice might entail, the prevailing concern has shifted to the risk of not offering it. In 2007, the ERISA Advisory Council formed a Working Group on Financial Literacy of Plan Participants and the Role of the Employer which has made a series of recommendations for consideration by the Secretary of Labor relating to participant education and advice. Included in the recommendations was a proposal for the Department's creation of a best practices grid that would point to the core financial literacy skills needed for the successful retirement of differently situated employees and a call for the expansion and updating of Interpretive Bulletin 96-1 to accommodate innovation in the financial marketplace.

The primary concern driving the Working Group, as well as attentive employers, is that, despite the ease and convenience of investing over the Internet, employees are not doing well in handling responsibility for their own retirement. The Working Group concluded that an effective educational program for plan participants requires giving them the tools to make sound investment decisions. The witnesses who appeared before the group testified unanimously that participants must have a familiarity with concepts such as the time value of money, asset allocation, risk management and taxation, as well as knowledge about the plan's investment options. It should be noted that general financial investment concepts will be within the safe harbor of Interpretive Bulletin 96-1 and will not be considered as the rendering of investment advice, provided that the information has no direct relationship to the plan's investment alternatives.

Although understanding investment basics is necessary, it is not enough, and participants also need to have a working knowledge of particular plan design features, such as the ramifications of the plan's various distribution options, the calculation of minimum withdrawals, and the rules relating to rollovers. It is to be noted that furnishing information as to the benefits of plan participation and/or increasing plan contributions, the effect of pre-retirement withdrawals on retirement income, the terms of the plan and how the plan operates are all matters that are within the safe harbor of Interpretive Bulletin 96-1.

The modern 401(k) plan demands active participant involvement. However, the Working Group discovered that participants and non-participants alike had no idea how much money will be required to provide an income stream at retirement that will support the participant's current

standard of living. Further, participants frequently misunderstood concepts, such as life expectancies, investment returns and other variables that are elements of a proper retirement income replacement calculation. Consequently, it urged the Department to encourage, assist and facilitate the inclusion in plan communications of retirement income replacement calculations and final pay multiples on a per participant basis. As stated in the group's report, "Plan communications should encourage participants to have a numerical goal, whether as a result of a sophisticated or elementary formula, and repeat that message. At the very least, participants should be able to determine and have access to an estimated account balance necessary for retirement." Retirement calculators are not investment advice under Interpretive Bulletin 96-1; the Working Group's recommendations would extend this treatment to such matters as mandatory 20% tax withholding, the 10% penalty tax on early withdrawal, and calculations of guaranteed income for life.

4. *Delivery of Investment Education*. The Working Group found that third party education via the Internet is not being widely used. The reason for this is simple; employees want one-on-one help from a person they can trust. Generally speaking, they do not have the confidence to implement advice provided to them via on-line tools. Regarding the medium for delivering financial literacy training, all of the Working Group's witnesses agreed that face to face financial counseling works best. As to the timing of the message, it was agreed that several meetings and several counseling sessions over a lifetime work best for the purpose of modifying participant behavior and learning financial topics. Mandatory one-to-one counseling may be appropriate before certain events, such as retirement, making a lump sum withdrawal or electing the purchase of an annuity with plan assets.

In recognition of the fact that successful programs are continuous, many plan sponsors have adopted a comprehensive educational regimen that uses a variety of techniques, such as posters, voice messaging, email, seminars, individual counseling, asset allocation models and tools, and reference material on the company's intranet site. Because cost is likely to be an inhibiting factor, a standardized set of counseling and instructional materials may be developed to assist employee decision making.

The available literature indicates that employee response to workplace financial education programs is generally favorable. Some employers have reported that the reaction to pre-retirement planning seminars has been that the seminar was one of the best benefits offered. Employees frequently comment that the employer should have provided the program much earlier. Studies have found that employees who attended training workshops subsequently increased their participation rate in 401(k) plans. While other strategies, such as automatic enrollment, might produce a similar result, studies have also shown that such financial education is effective in eliminating bad financial habits. This is critical because, in the end, training and communication must pave the way to action that leads to retirement income adequacy.

5. *Beneficial Effects of Financial Education Programs*. Employers should recognize that they are primarily responsible for helping employees transition from work to retirement. Financial education programs are one means of furnishing this assistance, and because they increase the efficacy of retirement savings, as well the rate of plan participation,

will be added to the list of plan sponsor best practices. From a plan sponsor's perspective, these programs have the added beneficial effect of reducing unwise investment decisions by employees that could ultimately be the basis of a legal action because of the feeling that the company had not adequately vetted investment alternatives or had somehow mishandled the retirement plan. Financial advisers and investment providers may be called on to assist employers in designing and/or implementing an appropriate program.

IV. Target-Date Funds

A. Background. Target-date funds (aka life-cycle funds) have grown dramatically since they emerged in the late 1990's.[13] Starting in 1998, IRS authorized automatic enrollment in 401(k) plans and other defined contribution plans.[14] At that time, the prevailing default investment option for participant-directed plans were stable value funds. This continued until the Pension Protection Act of 2006 ("PPA") endorsed qualified default investment alternatives ("QDIAs") for participant-directed plans.

Essentially, PPA extended ERISA § 404(c) protection to QDIAs. Under ERISA § 404(c), plan sponsor and other plan fiduciaries are not responsible for losses resulting from the plan participants' investment directions. In effect, PPA provides that the plan sponsor and other fiduciaries are not responsible for the losses resulting from default investments under the QDIA. With this fiduciary protection, PPA encouraged plan sponsors to include QDIAs in their participant-directed plans.[15]

PPA did not specify that the types of investment arrangements that would qualify as QDIAs but left that decision to the U.S. Department of Labor ("DOL"). In 1997, DOL endorsed target-retirement-date funds, balanced funds, and managed accounts as QDIAs.[16] DOL specifically rejected money market and stable value funds as QDIAs,[17] although the QDIA regulations grandfather contributions made to stable-value funds before the December 24, 2007, the effective date of the regulations.[18] The common characteristics of the three types of QDIAs are that they must (a) expose plan participants to equity investments and (b) provide a glide path to reduce the equity exposure as participants grow older. With that as brief background, let's take a look at key problems with target-date funds.

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[13] In ten years, target-date funds grew from $2 billion in assets in 1997 to $183 million in 2007. See William E. Nessmith and Stephen P. Utkus, "Target-Date Funds: Plan and Participant Adoption in 2007," Vanguard Center for Retirement Research, November 2008.

[14] Revenue Ruling 98-30 (401(k) plans); Revenue Ruling 2000-33 (457(b) plans); Revenue Ruling 2000-35 (403(b) plans).

[15] In 2001, 53% of the Vanguard-administered plans with automatic enrollment chose a money market or stable-value fund as the default option. By June 2007, only 11% chose money market or stable value fund as the default option. Instead, 67% chose target-date funds and 22% chose balance funds. See Michael Hess, John Ameriks, and Scott J. Donaldson, "Evaluating and Implementing Target-Target-Date Portfolios: For Key Considerations," Vanguard Center for Retirement Research, March 2008.

[16] 29 CFR 2550.404(c)-5, published at 72 Fed. Reg. 60451 (Oct. 24, 2007).

[17] Preamble to 29 CFR 2550.404(c)-5 at 72 Fed. Reg. 60463 (Oct. 24, 2007).

[18] 29 CFR 2550.404(c)-5(e)(4)(v).

B. **Risk of Equity Exposure**. As just noted, target-date funds must provide a glide path to reduce plan participants' equity exposure as they grow older. However, participants in target-date funds have recently suffered significant losses because of the equity exposure, including participants with a 2010 target retirement date. The following table illustrates the magnitude of the losses in 2008:

2010 Target-Date Funds[19]

	2008 Equity Allocation	2008 Loss	Jan 31, 2009 Equity Allocation
T. Rowe Price	63%	-27.7%	58%
Fidelity	50%	-26.6%	41%
Vanguard	52%	-20.7%	54%

1. *Congressional Hearing*. The magnitude of the target-date fund losses in 2008 triggered a Congressional hearing in May 2009:[20]

> "U.S. Senate Special Committee on Aging Chairman Herb Kohl (D-WI) held a hearing . . . . The panel took a particularly close look 401(k) target date funds, which are designed to gradually shift to more conservative investments as workers approach retirement. Kohl also unveiled findings from a Committee investigation of 401(k) funds designed for people planning to retire in 2010, which revealed a wide variety of objectives, portfolio composition and risk within same-year target date funds. The results of excessive risk can be devastating for those on the brink of retirement: one 2010 target date fund lost 41 percent in 2008. In conjunction with the hearing, Kohl is sending letters today to U.S. Secretary of Labor Hilda Solis and U.S. Securities and Exchange Commission Chairwoman Mary Schapiro, urging them to immediately commence a review of target date funds and begin work on regulations to protect plan participants." (emphasis added)

2. *Joint DOL-SEC Hearing*. Later in May, DOL unofficially announced joint hearings with SEC on target-date funds scheduled for June 18, 2009.[21] The official hearing notice[22] asked potential witnesses to testify on:

- How target date fund managers determine asset allocations and changes to asset allocations (including glide paths) over the course of a target date fund's operation;
- How they select and monitor underlying investments;
- How the foregoing, and related risks, are disclosed to investors; and
- The approaches or factors for comparing and evaluating target date funds.

[19] The source for the table is Target Date Analytics Inc. LLC using Morningstar data as reported at John D'Antona Jr., "A Future Full of Change," *Pensions & Investments*, Feb 9, 2009, page 12.
[20] February 25, 2009, press release posted at http://aging.senate.gov/record.cfm?id=308665.
[21] Unofficial announcement posted at http://www.dol.gov/ebsa/TDFRelease050809.html.
[22] Official announcement published at 74 *Fed. Reg.* 24052 (May 22, 2009).

The testimony at the joint hearing was summarized in various trade journals following the hearings.[23] The hearing did not indicate what SEC or DOL intended to do in light of the testimony. However, a SEC official subsequently revealed what SEC might do.

In an interview, Andrew J. Donahue, Director of SEC's Division of Investment Management, indicated that the SEC is likely only to require that target-date funds clarify the endpoint of the glide path, but is unlikely to impose any substantive requirements on target-date funds:

> "Having said that, the question that has really surfaced with respect to target-date funds is whether or not the use of the name, like Target-Date 2015 fund, can mislead investors to have a certain expectation about what that particular portfolio will look like for 2015 and what it's trying to achieve.
>
> One of the things that came out of the joint hearing with the DOL is that, actually, there are two different models for what target-date funds do. One is that the money is available on the target date for an investor to roll over into an annuity or some other choice. The more prevalent target-date funds hold the expectation that the fund is managing your money up to your retirement and then beyond. So basically the glide path will continue after 2015.
>
> The question is, how do you pick what asset classes and what asset mix you will want from 2015 throughout the rest of your retirement? They're two totally different models. It's something we're giving a lot of thought to because we don't want investors confused. Nobody should be making a decision solely on the name of the fund. We have rules that you can't have misleading fund names.
>
> However, we don't tend to try and limit strategies people can use inside funds or to mandate asset allocations or things of that nature. That's not what the commission has historically done, as long as they're compliant with the provisions of the Investment Company Act of 1940 and their disclosures to investors." (emphasis added)[24]

So far, DOL officials do not appear to have revealed whether or how they will revise the QDIA regulations to address the issues raised by target-date fund critics.

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[23] Dou Halone, "More Target-Date Scrutiny in Future," *Pensions & Investments*, June 29, 2009. Marian Lemann, "Funds Resist Regulation of Target Date Pensions," *Financial Times*, July 5,, 2009, posted at FT.com. Craig L. Iraelsen, "Bad Match: Overly Aggressive Target-Date Funds Ignore the Fact That Investors May Choose to Cash-Out after They Retire," Financial Planning, August 2009.

[24] John Morgan, "A Measured Approach to Reform at the SEC," *Investment Dealers' Digest*, August 21, 2009.

C. Benchmarking. One of the fundamental criticisms against target-date funds is the difficulty of benchmarking them because no standards have evolved for the glide paths. Consider the Employee Benefit Research Institute's recent observations on the current state of affairs:

> "The glide paths of different target-date funds have significantly different shapes and starting/ending equity allocations. As of 2007, the equity allocation ranges from about 80–90 percent for 2040 funds (for workers about 30 years away from retirement), and from 26–66 percent for 2010 funds (for workers one year away from retirement)—a 40 percentage-point difference. Moreover, the fund families change their relative rank in equity allocation within the different fund years." (emphasis added)[25]

In an effort to improve the situation, Morningstar has developed a series of 30 target-date indexes for benchmarking purposes. Morningstar first divides the indexes into three categories based on the asset allocation: aggressive, moderate and conservative. Within each of these three categories, Morningstar then creates ten separate indexes based on the different retirement dates these funds most frequently target. Notwithstanding Morningstar's effort, some critics still question whether the benchmarks will serve their intended purpose because of the differences in the portfolio composition of the indexes and the benchmarked funds. In any event, Morningstar launched its target-date fund ratings and research reports based on its indexes on September 9, 2009[26] with an assessment of the largest target-date mutual funds.

D. Cost. Anticipating the launch of its target-date indexes, Morningstar also published a report that focused solely on cost of target-date funds.[27] The report noted the wide disparity of expense ratios from Vanguard's 19 basis points for its Target Retirement series to 144 basis points for Oppenheimer's Transition series. To illustrate the impact that fees can have on retirement savings, Morningstar calculated that a 50 basis points difference in fees would cost nearly $70,000 in retirement savings after 40 years with the following example:

> "Say you're 25 years old and invest $5,000 in a target-date 2050 fund this year, add $3,000 to the account each subsequent year, and the fund earns a 6% compound annualized return over the next 40 years. At that point, you'd have a nest egg of $549,657. But invest in a different fund that earns the same total return but charges 50 basis points more in expenses per year, and you'd end up with $480,264--a full $69,000 less."

If you take into account only a quarter of the cost from this example and multiple by the number of participants in a large 401(k) plan—let's say 5,000 participants—we are still talking about $86 million in losses. Clearly, the magnitude of these losses explains why the 401(k) fee class action lawsuits are likely to continue for the foreseeable future.

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[25] Craig Copeland, "Use of Target-Date Funds in 401(k) Plans, 2007," *Employee Benefit Research Institute Issue Brief No. 327* (March 2009).

[26] See Morningstar press release, "Morningstar Launches Target-Date Fund Series Ratings and Research Reports," September 9, 2009, at http://corporate.morningstar.com/us/asp/subject.aspx?xmlfile=174.xml&filter=PR4417.

[27] Josh Carlson, "Frugality Pays with Target-Date Funds," Morningstar, August 10, 2009, at http://news.morningstar.com/articlenet/article.aspx?id=303077&_QSBPA=Y&pgid=FFC_putnam1&t1=1253287163.

E. Fund of Funds. Many target-date funds are structured as fund of funds.[28] With a fund of funds arrangement, the higher-tiered target-date fund invests in lower tiered equity, bond, and money market funds within the same mutual family based on the asset allocation decision by the investment adviser for the higher-tier target-date fund. This fund of funds structured raises significant conflicts of interest issues for plan sponsors to consider.

1. Conflicts of Interest. When the investment adviser (e.g., Fidelity Management and Research Company) that services the mutual fund family (e.g., Fidelity funds) sponsoring the fund of funds determines the asset allocation, then the investment adviser may have a financial incentive to skew the asset allocation to those funds where the investment adviser's margins are the greatest. The mutual fund industry argues this conflict of interest is not currently a prohibited transaction under ERISA because mutual fund's assets are not plan assets.[29] However, critics[30] have advocated an exception to this mutual-fund-assets-are-not-plan-assets rule under certain circumstances.[31]

2. Plan Sponsor Monitoring Responsibility. Until DOL acknowledges that a target-date fund of funds arrangement creates a prohibited transaction under ERISA where the investment adviser's asset allocation decisions are conflicted, plan sponsors have significantly more fiduciary responsibility for monitoring a target-date fund of fund arrangement.

In a March 15, 1998, letter from Deputy Assistant Secretary of the Labor Ann L. Combs to Secretary of the SEC Jonathon Katz, the DOL opined that if plan sponsors invested in certain mutual funds being registered with SEC by College Retirement Equities Fund ("CREF"), they could not fulfill their ongoing fiduciary responsibilities to effectively monitor the plan investments. The "Combs Letter" stands for ERISA principle that plan sponsors have significantly increased monitoring obligations for plan investments (e.g., target-date fund of funds) that lack critical ERISA protections (e.g., prohibited transaction rules barring conflicts of interest by a fund's investment adviser).

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[28] Lifestyle funds are also frequently structured as funds of funds. A lifestyle fund differs from a target-date fund in that equity/fixed income mix does not change automatically as the participants in the fund become older. For this reason, a lifestyle fund by itself could not qualify as QDIA. See Preamble to QDIA regulations at 72 Fed. Reg. 60451, 60461 (Oct. 24, 2007).

[29] Mutual fund shares purchased with plan assets constitute plan assets. However, the underlying assets of the mutual funds generally do not constitute plan assets. See ERISA § 3(21)(B), 29 U.S.C. § 1002(21)(B). Therefore, the fiduciary rules, including the prohibited transaction rules, would generally not to apply to conflicted transactions (e.g., asset allocations) that occur within the mutual fund.

[30] Doug Halonen, "Target-Date Funds Could Fall under ERISA," *Pensions & Investments*, April 20, 2009. ("Avatar Associates LLC is asking the Department of Labor for an advisory opinion that could, for the first time, subject mutual fund companies offering target-date funds to ERISA.")

[31] An exception for arrangements designed to avoid ERISA may be found in the legislative history of ERISA which states:

> "Since [ERISA] prohibits both direct and indirect transactions, it is expected that where a mutual fund, e.g., acquires property from a party-in-interest as part of the arrangement under which the plan invests or retains its investment in the mutual fund, this is to be a prohibited transaction." (3 U.S. Cong. & Adm. News 1974, p. 5089).

Plaintiffs' attorneys also could reasonable argue that a plan sponsor is liable under ERISA for allowing plan participants to invest in a target-date fund whose asset allocation is decided by a conflicted investment adviser. Alternatively, they could argue that the plan sponsor is liable for not disclosing the investment adviser's conflict of interest to the plan participants if the target-date mutual fund or its investment adviser does not disclose the conflict of interest.