Benefits & Compensation DIGEST
Vol. 43, No. 8 | August 2006

Fiduciary Investment Issues in Defined Contribution Plans

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The recent emergence of multiemployer 401(k), profit-sharing and money purchase plans as important retirement tools has led to a reexamination of the respective roles and responsibilities of trustees, money managers, consultants, brokers and other service providers. This article reviews trustee fiduciary duties relating to defined contribution (DC) plan investments, shielding trustees from fiduciary liability for poor investment performance, and controlling investment costs and fees.

Introduction

In recent years, the number of DC plans has increased dramatically, most often at the expense of traditional defined benefit (DB) plans. In part, this is because Congress has offered new tax breaks for DC plans, while piling on restrictions for DB plans and offering incentives for corporations to terminate them. In addition, 401(k) plans have an unbeatable employer advantage that does not exist for any other plan structure—Because contributions are taken from employees' paychecks, a 401(k) plan can be designed in a way that truly costs the employer nothing while shifting the cost burden entirely to the employees.

As DC plans have proliferated, they have been thrust into the spotlight by criminal and civil prosecutions, and investigations by the federal Securities and Exchange Commission, New York Attorney General Elliott Spitzer and other government agencies. In response to this new regulatory attention, this article focuses on three topics: trustee fiduciary duties relating to DC plan investments, shielding trustees from fiduciary liability for poor investment performance, and controlling investment costs and fees.

At various points, I cite published court decisions, sections of ERISA and other laws, and DOL regulations. One good source for court cases is www.law.cornell.edu/opinions. Federal statutes and regulations are available at www.law.cornell.edu/uscode and www4.law.cornell.edu/cfr.

Fiduciaries and Plan Assets

ERISA requires that, with a few exceptions, "all assets of an employee benefit plan shall be held in trust by one or more trustees." ERISA §403(a), 29 U.S.C. §1103(a). ERISA distinguishes several kinds of fiduciaries with respect to investments. In general, fiduciaries are divided into two groups: named fiduciaries and functional fiduciaries. *Named fiduciaries* are persons or entities that are specifically identified as the plan's fiduciaries. ERISA provides that "[e]very employee benefit plan shall be established and maintained pursuant to a written instrument" that provides for "one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan." ERISA §402(a)(1), 29 U.S.C. §1102(a)(1). A named fiduciary is either a fiduciary "named in the plan instrument" or otherwise identified as such by an employer, union, or an employer and union acting jointly. ERISA §502(a)(2), 29 U.S.C. §1102(a)(2). For multiemployer plans, the board of trustees is usually the named fiduciary. For corporate plans, the named fiduciary is usually the employer or the members of a committee appointed to manage the plan.

Every fiduciary that is not a named fiduciary is a functional fiduciary. *Functional fiduciaries* acquire fiduciary status by virtue of what they do, and there are three kinds:

1. Persons with discretionary authority or control over the management of the plan or its assets
2. Persons who give the plan investment advice for a fee
3. Persons with discretionary authority or control over plan administration, including power to designate someone else to carry out fiduciary functions.

There are a variety of functional fiduciaries in multiemployer plans.

Trustees: Under ERISA, a plan's trustees have "exclusive authority and discretion to manage and control the assets of the plan." *Id.*

Investment managers: ERISA permits trustees to "appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan." ERISA §402(c)(3), 29 U.S.C. §1102(c)(3).

An *investment manager* is a fiduciary:

- Who has the power to manage, acquire, or dispose of any asset of a plan
- Who is registered under the Investment Advisers Act of 1940, 15 U.S.C. §80b-1 et seq., or an equivalent state law, or is a bank or insurance company "qualified to manage, acquire or dispose of any plan asset"
- Who "has acknowledged in writing that he is a fiduciary with respect to the plan." ERISA §2(38), 29 U.S.C. §1002(38).

Co-fiduciaries: In addition to trustees and investment managers, ERISA provides that a person is a fiduciary to the extent that:

> (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, [or] (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has authority or responsibility to do so. . . .

ERISA §3(21)(A)(i),(ii), 29 U.S.C. §1002(21)(A)(i),(ii).

Liability: A fiduciary is personally liable for any losses to a plan caused by his or her breach of fiduciary duty, and must restore any profits made through his or her improper use of plan assets. The Department of Labor (DOL), a participant or beneficiary, or another plan fiduciary can sue in federal court for a breach of fiduciary duty. ERISA §502(a), 29 U.S.C. §1132(a).

The Intersection of Plan Investments and Fiduciary Duties

The duty of loyalty: ERISA requires that plan fiduciaries, including trustees, act solely in the interests of plan participants and beneficiaries, with due regard for administrative costs. ERISA §404(a)(1)(A), 29 U.S.C. §1104(a)(1)(A).

The duty of prudence: A fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA §404(a)(1)(B), 29 U.S.C. §1104(a)(1)(B).

The focus is on procedure, not outcome: In determining whether fiduciary duties have been met, the courts and regulations look to the process followed by the fiduciary in determining whether to make or continue an investment, rather than focusing on the investment's success or failure.

No prohibited classes of investments: The question is whether the trustees properly investigated and considered the merits of the proposed investment or investment strategy before authorizing the investment, as in *Donovan v. Mazzola,* 716 F.2d 1226 (9th Cir. 1983). Unlike the regulations governing IRAs, there are no categories of investments that are prohibited. Thus, a plan can invest in art, precious metals or collectibles even though they may not be easy to liquidate, provided that the trustees comply with the processes described in the DOL regulations in reaching their decision to invest in such assets.

The role of documentation: Since the most important factor in determining whether an investment is prudent is the process followed in making it, it is vital that fiduciaries document the process that was followed in investigating and evaluating the investment, including the facts and reasoning that were involved in the decision to invest. Even if an investment goes south, the fiduciaries that made the investment decision will be found to have acted prudently if they followed prudent procedures and carefully documented them. See *Brock v. Robbins,* 830 F.2d 640, 648.

Defining prudent procedures: With respect to plan investments, DOL interprets ERISA's duty of prudence to require fiduciaries to give "appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties." DOL Reg. §2550.404a-1, 29 CFR §2550.404a-1. The fiduciary must then act in accordance with the foregoing analysis. Thus, ERISA requires a fiduciary to determine the plan's asset allocation and select the plan's investments at all times based on whether the investment furthers the plan's purposes.

Required analysis: In determining whether to make or continue an investment, a fiduciary must analyze whether "the particular investment . . . is reasonably designed, as part of the portfolio . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment. . . ." DOL Reg. §2550.404a-1(b), 29 CFR §2550.404a-1(b).

A fiduciary must also consider "the following factors as they relate to such portion of the portfolio: (A) the composition of the portfolio with regard to diversification; (B) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and (C) the projected return of the portfolio relative to the funding objectives of the plan." *Id.*

The duty to diversify: ERISA also imposes an additional fiduciary obligation specifically applicable to plan investments. As part of the "prudent man" duty, a fiduciary must diversify plan investments "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." ERISA §404(a)(1)(C), 29 U.S.C. §1104(a)(1)(C).

The goal is to distribute the risks of loss by limiting the proportion of assets invested in any one investment or class of investments, thereby protecting the fund to some degree against adverse business conditions, imprudence or dishonesty in a particular field and minimizing the risk of large losses. For example, see *Brock v. Citizens Bank of Clovis*, 1985 WL 71535 (D.N.M. 1985), *amendment denied*, 1986 WL 82936 (D.N.M. 1986), 841 F.2d 344 (10th Cir. 1988).

Investments should be diversified by type of investment (e.g., stocks, bonds, real estate) as well as within each class. Real estate investments should also be diversified geographically. Maturity dates for fixed income investments should be staggered as well.

For participant-directed plans, investment options must be adequately diversified. In general, a *participant-directed plan* (also called a 404(c) plan) is one that lets participants choose their investments and otherwise complies with DOL regulations. The regulations under §404(c) of ERISA, 29 U.S.C. §1104(c), require a plan to offer a minimum of three different investment alternatives "each of which has materially different risk and return characteristics" so that participants may adequately diversify the investments in their accounts. DOL Reg. §2550.404c-1(c)(3), 29 CFR §2550 .404c-1(c)(3). Participant-directed plans are discussed in greater detail on page 4.

Statements of investment policy: While ERISA does not require or even refer to investment policy statements, DOL encourages plans to promulgate and adhere to them. DOL Interpretive Bulletin 94-2, 29 CFR §2509.94-2 (July 29, 1994), at www.dol.gov/dol/allcfr/title_29/Part_2509/29CFR2509.94-2.htm.

According to DOL, an investment policy statement should be written and should address the following issues:

- Evaluation of the specific needs of the plan and its participants
- Investment objectives and goals
- Standards of investment performance/benchmarks
- Classes of investment authorized
- Styles of investment authorized
- Diversification of portfolio among classes of investment, among investment styles and within classes of investment
- Restrictions on investments
- Directed brokerage
- Proxy voting
- Standards for reports by investment managers and investment consultants on performance, commission activity, turnover, proxy voting, compliance with investment guidelines
- Policies and procedures for the hiring of an investment manager
- Disclosure of actual and potential conflicts of interest.

See DOL Advisory Counsel, "Report of the Working Group on Guidance in Selecting and Monitoring Service Providers" (November 13, 1996), at www.dol.gov/ebsa/adcoun/srvpro.htm.

DOL also suggests that plans separate written investment guidelines for each money manager. DOL Interpretive Bulletin 94-2, 29 CFR §2509.94-2 (July 29, 1994), at www.dol.gov/dol/allcfr/title _29/Part_2509/29CFR2509.94-2.htm. While written investment policy statements and money manager guidelines are not required by law, every plan should have them if for no other reason than DOL will ask to see them if the plan is audited.

Investment Managers

Trustee Liability and Duties

Trustees are not liable for an investment manager's errors, and are not required to invest or manage plan assets under the investment manager's control. As noted earlier, ERISA permits trustees to "appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan." ERISA §402(c)(3), 29 U.S.C. §1102(c)(3). If an investment manager is appointed, "no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager." ERISA §405 (d)(1), 29 U.S.C. §1105(d)(1). And the trustees will no longer be fiduciarily obligated "to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager." ERISA §405(d)(1), 29 U.S.C. §1105(d)(1).

Trustees retain a fiduciary duty to monitor retained money managers, however. Shortly after the passage of ERISA, DOL provided the following description of a fiduciary's duty to monitor individuals to whom fiduciary responsibilities have been delegated:

> At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan. No single procedure will be appropriate in all cases; the procedure adopted may vary in accordance with the nature of the plan and other facts and circumstances relevant to the choice of the procedure.

DOL Reg. §2509.75-8, 29 CFR §2509 .75-8 (FR-17).

Mutual Fund Managers

In most instances, mutual fund managers are not fiduciaries. Mutual funds and brokers making investments at the direction of an investment consultant usually do not have discretionary authority over plan assets, and they do not provide investment advice for a fee. See *Harris Trust & Sav. Bank v. Salomon Bros, Inc.,* 530 U.S. 238, 120 S.Ct. 2180, 147 L. Ed. 3d 187 (2000).

In one case, an investment firm and its manager were held not to be fiduciaries because they had no contractual agreement with the fund regarding the disposition of fund assets, were not alleged to have had any role in the trustees' decision to purchase the investment, and were not alleged to have been granted fiduciary authority over the plan assets used to make the purchase or to have acted in any way as fiduciaries. The fact they were alleged to have fraudulently misappropriated fund assets meant for purchase of the note did not in itself transform them into fiduciaries. *Local 875 I.B.T. Pension Fund v. Pollack,* 992 F.Supp. 545 (E.D.N.Y. 1998).

DOL regulations also provide that an asset manager who would otherwise be considered an ERISA fiduciary is not deemed a fiduciary if less than 25% of the value of the equity interests in the fund is held by ERISA plans. DOL Reg. §2510.3-101, 29 CFR §2510.3-101. For this reason, many funds limit the number of ERISA plans that can invest. Thus, in *Ennis v. Montemayor,* 14 F.Supp. 2d 379, 22 Employee Benefits Cas. (BNA) 1455, Fed. Sec. L. Rep. (CCH) ¶90258 (S.D.N.Y. 1998), the court found that, pursuant to DOL regulations, the manager of an investment fund was not a fiduciary under §3(21)(A)(i) or (ii) of ERISA, 29 U.S.C. §1002(21)(A)(i), (ii), because the global hedge fund was comprised of less than 25% ERISA funds.

The court ruled because the percentage of ERISA benefit plan investors never exceeded 4.8% of the value of equity interests in the fund, the defendants should not be considered ERISA fiduciaries under DOL regulations defining what constituted "significant" participation in an entity by ERISA benefit plan investors.

The court also noted if benefit plan investors hold less than 25% of any class of equity interest in an entity, there is no substantial expectation that the assets of the entity will be managed in the furtherance of the investment objectives of the plan investors. Because there was no dispute that the defendants had rendered investment advice only in relation to the investment of hedge fund partnership assets, they were not ERISA fiduciaries.

The defendants' failure to disclose their nonfiduciary status in any of the documents on which the ERISA plan relied in deciding to invest in the partnership was irrelevant, since to hold otherwise would cause the absurd result of creating ERISA liability for failure to notify plan trustees that one is not subject to ERISA liability.

Banks and Broker-Dealers

Banks and broker-dealers often are not ERISA fiduciaries. In one court decision, a bank and broker were held not to be ERISA fiduciaries as to options trading done through them at the direction of the plan's independent investment advisor since the investment advisor was the sole person with discretionary authority over the accounts.

The court also found that even if the broker and bank were considered fiduciaries, they were exempt from liability under DOL regulations protecting brokerage firms that merely execute trades and do not give investment advice for a fee. *Chee v. Marine Midland Bank, N.A.,* Fed. Sec. L. Rep. (CCH) ¶95806, 1991 WL 15301 (E.D.N.Y. 1991), *applying* DOL Reg. §2510.3-21(d)(1), 29 CFR §2510.3-21(d)(1).

The implications for trustees are significant. Since mutual fund managers, brokers and banks ordinarily are not fiduciaries under ERISA, investing in mutual funds does not provide automatic protection from personal liability, unlike investing plan assets through a true investment manager.

Investment Consultants

Investment consultants can perform a wide range of services for a plan. Typically, they monitor the performance of investment managers, recommend hiring or replacing particular money managers or investments, recommend asset allocation for the plan, prepare the plan's investment policy statement and negotiate fee arrangements with fund managers.

ERISA authorizes plans to hire consultants "to render advice with regard to any responsibility such fiduciary has under the plan," including investment responsibilities. ERISA §402(c)(2), 29 U.S.C. §1102(c)(2).

In fact, one appellate court has ruled ERISA fiduciaries have an affirmative duty to seek the advice of an independent expert whenever their knowledge or ability is insufficient. *Katsaros v. Cody,* 744 F.2d 270, 279 (2d Cir. 1984).

Reliance on expert advice does not automatically insulate trustees. Trustees must investigate the expert's qualifications, give the expert complete and accurate information, and ensure that reliance on the expert's advice is reasonably justified under the circumstances. *Chao v. Hall Holding Co., Inc.,* 285 F.3d 415, 430 (6th Cir. 2002); *Howard v. Shay,* 100 F.3d 1484, 1489 (9th Cir. 1996).

While some consultants from large investment firms disclaim fiduciary status in their contracts, they nonetheless are fiduciaries under ERISA to the extent they have authority to "render investment advice for a fee . . . with respect to any moneys or property of such plan." ERISA §3(21)(A)(ii), 29 U.S.C. §1002(21)(A)(ii).

DOL also considers investment consultants to be fiduciaries. The regulations provide an individual renders investment advice if he or she advises a plan concerning the value of securities or other property, or makes recommendations on the advisability of buying or selling securities or other property.

In addition, the regulations provide an investment consultant also gives investment advice within the meaning of ERISA §3(21)(A)(ii) if the consultant gives advice, directly or indirectly, with the understanding that the advice will be the primary basis for investment decisions concerning plan assets and that the individual will give individualized investment advice based on the particular needs of the plan. DOL Reg. §2510.3-21, 29 CFR §2510.3-21.

Trustees' Duty to Prudently Select and Monitor Investment Managers and Consultants

Trustees have a fiduciary duty to prudently select and prudently monitor plan providers, including investment managers and consultants. As DOL has stated:

> [A] responsible plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. In addition, such process should be designed to avoid self-dealing, conflicts of interest or other improper influence. What constitutes an appropriate method of selecting a service provider, however, will depend upon the particular facts and circumstances. Soliciting bids among service providers is a means by which a fiduciary can obtain the necessary information relevant to the decision-making process, including information about contractual provisions . . . relating to limitations of liability and indemnification.

DOL Advisory Op. 2002-08A (August 20, 2002), at www.dol.gov/ebsa/regs/AOs/ao2002-08a.html.

Fiduciaries remain personally liable if they select or retain an investment manager or consultant when it is not prudent to do so. See *California Ironworkers Field Pension Trust v. Loomis Sayles & Co.,* 259 F.3d 1036 (9th Cir. 2001); *Lowen v. Tower Asset Management, Inc.,* 829 F.2d 1209 (2d Cir. 1987).

Trustees have additional reasons to be cautious. An SEC study has found some investment consultants are not giving unbiased advice. In response, SEC and DOL have prepared a list of ten questions trustees can use to determine whether investment consultants have potential conflicts of interest. See "Selecting And Monitoring Pension Consultants—Tips For Plan Fiduciaries," at www.dol.gov/ebsa/newsroom/fs053105.html. As a protective measure, every plan should insist that its investment consultant submit full and complete responses to the ten questions.

Participant-Directed Investments

Section 404(c)(1) of ERISA, 29 U.S.C. §1104(c)(1), protects trustees and other fiduciaries of defined contribution plans from liability if participants and beneficiaries "exercise control over the assets in [their] account[s]." If the requirements of the DOL regulations are met, the plan's fiduciaries "shall not be liable . . . for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control" over the assets in their accounts. ERISA §404(c)(1)(B), 29 U.S.C. §1104(c)(1)(B).

To acquire this protection from fiduciary liability, the plan must comply with the more than 20 detailed requirements of §2550.404c-1 of the DOL regulations, 29 CFR §2550.404c-1. These requirements include allowing a reasonable opportunity to exercise independent control of their investments, offering a broad range of investment alternatives, and various disclosures. In addition, the trustees continue to be fiduciarily obligated to prudently select, monitor and replace investment choices offered by the plan.

As noted above, the plan must offer participants a broad range of investment options that include at least three core alternatives. The alternatives must be diversified and have materially different risk and return characteristics. The core alternatives together must enable the participant to structure "a portfolio with aggregate risk and return characteristics within the range normally considered appropriate for that participant." DOL Reg. §2550.404c-1(b), 29 CFR §2550.404c-1(b).

The investment alternatives made available must also give the participant the opportunity to "[m]aterially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject."

The plan must also enable participants to transfer among the investment alternatives at least quarterly. DOL Reg. §550 .404c-1(b)(ii)(C)(i), 29 CFR §2550.404c-1(b)(ii)(C)(i).

The participant or beneficiary must be given the "opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan, and incidents of ownership appurtenant to such investments." DOL Reg. §2550. 404c-1(b)(2)(B), 29 CFR §2550.404c-1(b)(2)(B). Thus, the regulation does not require that plans educate their participants. Rather, plans need only provide participants with information about available investment alternatives.

Relief from fiduciary liability under §404(c) is available only when the participant actually exercises control. ERISA §404(c)(1), 29 U.S.C. §1104(c)(1). If a participant fails or refuses to exercise control, the trustees of a participant-directed plan must choose the investments for the participant. The trustees are then fiduciarily responsible for the choice of "default" investments for the participant.

Most plans do not comply with §404(c). The protections of §404(c) disappear if a plan fails to comply with the requirements of the DOL regulations. Most plans that style themselves as "participant-directed" plans do not comply with all DOL regulatory requirements. For example, some otherwise compliant plans fail to provide participants with a prospectus when the participant first invests in a particular investment option. Similarly, many fail to notify participants in writing of the identity of the §404(c) fiduciary or fiduciaries (i.e., the fiduciary responsible for overseeing compliance with DOL regulatory requirements). Very few provide participants with materials relating to the exercise of shareholder voting, tender or similar rights. A good checklist of 20 requirements for Section 404(c) compliance can be found at www.reish.com/pa/benefits/20steps.cfm.

The good news is that a new federal court of appeals decision holds that in some instances trustees will not be liable for investment losses if the plan does not meet requirements of §404(c) or the DOL regulations, if the trustees otherwise prudently selected and monitored plan investments. *Jenkins v. Yager,* _________F.3d_________, 2006 WL 956944, 2006 U.S. App. LEXIS 9300 (7th Cir. 4/14/06). The case holds that §404(c) (providing for participant-directed investments) creates an "implied exception" to §403(a)'s rule that investment decisions cannot be delegated to participants.

Jenkins v. Yager is the first published decision to address what happens when a participant-directed plan does not meet requirements of §404(c) and the DOL Regulations The decision attempts to reconcile two conflicting sections of ERISA. Section 404(a)(3), 29 U.S.C. §1104(a)(3), provides that trustees cannot delegate their investment responsibilities to anyone who is not an investment manager or a named fiduciary. The other section, which is §404(c), permits trustees to avoid fiduciary liabilities by creating participant-directed plans. The issue in *Jenkins v. Yager* was: What happens if a participant-directed plan does not meet requirements of §404(c) or the DOL regulations if the trustees prudently selected and monitored all the investment alternatives? The specific violation of §404(c) and the DOL regulations in the case was that the plan did not allow participants to change their investment mix every three months.

The court of appeals ruled that §404(c) and the DOL regulations are not the only possible means by which a trustee can escape liability for participant-directed plans. If the trustees act prudently in selecting and monitoring the investments offered participants, they may avoid personal liability. Whether they have acted prudently turns on if the trustees properly investigated and considered the merits of the proposed investment or investment strategy in light of the plan's goals, as discussed above.

One caveat: *Jenkins v. Yager* may not be over. The loser can petition for rehearing by the Seventh Circuit or appeal to the Supreme Court. In addition, the decision is only binding within the Seventh Circuit, which consists of Illinois, Indiana and Wisconsin.

Mutual Fund Costs

The Impact of Excessive Fees

Hidden costs and fees are the latest scandal in the world of defined contribution plans. According to regulatory agencies, undisclosed fees and commissions are eroding some 401(k) participants' retirement savings.

DOL has recognized that investment management fees can significantly reduce participants' account balances. It gives this example:

> Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7% and fees and expenses reduce your average returns by 0.5%, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5%, however, your account balance will grow to only $163,000. The 1% difference in fees and expenses would reduce your account balance at retirement by 28%.

DOL, "A Look at 401(k) Plan Fees," at www.dol.gov/ebsa/publications/401k_employee.html.

As noted previously, fees and costs may not be readily apparent in investment manager reports and publications. For example, investments may include sales charges or commissions that were paid in advance to the financial advisor upon engagement. The fund may be required to pay these contingent deferred sales charges when the investment is terminated.

The other side of the coin is that exceptional fund performance may justify high fees. Using DOL's example of the impact of fees quoted above, assume the rate of return on the higher cost plan is 9% rather than 7%. In this case, the participant's account balance will grow to $314,000, and the 1% difference in fees and expenses, combined with the higher rate of return, would increase the participant's account balance at retirement by a startling 38%.

Implications for Fiduciaries

Trustees have an ongoing fiduciary obligation to monitor fees charged by investment managers, mutual funds and other providers. See *Liss v. Smith*, 991 F.Supp. 278 (S.D.N.Y. 1998); *Whitfield v. Cohen*, 682 F.Supp. 188 (S.D.N.Y. 1988).

Because of the real impact of management fees on account balances, trustees have a fiduciary obligation under ERISA to evaluate and monitor fees and costs paid by participants and the plan. They must:

- Establish a prudent process for selecting investment alternatives and service providers
- Ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided
- Select prudent and adequately diversified investment alternatives
- Monitor investment alternatives and service providers once selected to see if they continue to be appropriate choices. *Id.*

DOL, "A Look at 401(k) Plan Fees," at www.dol .gov/ebsa/publications/401k _employee.html.

DOL Checklist

DOL has published a comprehensive checklist that can be modified and submitted to financial consultants, fund managers and other service providers to obtain detailed information about the fees or costs that may be charged. While use of the checklist is optional, it can enable plans to calculate total plan expenses and to compare fees charged by providers. See *ABC Plan 401(k) Fee Disclosure Form,* at www.dol.gov/ebsa/pdf /401kfefm.pdf.

Contents of Fee Agreements

Plan sponsors and trustees should require written agreements with all service providers, including investment representatives. All fee agreements should contain the following provisions.

- **Full disclosure:** The trustees should insist that every cost is clearly disclosed in the fee agreement. The agreements should outline in detail services to be performed, fee schedules, how fees will be paid, disclosure of all compensation that will be received (both hard and soft dollars) and how revenue in excess of the service provider's fees will be distributed.
- **Direct payment of fees by the plan:** The broker or financial consultant should agree that the only source of compensation is money paid directly by the plan. No kickbacks, no commissions, no soft dollars, no incentives and no other compensation will be retained.
- **100% rebates:** The broker or financial advisor should agree that all available payments by mutual funds go to the plan, either as a credit against costs or as a direct payment to the plan.
- **Revenue neutrality:** The broker or consultant should receive the same payment from the funds regardless of the investment options selected.

Fee Terminology

Expense Ratios

Investorwords.com defines *expense ratios* in mutual funds as follows:

> For a mutual fund, operating costs, including management fees, expressed as a percentage of the fund's average net assets for a given time period. The expense ratio does not include brokerage costs and various other transaction costs that may also contribute to a fund's total expenses.

Expense ratios show the actual amounts that mutual funds deduct each year to cover their expenses. While expense ratios do not include broker fees, sales charges or group annuity fees, they do include 12b-1 fees, administrative fees and various other asset-based charges incurred by the fund. (These fees and charges are discussed later.) Smaller funds and international funds usually have higher expense ratios than those of larger funds.

High expense ratios decrease returns. For example, assume two mutual funds both earn a 10% return before fees. If the first fund has an expense ratio that is 1% higher than the second fund, an investor would lose an extra 10% of expected returns each year for investments made in the first fund. Since costs are more easily controlled than performance, expense ratios are an obvious place to look for improvement. In addition, the lower the fund's cost, the less the fund needs to overcome by performance. On the other hand, a fund with a higher expense ratio is preferable if it outperforms funds with lower expense ratios.

12b-1 Fees

12b-1 fees are authorized by SEC Rule 12b-1, 17 CFR §12b-1, which was promulgated in 1980 pursuant to the Investment Company Act of 1940, 15 U.S.C. §80a-1 et seq.

The rule allows mutual funds to pay distribution and marketing expenses out of the funds' assets. Since the adoption of Rule 12b-1, mutual funds have used 12b-1 fees, often in combination with contingent deferred sales charges, as an alternative to using front-end sales loads to compensate insurance agents and brokers ostensibly for assisting the ultimate purchasers of the funds. According to industry critics, 12b-1 fees are little more than a sales commission. 12b-1 fees are limited to 1% annually with a maximum of 0.25% going to brokers.

While sometimes called a hidden fee, 12b-1 fees are in fact disclosed in a mutual fund's prospectus. A fund is allowed to advertise itself as a "no-load" fund, however, even though it charges 12b-1 fees of 0.25% or less per year. No-load funds that do not charge any 12b-1 fees often call themselves "100% no-load" or "true no-load" funds.

Section 28(e) Fees

Section 28(e) of the Securities Exchange Act of 1934, 15 U.S.C. §78bb(e), as amended in 1975, provides a safe harbor for money managers who use commission dollars from their advised accounts to obtain research and brokerage services. A brokerage executing a trade for a mutual fund is permitted to charge more than the cost of execution and use the excess to purchase additional services from the brokerage in the form of investment research.

To receive safe harbor protection, the mutual fund must act in good faith to ensure that the excess commission is "reasonable in relation to the brokerage and research services provided by the broker-dealer." See DOL, "Statement on Policies Concerning Soft Dollars and Directed Commissions Arrangements," ERISA Technical Release No. 86-1 (May 22, 1986), at www.occ.treas.gov/ftp/tbc/tbc-25b.txt.

In fact Section 28(e) revenues have frequently been used unlawfully. For example, the Securities and Exchange Commission (SEC) recently found that investment managers have directed money to consultants in return for, among other things, potential recommendations to plans. SEC, "Staff Report Concerning Examinations of Select Pension Consultants" (May 16, 2005), at www.sec.gov/news/studies/pensionexamstudy.pdf.

Sub-Transfer Agent (aka sub-t/a) Fees

Mutual funds often contract out recordkeeping services to banks, trust companies or third-party administrators. The transfer agent processes orders and keeps records of mutual fund shareholders. Transfer agents are also responsible for preparing and mailing shareholder account statements, calculating and disbursing dividends, and mailing confirmations of account transactions.

Payments to these subcontractors have come to be known as sub-transfer agent fees or sub-t/a fees. They are usually a flat dollar amount per participant, paid annually or quarterly. As discussed later, ERISA plans can recover sub-t/a fees from mutual funds and use them to defer recordkeeping and other costs.

Finder's Fees

Some mutual fund groups pay a finder's fee for the placement of money in their investments. Finder's fees can be a very attractive revenue-sharing vehicle for a plan since they are entirely paid for by the fund family. Unfortunately, plans sometimes unknowingly permit finder's fees to be secretly retained by a broker.

Management Fees

These fees are charged by a fund's investment manager for managing the fund's portfolio of securities and providing related services.

Shareholder Servicing Fees

These expenses include, among others, fees paid for shareholder services, such as toll-free phone communications, Web services, help centers, recordkeeping, printing and mailing. Shareholder servicing fees are sometimes greater than the 12b-1 fee paid to the broker-dealer.

Sales Loads or *Sales Charges*

Some mutual funds also impose a *sales charge* or a *sales load,* which is paid to brokers. SEC does not limit sales loads but the National Association of Securities Dealers (NASD) restricts mutual fund sales loads to a maximum of 8.5%, which is reduced further if the fund imposes certain other charges.

There are various kinds of sales loads. Investors pay *front-end* sales loads when they purchase funds or *back-end* or *deferred* sales loads when shares are sold or redeemed.

Group Annuity Fees or *Wrap Fees*

Insurance companies frequently offer a range of investment alternatives for 401(k) plans through group variable annuity contracts. The variable annuity contract "wraps" around investment alternatives, often a number of mutual funds. DOL, "A Look at 401(k) Plan Fees," at www.dol.gov/ebsa/publications/401k_employee.html. Wrap fees can range from 0.5% to 3% or more of plan assets for group annuity plans. The fees are generally shared between the insurance company and the broker.

Reducing Administrative Costs

Plans increasingly negotiate rebates of fees paid to mutual fund companies, often to offset the costs of unused services. Fund families often charge for services that are performed by the plan's financial consultant, recordkeeper or third-party administrator instead of the mutual fund.

By the same token, mutual funds often hire outside organizations, including transfer agents and investment advisors, to provide services that would otherwise be performed by plan consultants. Where these services are performed by plan consultants, mutual fund families will usually agree to rebate sub-t/a, finder's, management and servicing fees, which can serve as important revenue sources for a plan.

Rebates should go to the plan, not the provider: DOL has opined that a fiduciary with control over a plan's investment selection may collect revenue-sharing payments on behalf of the plan but must account for all payments and pass them on to the plan in the form of an expense offset or direct payment. Advisory Op. 10:56 97-15A (May 22, 1997), at www.dol.gov/ebsa/programs/ori/advisory97/97-15a.htm.

In a later opinion, DOL clarified that a directed trustee with no discretion over plan assets who did not give investment advice could keep revenue-sharing payments. Advisory Op. 2003-09A (June 25, 2003), at www.dol.gov/ebsa/regs/aos/ao2003-09a.html. Some examples follow.

Sub-transfer agent fees: Mutual fund investors typically do not submit orders directly to a transfer agent. Instead, they place orders with a third-party broker-dealer or, in the case of some defined contribution plans, the plan administrator.

For defined contribution plans, the plan administrator or recordkeeper may perform many transfer agent functions. In such a case, the transfer agent will maintain only one account (in the name of the plan), while the recordkeeper maintains the individual participants' interests in the fund accounts. This assumption of servicing duties is ordinarily set out in an agreement between the fund transfer agent and the recordkeeper. The recordkeeper becomes the sub-transfer agent, sub-dividend disbursing agent, or sub-shareholder servicing agent.

The agreement between the fund transfer agent and the recordkeeper typically provides for the mutual fund distributor to pay sub-shareholder service or sub-transfer agency fees to the recordkeeper. These fees are paid from the general administrative expenses of the mutual fund and should be disclosed by the recordkeeper.

Rebates for education services: A plan's financial advisor, rather than the fund company, may provide educational services and field inquiries from participants. A mutual fund company may be willing to reimburse the plan for the fees it ordinarily charges investors for this service. Any such reimbursement should be disclosed by the financial advisor.

Conclusion

Trustees of DC plans should be alert to potential fiduciary liability issues accompanying the investment of plan assets. Unlike DB plans, it is often difficult for DC plan trustees investing in mutual funds to shield themselves from fiduciary liability by delegating their investment responsibilities to investment managers. DC plan trustees can limit their potential liability by prudently investigating and evaluating potential plan investments, and by documenting the facts and reasoning that led to the decision to invest. Trustees can further reduce their potential fiduciary liability by relying on the advice of an investment consultant and by structuring the plan to allow participant-directed investments in compliance with DOL regulations. After an investment decision is made, the trustees have a continuing fiduciary duty to monitor the performance of their investments. Finally, DC plan trustees should investigate potential undisclosed fees and expenses that may be charged by their investment advisors. **B&C**

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