FIDUCIARY ISSUES IN DEFINED CONTRIBUTION PLANS

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I. **INTRODUCTION:** The nation's increasing dependence on 401(k), profitsharing and money purchase plans as substitutes for defined benefit plans has led to a reexamination of the roles and responsibilities of trustees, employers, plan professionals, brokers and other service providers. This paper reviews a variety of fiduciary duty issues implicating multiemployer DC plan personnel and providers of all stripes, with particular attention to changes wrought by the Pension Protection Act, new regulatory initiatives, and recent investment fees litigation.

II. **FIDUCIARIES: THE BASICS:** ERISA requires, with a few exceptions, that "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).

A. **"Named" vs. "functional" fiduciaries:** ERISA establishes two categories of fiduciaries:

B. **Named fiduciaries:** ERISA provides that "[e]very employee benefit plan shall be established and maintained pursuant to a written instrument" which 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). This requirement enables participants and regulatory agencies to identify the fiduciaries responsible for operating the plan.

1. **Definition:** A "named fiduciary" is either a fiduciary "named in the plan instrument" or one 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). Every plan must "have at least one named fiduciary who serves as plan administrator and, if plan assets are held in trust, the plan must have at least one trustee." 29 C.F.R. § 2509.5-8, FR-12.

2. **Taft-Hartley plans:** In the case of multiemployer plans and other collectively-bargained plans established pursuant to the Taft-Hartley Act, the named fiduciary is usually the fund's Board of Trustees. *See* Section 302(c)(5) of the Labor Management Relations Act, 1947, as amended, 29 U.S.C. § 186(c)(5).

3. **Single employer plans:** In the case of single employer plans, a person or committee (and sometimes the sponsoring employer itself) may be designated as the named fiduciary.

C. **Functional fiduciaries:** All fiduciaries other than named fiduciaries acquire fiduciary status by exercising one or more fiduciary functions. Section

3(21)(a) of ERISA, 29 U.S.C. § 1002(21)(a) establishes three broad categories of functional fiduciaries – "a person is a fiduciary with respect to a plan 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,
>
> "(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 any authority or responsibility to do so, or
>
> "(iii) he has any discretionary authority or discretionary responsibility in the administration of such plan."

1. **Trustees:** ERISA requires that with limited exceptions, all plan assets "shall be held in trust by one or more trustees." ERISA § 303(a), 29 U.S.C. § 1103(a).

    a. **Appointment:** Under ERISA, a plan's trustees must also be appointed by a fiduciary or named in the trust or plan instrument.

2. **Allocation and delegation of fiduciary duties**: While ERISA requires that plan fiduciaries must have "exclusive authority and discretion to manage and control the assets of the plan" (ERISA § 403(a), 29 U.S.C. § 1103(a)), some fiduciary responsibilities can be allocated or delegated:

    > "Under section 402(c)(1) of the Act, if the plan so provides, any person or group of persons may serve in more than one fiduciary capacity, including serving both as trustee and administrator. Conversely, fiduciary responsibilities not involving management and control of plan assets may, under section 405(c)(1) of the Act, be allocated among named fiduciaries and named fiduciaries may designate persons other than named fiduciaries to carry out such fiduciary responsibilities, if the plan instrument expressly provides procedures for such allocation or designation."

29 C.F.R. § 2509.5-8, FR-12.

3. **Investment managers:**

a. **Limitation on trustee liability:** 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, a trustee will not be liable for the investment manager's acts or omissions, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of the investment manager. ERISA § 405(d)(1), 29 U.S.C. § 1105(d)(1). Trustees therefore 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.

b. **Definition:** An investment manager is a fiduciary:

(1) "who has the power to manage acquire, or dispose of any asset of a plan;"

(2) who is registered under the Investment Advisors Act of 1940, 15 U.S.C. § 80b-1 *et seq.* ("IAA"), or an equivalent state law, or is a bank or insurance company "qualified to manage, acquire or dispose of any plan asset"; and

(3) who "has acknowledged in writing that he is a fiduciary with respect to the plan." ERISA § 2(38), 29 U.S.C. § 1002(38).

c. **Trustees' continuing fiduciary duties:** Trustees retain a fiduciary duty to monitor retained money managers. Shortly after the passage of ERISA, the 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 Regs. § 2509.75-8, 29 C.F.R. § 250.75-8 (FR-17).

4. **Administrators:** Plan administrators are always fiduciaries because the scope of their authority necessarily includes discretionary authority.

   a. **Definition:** Section 3(16)(A) of ERISA, 29 U.S.C. § 1002(16)(A), defines "administrator" as:

   > "(i) the person specifically so designated by the terms of the instrument under which the plan is operated;
   >
   > "(ii) if an administrator is not so designated, the plan sponsor; or
   >
   > "(iii) in the case of a plan for which an administrator is not designated and a plan sponsor cannot be identified, such other person as the Secretary may by regulation prescribe."

   b. **ERISA administrators are not managing administrators:** The definition above differs from the ordinary usage of "administrator" in the employee benefits community. Third party administrators and the managers of self-administered plans are not always ERISA "administrators" (although they are almost always fiduciaries because of their functions). In Taft-Hartley plans, the Board of Trustees is almost always the ERISA administrator. For single employer plans, the administrator is typically the plan sponsor (i.e., the employer), unless another person is specifically so designated in the plan documents. *See* ERISA § 3(16)(B), 29 U.S.C. § 1002(16)(B) ("The term 'plan sponsor' means . . . the employer in the case of an employee benefit plan established or maintained by a single employer. . . .").

(1) **Examples of nonfiduciary functions of managing administrators:** An early DOL Q&A, 29 C.F.R. § 2509.75-8, gives examples of the kinds of services that administrators and recordkeepers perform that are nonfiduciary in nature:

> "D-2 Q: Are persons who have no power to make any decisions as to plan policy, interpretations, practices or procedures, but who perform the following administrative functions for an employee benefit plan, within a framework of policies, interpretations, rules, practices and procedures made by other persons, fiduciaries with respect to the plan:
>
> "(1) Application of rules determining eligibility for participation or benefits;
>
> "(2) Calculation of services and compensation credits for benefits;
>
> "(3) Preparation of employee communications material;
>
> "(4) Maintenance of participants' service and employment records;
>
> "(5) Preparation of reports required by government agencies;
>
> "(6) Calculation of benefits;
>
> "(7) Orientation of new participants and advising participants of their rights and options under the plan;
>
> "(8) Collection of contributions and application of contributions as provided in the plan;
>
> "(9) Preparation of reports concerning participants' benefits;

"(10) Processing of claims; and

"(11) Making recommendations to others for decisions with respect to plan administration?

"A: No. Only persons who perform one or more of the functions described in section 3(21)(A) of the Act with respect to an employee benefit plan are fiduciaries. Therefore, a person who performs purely ministerial functions such as the types described above for an employee benefit plan within a framework of policies, interpretations, rules, practices and procedures made by other persons is not a fiduciary because such person does not have discretionary authority or discretionary control respecting management of the plan, does not exercise any authority or control respecting management or disposition of the assets of the plan, and does not render investment advice with respect to any money or other property of the plan and has no authority or responsibility to do so. . . ."

D. **Nonfiduciaries:**

1. **Plan professionals and service providers:** Plan professionals and service providers are not fiduciaries except in unusual circumstances. A Q&A in an early DOL interpretive bulletin, at 29 C.F.R. § 2509.75-5, remains valid and instructive:

"D-1 Q: Is an attorney, accountant, actuary or consultant who renders legal, accounting, actuarial or consulting services to an employee benefit plan (other than an investment adviser to the plan) a fiduciary to the plan solely by virtue of the rendering of such services, absent a showing that such consultant (a) exercises discretionary authority or discretionary control respecting the management of the plan, (b) exercises authority or control respecting management or disposition of the

plan's assets, (c) renders investment advice for a fee, direct or indirect, with respect to the assets of the plan, or has any authority or responsibility to do so, or (d) has any discretionary authority or discretionary responsibility in the administration of the plan?

"A: No. However, while attorneys, accountants, actuaries and consultants performing their usual professional functions will ordinarily not be considered fiduciaries, if the factual situation in a particular case falls within one of the categories described in clauses (a) through (d) of this question, such persons would be considered to be fiduciaries within the meaning of section 3(21) of the Act."

a. **Representative decisions**: *Chapman v. Klemick*, 3 F.3d 1508 (11th Cir. 1993) (attorney); *Painters of Philadelphia District Council No. 21 Welfare Fund v. Price*, 879 F.2d 1146 (3d Cir. 1989) (accountant); *Pappas v. Buck Consultants, Inc.*, 923 F.2d 531 (7th Cir. 1991); *Schloegel v. Boswell*, 994 F.2d 266 (5th Cir. 1993) (insurance agent); *Beddall v. State Street Bank and Trust Co.*, 137 F.3d 12 (1st Cir. 1998) (custodial bank); *Farm King Supply Inc. Integrated Profit Sharing Plan & Trust v. Edward D. Jones & Co.*, 884 F.2d 288 (7th Cir. 1989) (broker-dealer which did not give investment advice for a fee).

b. **Exception when functional fiduciary:** Plan professionals and providers will be considered fiduciaries if they exercise discretion or control over plan assets or over the plan's management and administration, even if the exercise of these fiduciary functions is unauthorized. *See, e.g., David P. Coldesina Employee Profit Sharing Plan and Trust v. Estate of Simper*, 407 F.3d 1126 (10th Cir. 2005) (accountant was ERISA fiduciary because he held assets in a bank account of which he was the sole signatory and exercised judgment in naming the payee); *Reich v. Lancaster*, 55 F.3d 1034 (5th Cir. 1995) (insurance broker was ERISA fiduciary because his "influence was so great" over the trustees that "it confers effective discretionary authority").

c. **Liability continues under state negligence laws:** Plan professionals and providers remain liable for malpractice, negligence and other torts under state laws. *See, e.g., Gerosa*

v. Savesta & Co., 329 F.3d 317 (2d Cir. 2003) (ERISA did not preempt “run-of-the-mill” state law malpractice claim against actuary).

2. **Mutual fund managers:** In most instances, mutual fund managers are not fiduciaries.

   a. **No control and not advisors:** Mutual funds and brokers making investments at the direction of an investment consultant usually are not fiduciaries because they do not have discretionary authority over plan assets and they do not provide investment advice for a fee. *Harris Trust & Sav. Bank v. Salomon Bros, Inc.*, 530 U.S. 238, 120 S.Ct. 2180, 147 L. Ed. 3d 187 (2000).

      For example, 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 that they were alleged to have fraudulently misappropriated fund assets meant for purchase of other assets 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).

   b. **Less than 25% ERISA funds:** DOL regulations 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 are held by benefit plans. The rule creates a bright-line test of when an asset is considered to be owned by an employee benefit plan and therefore subject to the fiduciary duties of Title I of ERISA. DOL Regs. § 2510.3-101, 29 C.F.R. § 2510.3-101.

      (1) **A case in point:** In *Ennis v. Montemayor*, 14 F. Supp. 2d 379 (S.D.N.Y. 1998), the court found that, pursuant to Department of Labor regulations, the manager of an investment fund was not a fiduciary under Section 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 that 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 Department of Labor regulations defining what constitutes significant participation in an entity by ERISA benefit plan investors.

The court also found that 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. As 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 non-fiduciary 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.

(2) **PPA changes:** The 25% test was long criticized by the securities industry because it added government, foreign and other non-ERISA plans into the 25% test. The PPA adds new Section 3(42), 29 U.S.C. § 1002(42), which defines and limits a "benefit plan investor" to ERISA plans for purposes of determining which plans are plan investors under the 25% test.

3. **Banks and broker-dealers:**

a. **Not liable if no advice given:** Banks and broker-dealers usually are not ERISA fiduciaries. In one court decision, for example, 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. *Chee v. Marine Midland Bank, N.A.*, Fed. Sec. L. Rep. (CCH) ¶ 95806, 1991 WL 15301 (E.D.N.Y. 1991), *applying* DOL Regs. § 2510.3-21(d)(1), 29 C.F.R. § 2510.3-21(d)(1).

b. **Broad SEC broker-dealer exemption found invalid:** In March 2007, the District of Columbia Court of Appeals struck down a 2005 SEC rule that broadly exempted broker-dealers receiving special compensation for investment advice from regulation under the IAA if the advice was solely incidental to brokerage services provided on a customer's account and specific disclosure was made to the customer. *Financial Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007). The exemption, allowed broker-dealers to offer their clients fee-based brokerage accounts without first registering those accounts with the SEC under the IAA and without being held to IAA's fiduciary standards.

4. **Implications for trustees of mutual fund managers,' banks' and brokers' nonfiduciary status:** 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.

III. **FIDUCIARY DUTIES:** ERISA imposes a number of fiduciary duties on individuals and entities that are responsible for the administration and management of employee benefit plans.

A. **The exclusive benefit rule, aka the duty of loyalty:** ERISA requires plan fiduciaries, including trustees, to act solely in the interest of plan participants and beneficiaries, with due regard for administrative costs. ERISA § 404(a)(1)(A), 29 U.S.C. § 1140(a)(1)(A). Similarly, ERISA provides that "the assets of a plan shall never inure to the benefit of any employer, and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." ERISA § 403(c)(1), 29 U.S.C. § 1103(c)(1).

B. **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).

1. **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.

2. **An example: prudent investing:**

   a. **There are no prohibited classes of investments:** The inquiry is whether the trustees properly investigated and considered the merits of a proposed investment or investment strategy before authorizing the investment. *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 readily liquidatable, provided that the trustees comply with the processes described in the DOL regulations in reaching their decision to invest in such assets.

   b. **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 who made the investment decision will be found to have acted prudently if they followed prudent procedures and carefully documented them. *Brock v. Robbins*, 830 F.2d 640, 648.

   c. **Defining prudent procedures:** With respect to plan investments, the 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 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 Regs. § 2550.404a-1(b)(1)(i), 29 C.F.R. § 2550.404a-1(b)(1)(i). The fiduciary must then act in accordance with the foregoing analysis. DOL Regs. § 2550.404a-1(b)(1)(ii), 29 C.F.R. § 2550.4041-1(b)(1)(ii). 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.

d. **Required analysis:** In determining whether to make or continue an investment, a fiduciary must:

(1) "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 Regs. § 2550.404a-1(b)(2)(i), 29 C.F.R. § 2550.4041-1(b)(2)(i).

(2) 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."

DOL Regs. § 2550.404a-1(b)(2)(ii), 29 C.F.R. § 2550.4041-1(b)(2)(ii).

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

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

(1) Evaluation of the specific needs of the plan and its participants;

(2) Investment objectives and goals;

(3) Standards of investment performance/benchmarks;

(4) Classes of investment authorized;

(5) Styles of investment authorized;

(6) Diversification of portfolio among classes of investment, among investment styles and within classes of investment;

(7) Restrictions on investments;

(8) Directed brokerage;

(9) Proxy voting;

(10) Standards for reports by investment managers and investment consultants on performance, commission activity, turnover, proxy voting, and compliance with investment guidelines;

(11) Policies and procedures for the hiring of an investment manager; and

(12) 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 http://www.dol.gov/ebsa/adcoun/srvpro.htm.

b. **Guidelines for investment managers:** The DOL also suggests that plans maintain separate written investment guidelines for each money manager. DOL Interpretive Bulletin 94-2, 29 C.F.R. 2509.94-2 (July 29, 1994), at http://www.dol.gov/dol/allcfr/title_29/Part_2509/29CFR2509.94-2.htm.

C. **The duty to diversify:** ERISA imposes an additional fiduciary obligation specifically applicable to plan investments. As an adjunct to the "prudent man" rule, 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).

1. **Purpose:** 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. *Brock v. Citizens Bank of Clovis*, 841 F.2d 344 (10th Cir. 1988) (investment of 85% of plan assets in mortgage loans).

2. **Scope:** 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.

3. **404(c) plans:** For participant-directed plans (discussed in greater detail at page 20 below), investment options must be adequately diversified. The regulations under Section 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 Regs. § 2550.404c-1(c)(3), 29 C.F.R. § 2550.404c-1(c)(3).

IV. FIDUCIARY LIABILITY:

A. **Basic Rule:** A fiduciary is "personally liable to make good to such plan any losses to the plan" caused by a breach of fiduciary duty, and must restore any profits made through his or her improper use of plan assets. A breaching fiduciary is also "subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary." ERISA § 409(a), 29 U.S.C. § 1109(a).

1. **Jurisdiction and remedies:**

a. **Relief to the plan:** ERISA authorizes the Secretary of Labor, a plan participant or beneficiary, or another plan fiduciary to sue in federal court "for appropriate relief under Section 409"

to redress violations of the ERISA's fiduciary responsibility provisions. ERISA § 502(a)(2) and (e)(1), 29 U.S.C. § 1132(a)(2), (e)(1). The Supreme Court has held that this section authorizes relief for the benefit of a plan only, and relief cannot flow directly to individual plan participants. Individuals who sue under Section 502(a)(2) may do so only on behalf of the plan as a whole. *Massachusetts Mutual Life Ins. Co. v. Russell*, 473 U.S. 134 (1985).

b. **Relief to the individual:** ERISA also permits a plan participant or beneficiary, or another plan fiduciary, to sue in federal court to enjoin an act or practice that violates Title I of ERISA (including ERISA's fiduciary duty requirements) or the terms of the plan, or "to obtain other appropriate equitable relief" to redress the violation. ERISA § 502(a)(3) and (e)(1), 29 U.S.C. § 1132(a)(3), (e)(1). In *Varity Corp. v. Howe*, 516 U.S. 489 (1996), the Supreme Court ruled that Section 502(a)(3) authorizes individualized equitable relief for fiduciary breaches that Section 502 does not adequately remedy elsewhere.

(1) **Damages unavailable:** In *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993), the Supreme Court ruled that Section 502(a)(3) of ERISA, 29 U.S.C. § 1132(a)(3), provides only for traditional equitable relief (for example, injunctive relief and monetary remedies such as restitution and disgorgement), but not for damages. The lower courts have struggled to agree on what is "equitable" relief under *Mertens*.

(a) A decision from the Seventh Circuit held that a Section 502(a)(3) suit against a claims administrator who failed to timely process claims forms causing them to fall outside the coverage window could not recover payments incurred by the participants because such relief is "damages" rather than "appropriate equitable relief." *Buckley Dement, Inc. v. Travelers Plan Administrators*, 39 F.3d 784 (7th Cir. 1994).

(b) In contrast, a Third Circuit panel held that plaintiffs were entitled to an injunction ordering specific performance of assurances of lifetime benefits and restitution of back benefits. *In re*

Unisys Corporation Retiree Medical Benefit "ERISA" Litigation, 57 F.3d 1265 (3d. Cir. 1995).

(2) **Plaintiff must suffer loss:** Section 409(a), 29 U.S.C. § 1109(a), has been consistently interpreted to mean that no monetary relief is available if the plaintiff did not suffer actual monetary losses as a result of the fiduciary breach. *See, e.g., Friend v. Sanwa Bank California*, 35 F.3d 466 (9th Cir. 1995).

(3) **Disgorgement:** The courts have ordered disgorgement of profits obtained through a fiduciary breach based on Section 409(a). *Lowen v. Tower Asset Management*, 829 F.2d 1209, 1221 (2d Cir. 1987). In *Amalgamated Clothing & Textile Workers Union v. Murdock*, 861 F.2d 1406 (9th Cir. 1988), the court held that a constructive trust could be imposed for the benefit of former plan participants and beneficiaries on profits allegedly obtained through fiduciary breaches, even though the plan had terminated and the participants had received distributions of their full accrued defined benefits.

(4) **Injunctions:** Preliminary and permanent injunctive relief can be order against breaching fiduciaries. *See, e.g., Beck v. Levering*, 947 F.2d 639 (2d Cir. 1991) (upholding permanent injunction against principals of investment firm from ever serving as fiduciaries or service providers to ERISA plans); *Martin v. Feilen,* 965 F.2d 660 (8th Cir. 1992) (holding that it was an abuse of discretion for district court *not* to issue injunction barring individuals from providing fiduciary or other services to ERISA plans).

(5) **Prejudgment interest:** ERISA does not provide for awards of prejudgment interest, except in actions by multiemployer plans to collect delinquent employer contributions. ERISA §§ 515 and 502(g)(2}, 29 U.S.C. §§ 1145, 1132(g)(2). Applying the common law, however, courts have ruled that an award of prejudgment interest is within the court's discretion in other ERISA cases, including fiduciary breach claims. *See Nelson v. EG&G Energy Measurements Group*, 37 F.3d 1384 (9th Cir.1994*)* (prejudgment interest is intended to cover the

lost investment potential of funds to which the plaintiff was entitled, from the time of entitlement to the date of judgment).

(6) **Attorney's fees and costs:** The court, in its discretion, can award attorney's fees and litigation costs to either party in a Section 502(a) suit. ERISA § 502(g)(1), 29 U.S.C. § 1132(g)(1).

B. **Co-fiduciary liability:**

1. **Fiduciaries ordinarily are not liable for a co-fiduciary's breach:** If the Plan's fiduciaries allocate responsibilities in accordance with the plan, a fiduciary will not be liable for the acts and omissions of other named fiduciaries in carrying out fiduciary responsibilities which have been allocated to them, except that:

a. **Liability for participation or knowing inaction:** Under Section 405(a) of ERISA, 29 U.S.C. § 1105(a), a fiduciary will be liable for another fiduciary's breaches in the following circumstances:

(1) If the fiduciary participates "knowingly in, or knowingly undertakes to conceal" a breach, while knowing it is a breach. Section 405(a)(1), 29 U.S.C. § 1105(a)(1).

(2) If the fiduciary fails to comply with his or her own fiduciary duties, and thereby enables another fiduciary to commit a fiduciary breach. Section 405(a)(2), 29 U.S.C. § 1105(a)(2).

(3) If the fiduciary knows that a breach has occurred and fails to "make reasonable efforts under the circumstances to remedy the breach." 29 U.S.C. § 404(a)(3), 29 U.S.C. § 1105(a)(3).

b. **Named fiduciary's liability for improper allocation or designation of responsibilities:** Under Section 405(c)(2)(A) of ERISA, 29 U.S.C. § 1105(c)(2)(A), relating to standards for establishment and implementation of allocation or designation procedures, a named fiduciary may be liable for another fiduciary's failure to carry out his or her duties if the named fiduciary failed to comply with the plan's allocation or designa-

tion procedures or continued the allocation or designation notwithstanding the second fiduciary's breach.

2. **Actual vs. constructive knowledge:** The courts are split on whether a co-fiduciary must have *actual* knowledge of the fiduciary's breach. *Contrast Davidson v. Cook*, 567 F. Supp 225, 233 (E.D. Va. 1983), *aff'd mem*. 734 F.2d 10 (4th Cir. 1984) (actual knowledge required), *with Diduck v. Kaszycki & Sons Contractors, Inc.*, 974 F.2d 270, 283 (2d Cir. 1992) (holding that a "defendant who is on notice that conduct violates a fiduciary duty is chargeable with constructive knowledge of the breach if a reasonably diligent investigation would have revealed the breach.").

C. **Nonfiduciary liability:** Although ERISA imposes duties only on fiduciaries of covered plans, the Supreme Court has held that a non-fiduciary may be held liable under Section 502(a)(3) of ERISA, 29 U.S.C. § 1132(a)(3), for participating in a prohibited transaction. *Harris Trust & Savings Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 245 (2000); *see also Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209 (2d Cir. 1987).

1. **Statutory penalty:** Section 502(l)(1)(B) of ERISA, 29 U.S.C. § 1132(l)(1)(B), imposes a civil penalty on non-fiduciaries for knowing participation in a fiduciary breach.

V. **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.

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

1. **Duty to seek expert advice:** 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).

2. **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).

B. **Fiduciary status:**

1. **ERISA:** While some consultants from large investment firms disclaim fiduciary status in their contracts, they nonetheless are fiduciaries under ERISA to the extent that 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).

2. **Regulations:** The DOL considers investment consultants to be fiduciaries. The regulations provide that 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 that 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 C.F.R. § 2510-3-21.

VI. TRUSTEES' DUTY TO PRUDENTLY SELECT AND MONITOR INVESTMENT MANAGERS AND CONSULTANTS:

A. **Fiduciary duty:** Trustees have a fiduciary duty to prudently select and prudently monitor plan providers, including investment managers and consultants. As the Department of Labor 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 http://www.dol.gov/ebsa/regs/AOs/ao2002-08a.html.

B. **Liability:** Fiduciaries remain personally liable if they select or retain an investment manager or consultant when it is not prudent to do so. *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).

VII. PARTICIPANT-DIRECTED INVESTMENTS:

A. **Statutory authority:** 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).

B. **Requirements:** To acquire this protection from fiduciary liability, the plan must comply with the more than 20 detailed requirements of Section 2550.404c-1 of the DOL regulations, 29 C.F.R. § 2550.404c-1. These requirements include allowing a participant a reasonable opportunity to exercise independent control over 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.

1. **Core alternatives:** 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 Regs. § 2550.404c-1(b), 29 C.F.R. § 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." *Id.*

2. **Opportunity to change investments:** The plan must also enable participants to transfer among the investment alternatives at least quarterly. DOL Regs. § 2550.404c-1(b)(ii)(C)(i), 29 C.F.R. § 2550.404c-1(b)(ii)(C)(i).

3. **Information, not education:** 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 Regs. § 2550.404c-1(b)(2)(B), 29 C.F.R. § 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.

C. **Most plans do not comply with Section 404(c):** The protections of Section 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, many fail to notify participants in writing of the identity of the Section 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. And most do not provide for all investment alternatives a description of all transaction fees (e.g., commissions, sales loads, deferred sales charges, redemption and exchange fees) and annual operating expenses (e.g., investment management fees, administrative fees, and transaction costs) that can affect participants' account balances.

D. ***Jenkins v. Yager*: a possible protection from fiduciary liability when safe harbor requirements are not met:** One court of appeals decision finds that, at least in some instances, trustees are shielded from liability for investment losses even if the plan does not meet all requirements of Section 404(c) or the DOL regulations, provided the trustees otherwise prudently

selected and monitored plan investments. *Jenkins v. Yager*, 444 F.3d 916 (7th Cir. 2006).

1. **The court's holding:** According to the decision, Section 404(c) (providing for participant-directed investments) creates an unwritten, implied exception to Section 403(a)'s rule that investment decisions cannot be delegated to participants. If the trustees act prudently in selecting and monitoring the investments offered participants, they can avoid personal liability even if they do not comply with Section 404(c)'s and the DOL's requirements for the safe harbor for participant-directed elections.

2. **Conflicting ERISA provisions:** The decision attempts to harmonize two 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. Section 404(c), in contrast, permits trustees to avoid fiduciary liabilities by creating participant-directed plans. The issue in *Jenkins v. Yager* was whether trustees are fiduciarily liable if a participant-directed plan does not meet the requirements of Section 404(c) or the DOL regulations, but the trustees nonetheless prudently selected and monitored all the investment alternatives.

    a. The violation of Section 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.

3. **The implied exception:** The court of appeals ruled that Section 404(c) and the DOL regulations are not the only possible means by which trustees can escape liability in 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 at page 11 above.

VIII. QDIAs: A SAFE HARBOR FOR DEFAULT FUNDS:

A. **Pre-PPA regulations:** Until the PPA, relief from fiduciary liability under Section 404(c) was available only when a participant actually exercised control. ERISA § 404(c)(1), 29 U.S.C. § 1104(c)(1). If a participant fails or

refuses to select investments, the trustees of a participant-directed plan must choose the investments for the participant. Until 2007, the trustees were responsible as fiduciaries for their choice of "default" investments for the participant.

B. **The PPA's safe harbor for QDIAs:** As part of the PPA, Section 404(c) was amended effective for plan years beginning after December 31, 2006 to extend the same safe harbor protection for participant-selected investments given by the Section 404(c)(1) to fiduciaries that invest participant assets in "qualified default investment alternatives" ("QDIAs") in the absence of participant investment direction. Specifically, Section 624(a) of the PPA added a new section 404(c)(5) to ERISA. Section 404(c)(5)(A) of ERISA provides that for purposes of Section 404(c)(1) of ERISA, a participant in a defined contribution plan will be treated as exercising control over the assets in the account with respect to the amount of contributions and earnings which, in the absence of an investment election by the participant, are invested by the plan in accordance with final regulations to be prescribed by the Secretary of Labor.

C. **The proposed DOL regulations:** On September 27, 2006, the EBSA issued proposed regulations (http://edocket.access.gpo.gov/2006/pdf/06-8282.pdf) that would relieve plan sponsors of fiduciary liability if they meet six notice and investment standards:

1. **Requirements for QDIAs:** Default funds must be QDIAs, which are defined to include lifecycle funds, targeted retirement date funds, balanced funds, and professionally managed accounts. The funds must be diversified to minimize the risk of unquantified large losses. No investments can be made in employer stock (with exceptions for certain publicly traded securities and for matching funds); and there can be no financial penalties or other restrictions imposed on employees who later choose to exercise control over their accounts. In addition, the funds must be managed by registered investment managers.

2. **Actual participant default:** Employees and beneficiaries must have been given an opportunity to choose investment options, but failed to do so.

3. **Notice requirements:** Employees and beneficiaries must be given notice at least 30 days in advance of the first investment, and at least 30 days in advance of each plan year thereafter containing:

a. A description of the circumstances under which assets would be invested in a QDIA;

b. a description of the investment objectives of the QDIA; and

c. an explanation of the right of participants and beneficiaries to direct their investments out of the default investment.

Plans could satisfy these responsibilities in a summary plan description or summary of material modifications.

4. **Prospectuses:** Any material, such as investment prospectuses and other notices, provided to the plan by the QDIA would need to be furnished to employees and beneficiaries.

5. **Opportunity to self-direct:** Employees and beneficiaries must have an opportunity to direct investments out of the QDIA as often as other employees but no less than quarterly, and as often as daily.

6. **Diversity:** The plan must offer a broad range of investment alternatives (this is a current Section 404(c) requirement).

D. The DOL regulations will not be effective until 60 days after final regulations are issued.

IX. INVESTMENT ADVICE SAFE HARBOR:

A. **Prohibited transaction issues:** The prohibited transaction provisions of Section 406 of ERISA, 29 U.S.C. § 1106, prohibit:

1. Various transactions between a plan and persons who are “parties in interest” (as defined in Section 3(14) of ERISA, 29 U.S.C. § 1002(14)) with respect to the plan, and

2. A fiduciary from dealing with assets of the plan in his own interest or for his own account, or receiving any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

B. **Definitions:** Section 601(a) of the PPA adds new sections 408(b)(14) and 408(g) of ERISA, 29 U.S.C. §§ 1108(b)(14), (G). Section 408(b)(14) provides relief from the prohibited transaction rules for certain kinds of investment

advice to participants if the requirements of new section 408(g) are met. Under section 408(g), subsection (b)(14) applies if the investment advice is provided by a "fiduciary adviser" under an "eligible investment advice arrangement."

1. **Fiduciary adviser:** A "fiduciary adviser" is a person who is providing specific investment advice to plan participants (not to be confused with an investment fiduciary, who is providing investment advice to the plan sponsor).

2. **Eligible investment advice arrangement:** An "eligible investment advice arrangement" must be a computer-driven advice model or be fee neutral (i.e., the fiduciary adviser's compensation may not be affected by which fund group, share class or asset mix is selected).

C. **Safe harbor:** The requirements for the new participant advice safe harbor are:

1. The plan sponsor must prudently select a qualified fiduciary adviser,

2. The fiduciary adviser must acknowledge fiduciary status in writing and disclose all conflicts of interest and forms of compensation,

3. The plan sponsor must determine that the fiduciary adviser's eligible investment advice arrangement is appropriate for the plan's participants, and

4. The plan sponsor must prudently monitor the fiduciary adviser and ensure that both the arrangement between the plan sponsor and the fiduciary adviser, and the eligible investment advice arrangement, are audited on an annual basis.

D. For further information, see DOL Field Assistance Bulletin No. 2007-01 (February 2, 2007), at http://www.dol.gov/ebsa/regs/fab_2007-1.html.

X. AUTOMATIC ENROLLMENT FOR 401(k) PLANS:

A. **Pre-PPA regulations:** Ordinarily, 401(k) plan participants must affirmatively elect to defer a portion of their wages as employee contributions. Beginning in 1998, however, IRS guidance permitted employers to deduct employee contributions from the paychecks of new and current non-participating employees under an "automatic enrollment" or "negative election" program.

The most important requirements were that the employees must be notified of the automatic deduction and given an opportunity to change their contribution or opt out at any time. *See* Rev. Rul. 98-30; Rev. Rul. 2000-8; 26 C.F.R. § 1.401(k)-1(a)(3)(ii).

B. **Automatic enrollment under the PPA:** Section 902 of the PPA provides new requirements for 401(k) plan ”qualified automatic contribution arrangements” (“QACAs”) with the added benefit that they can automatically meet ERISA nondiscrimination and top-heavy rules, and explicitly preempts state laws that restrict involuntary redirection of wages. The PPA requires that notices be given to employees explaining:

   1. Employees’ rights to opt out of automatic employee contributions or to elect a different amount or percentage; and

   2. How the contributions will be invested in the absence of an investment election.

C. **Return of contributions:** The employer may return automatic contributions to participants, but only if they elect to receive the “erroneous automatic contribution” within 90 days after the first automatic contribution was made.

D. **Safe harbor requirements:** Starting with the 2008 plan year, the PPA creates a new safe harbor for automatic contribution arrangements to avoid ADP and ACP testing.

   1. **ADP safe harbor requirements:** In addition to complying with the above-described notice and opt-out requirements, a plan wishing to take advantage of the new ADP safe harbor must meet the following requirements:

      a. **Automatic deferral:** The arrangement must treat each eligible employee as having elected to make deferrals equal to a uniformly applied percentage of compensation of at least but not more than 10% for the first plan year the deemed election applies to the employee. For the second plan year, the minimum deferral percentage increases to 4% and continues to increase by 1% each plan year until the minimum deferral percentage is 6% for the fourth and succeeding years.

      b. **Current employees:** The employer need not automatically make contributions for current employees who have already elected whether or not to contribute to the plan.

c. **Matching or nonelective contributions:** Plans must provide for either employer safe harbor matching contributions or employer safe harbor nonelective, profitsharing contributions.

(1) **Basic matching contributions:** An employer must match 100% of elective contributions of non-highly compensated employees ("NHCEs") up to 1% of compensation, plus 50% of elective contributions between 1% and 6% of compensation, for a maximum matching contribution equal to 3½% of compensation.

(2) **Alternative matching contributions:** A plan can use an alternative formula for matching contributions, provided that the rate of employer matching contributions does not increase as an employee's rate of elective contributions increases. In addition, the alternative design must be at least as generous for each rate of contributions as the basic method.

(3) **Nonelective contributions:** Instead of matching contributions, a qualified automatic contribution arrangement can provide for an employer nonelective profit-sharing contribution of at least 3% of compensation for all NHCEs eligible to participate in the plan, regardless of whether the employees make elective deferrals.

d. **Vesting:** Employer matching and nonelective contributions must be fully vested after two years of service.

e. **Distribution restrictions:** Plans must limit the distribution of safe harbor matching and nonelective contributions in the same manner as employee elective contributions.

E. **ACP safe harbor requirements:** To satisfy the ACP safe harbor requirements, in addition to complying with the provisions above, a plan cannot:

1. match contributions above 6% of compensation,

2. increase the rate of matching contributions as an employee's elective contributions increase, or

3. provide a higher matching rate for HCEs than for NHCEs.

F. **Top heavy rules:** A plan that satisfies the new safe harbor rules and does not provide for additional employer contributions will not be considered top heavy.

G. **Growing acceptance of automatic enrollment:** According to survey results from Hewitt's 2007 "Hot Topics in Retirement," 36% percent of surveyed 401(k) plan sponsors have adopted automatic enrollment, up from 24% in 2006. Fully 55% of plan sponsors who have not adopted automatic enrollment say they are very likely or somewhat likely to offer it to new hires in 2007, and 26% state they may offer it to current non-participants as well.

XI. FUND COSTS:

A. **Duty to monitor:** Trustees have an ongoing fiduciary obligation to monitor fees charged by investment managers, mutual funds and other providers. *Liss v. Smith*, 991 F. Supp. 278 (S.D.N.Y. 1998); *Whitfield v. Cohen*, 682 F. Supp. 188 (S.D.N.Y. 1988). Recent litigation and regulatory initiatives aimed at excessive fees are discussed beginning at page 36 below.

B. **High fees undermine performance:**

1. **Traditional pension plans outperform mutual fund-dependent 401(k) plans:** According to a recent study, mutual funds lag actively-managed pension funds by an average of 250 basis points. Frehen, Rik G.P., Bauer, Rob, Otten, Roger and Lum, Hubert, "The Performance of US Pension Funds" (February 26, 2007), available at SSRN: http://ssrn.com/abstract=965388. According to the authors, the difference is a combination of observable and hidden mutual fund costs.

2. **Provider fees typically exceed true costs:** Stephen J. Butler of Pension Dynamics Corp., testified before a Congressional committee in March 2007 regarding the impact of excessive fees on retirement savings. He estimated that the annual recordkeeping and compliance costs for a professional firm with 50 employees and $3 million in 401(k) assets should break down to about $130 per employee. Adding in the actual cost of money management, the plan's total yearly cost should be $7,800. But the typical 401(k) vendor would charge the firm $36,500. Some providers would charge $60,000, which represents 2 percent of assets. Butler estimated that excessive fees over the past 20 years have reduced the average 401(k) account balance by 15

percent. Butler's testimony can be found at http://edlabor.house.gov/testimony/030607StephenButlertestimony.pdf

3. **Reasonable fees often become excessive over time:** As plan assets grow, recordkeeper fees based on a percentage of plan assets may become excessive. The plan may also become eligible for a lower-fee class of shares. If fiduciaries fail to negotiate for lower recordkeeper fees and share classes, they are vulnerable to charges that they breached their fiduciary duty. In addition, large plans relying exclusively on mutual funds face potential claims that plan assets have grown so large that the plan sponsor or fiduciaries could invest in collective or synthetic funds at dramatically lower cost.

4. **The DOL's example:** The Department of Labor has recognized that investment management fees can significantly reduce participants' account balances. It gives this widely-quoted 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 percent and fees and expenses reduce your average returns by 0.5 percent, 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 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent."

DOL, A Look at Plan Fees, at http://www.dol.gov/ebsa/ publications/401k_employee.html.

In addition, 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.

C. **Trustees' fiduciary obligations:** 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:

1. Establish a prudent process for selecting investment alternatives and service providers;

2. 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;

3. Select investment alternatives that are prudent and adequately diversified; and

4. Monitor investment alternatives and service providers once selected to see that they continue to be appropriate choices. *Id.*

DOL, "A Look at Plan Fees," at http://www.dol.gov/ebsa/ publications/401k_ employee.html.

D. **DOL checklist:** The 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/401-kfefm.pdf.

E. **Contents of fee agreements:** Plan sponsors and trustees should have written agreements with all service providers, including investment representatives. All fee agreements should contain the following provisions:

1. **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.

2. **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.

3. **100% rebates:** The broker or financial advisor should agree that all available revenue sharing payments by mutual funds go to the plan, either as a credit against costs or as a direct payment to the plan.

4. **Revenue neutrality:** The broker or consultant should receive the same payment from the funds regardless of the investment options selected.

F. **Fee terminology:**

1. **"Expense ratios":**

a. **Definition:** 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.

b. **Use:** 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. Smaller funds and international funds usually have higher expense ratios than larger funds.

c. **Effect:** 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 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.

2. **12b-1 Fees:**

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

b. **Use:** Rule 12b-1 allows mutual funds to pay distribution and marketing expenses out of fund assets. Since the adoption of Rule 12b-1, mutual funds have passed on 12b-1 fees, often in combination with back-loaded redemption charges (such as contingent-deferred sales charges), as an alternative to using front-end sales loads to compensate or reward 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.

c. **Limits:** 12b-1 fees are limited to 1% annually with a maximum of 0.25% going to brokers.

d. **Disclosure:** While sometimes cast as a "hidden fee," 12b-1 fees are in fact disclosed in a mutual fund's prospectus. Terminology is deceptive, however. A fund is allowed to advertise itself as a "no-load" fund although 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.

3. **Section 28(e) Fees:**

a. **Statutory authority and operation:** 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. DOL, "Statement on Policies Concerning Soft Dollars and Directed Commissions Arrangements," ERISA Technical Release No. 86-1 (May 22, 1986), at http://www.occ.treas.gov/ftp/tbc/tbc-25b.txt.

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

4. **"Finders fees":** Some mutual fund groups pay finders fees to brokers for the placement of money in their investments. Finders fees can be a very attractive revenue-sharing vehicle for a plan since they are entirely paid by the fund family. Unfortunately, finders fees often are kept secret by the fund or broker or are hidden in expense ratios.

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

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

   a. **Types:** 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.

7. **"Group annuity" 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, typically a variety of mutual funds. DOL, "A Look at 401(k) Plan Fees," at http://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.

8. **“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, and they sometimes are charged for services that in actuality are performed by the plan administrator.

9. **“Subtransfer 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 at page 35, ERISA plans can benefit by revenue-sharing arrangements that allow them to recover sub-t/a and similar fees from mutual funds and use them to defer recodkeeping and other costs.

G. **Reducing administrative costs through revenue-sharing arrangements:**

1. **Revenue-sharing:** Revenue-sharing ordinarily involves payments between service providers. Revenue-sharing payments are most often computed as a percentage of assets paid to service providers (such as recordkeepers, investment managers, third party administrators and trustees), and are part of a mutual fund’s expense ratio.

2. **Revenue-sharing arrangements benefitting plans:** Plans increasingly negotiate rebates of fees charged by mutual fund companies, often to offset the costs of unused services offered by fund families that are performed by the plan’s financial consultant, recordkeeper, or third party administrator instead of the mutual fund. The rebates may include the costs of unused services performed by outside entities hired by the mutual fund, including sub-t/a, finder’s, management and servicing fees. This kind of revenue-sharing can serve as an important revenue source for a plan.

   a. **Revenue-sharing payments should go to the plan, not the provider:** The DOL permits a fiduciary with control over a

plan's investment selection to collect revenue-sharing payments on behalf of the plan, but the fiduciary 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 http://www.dol.gov/ebsa/programs/ori/advisory97/97-15a.htm. In a later opinion, the DOL clarified that a directed trustee with no discretion over plan assets that did not give investment advice could keep revenue-sharing payments. Advisory Op. 2003-09A (June 25, 2003), at http://www.dol.gov/ebsa/regs/aos/ao2003-09a.html.

b. **Examples:**

(1) **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 must be disclosed by the recordkeeper.

(2) **Rebates for education services:** A plan's financial advisor, rather than the fund company, may provide educational services and field inquiries from partici-

pants. A mutual fund company may be willing to reimburse the plan for the fees that it ordinarily charges investors for this service. Any such reimbursement should be disclosed by the financial advisor.

XII. EXCESSIVE FEES AS A FIDUCIARY BREACH: RECENT LITIGATION AND REGULATORY EFFORTS:

A. **Fiduciary duty litigation:** In recent months, lawsuits have been filed against more than a dozen big companies, including Boeing, Lockheed-Martin, International Paper, Caterpillar and Kraft Foods, claiming that these employers have allowed their 401(k) plan managers to charge excessive fees.

1. **Participant suits against trustees and plan sponsors:** The litigation targets fiduciaries and sponsors of single employer plans, as well as providers. Some lawsuits assert that plan fiduciaries have violated ERISA's mandate to invest plan assets as experts would, by failing to monitor and control fees, resulting in excessive fees charged to the plan or against mutual fund assets. The complaints allege that the employer is in fact a fiduciary on the theory that it exercised discretionary control over plan assets, management and operation. The complaints also typically assert that the fiduciaries failed to properly inform participants about the fees, thereby forfeiting Section 404(c)'s safe harbor protection that otherwise insulates fiduciaries from losses resulting from participant-directed investments.

2. **Trustee suits against providers for undisclosed revenue sharing:** Plan fiduciaries are also beginning to sue investment providers for undisclosed fee sharing arrangements. In one widely-publicized case, the trustees of five plans sued Nationwide Financial Services, a large 401(k) investment provider, for secretly receiving and retaining revenue sharing payments from mutual funds. The court denied Nationwide's summary judgment motion, ruling:

> "a fact-finder viewing the evidence in the light most favorable to the Trustees could conclude that the contracts were a guise for making payments to Nationwide or that Nationwide provided only nominal services and that the payments were not in consideration for those services. The Trustees have also raised triable issues concerning whether the challenged payments

constitute plan assets under a functional approach and whether, even if the revenue-sharing payments do not constitute plan assets, Nationwide's service contracts constitute prohibited transactions."

Haddock v. Nationwide Fin. Servs. Inc., 419 F. Supp. 2d 156, 171-72 (D. Conn. 2006); *see also Boeckman v. A.G. Edwards, Inc., 461 F. Supp. 2d 801*, 811 (judgment on pleadings dismissing complaint denied where complaint alleged, *inter alia*, that "because A.G. Edwards [the employer and plan sponsor] did not use its stature as a large investor to secure appropriate fees, [the participant] did not receive the full value of his benefits under the Plan.").

3. **Bases for investment provider liability:**

a. **Revenue sharing as self-dealing:** DOL regulations provide:

> "a fiduciary may not . . . cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) to provide a service. Nor may a fiduciary use such authority, control, or responsibility to cause a plan to enter into a transaction involving plan assets whereby such fiduciary . . . will receive consideration from a third party in connection with such transaction."

29 C.F.R. § 2550.408b-2(e).

4. **Consequences of excessive fees to trustees:**

a. **Breach of fiduciary duty:** As noted at page 30 above, trustees have an ongoing fiduciary obligation to monitor fees charged by investment managers, mutual funds and other providers. ERISA requires a fiduciary to act "with the care, skill, prudence, and diligence" as would a prudent person under the same circumstances. ERISA 404(a)(1)(B), 29 U.S.C. 1104(a)(1)(B). If a fiduciary breaches this duty, he or she is personally liable to the plan for any plan losses that result from the breach. The fiduciary is also "subject to such other equitable or remedial relief as the court may deem appropriate. . . ." ERISA § 409(a), 29 U.S.C. 1109(a).

ERISA's fiduciary duty designed "to hold plan administrators to a duty of loyalty akin to that of a common-law trustee." *Ameritech Benefit Plan Comm. v. Comm. Workers of America*, 220 F.3d 814, 825 (7th Cir. 2000). Accordingly, "the fiduciary must act as though [he or she] were a reasonably prudent businessperson with the interests of all the beneficiaries at heart." *Id*.

b. **Loss of 404(c) safe harbor protection from fiduciary liability:** Undisclosed fees may result in the loss of the safe harbor protection available to fiduciaries when a plan offers participant-directed investments. To come within the Section 404(c) safe harbor, the plan must provide participants with "the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan." 29 C.F.R. § 2550.404c-1(b)(2)(i)(B). Under the DOL regulations, "sufficient investment information" includes:

(1) "A description of any transaction fees and expenses which affect the participant's or beneficiary's account balance in connection with purchases or sales of interests in investment alternatives (e.g., commissions, sales load, deferred sales charges, redemption or exchange fees)." *Id.*; and

(2) Upon request, "[a] description of the annual operating expenses of each designated investment alternative (e.g., investment management fees, administrative fees, transaction costs) which reduce the rate of return to participants and beneficiaries, and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative." *Id*.

c. **Unreasonable fee payments are a prohibited transaction:** Fiduciaries and non-fiduciary parties in interest are subject to ERISA's prohibited transaction rules, which limit the type and amount of fees that can properly be paid for services provided to a plan. Payments to service providers are normally permitted through the exemption for services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor. ERISA § 408(b)(2), 29 U.S.C. §1108(b)(2); 29 C.F.R. § 2550.408b-2(a).

B. **Government responses to the excessive fees issue:**

1. **Congressional hearings:** The U.S. House of Representatives' Committee on Education and Labor began holding hearings on 401(k) plan fees on March 6, 2007. *See* http://edlabor.house.gov/hearings/-fc030607.shtml.

2. **Proposed changes to Form 5500:** The DOL has proposed regulations that would impose additional disclosure requirements. Form 5500s would be modified to require plans to provide more detailed disclosures of compensation paid to plan providers, including identifying every person who received, directly or indirectly, $5,000 or more in total compensation from the plan during the plan year. Plans would also have to state whether the provider received any compensation attributable to its relationship with, or services provided to, the plan from someone other than the plan or plan sponsor (including revenue sharing payments). Reportable compensation would include brokerage commissions and fees charged to the plan for purchases, sales and exchanges regardless of whether the broker exercised discretion. The DOL explained the purpose of the proposed Form 5500 requirements:

   > "The Department believes that an annual review of such expenses is part of a plan fiduciary's on-going obligation to monitor service provider arrangements with the plan. Requiring the reporting of such information should emphasize that monitoring obligation."

   Federal Register, Vol. 71, No. 140, p. 41621.

3. **DOL information request:** On April 25, 2007, the DOL released a request for information to assist the Department to determine to what extent rules governing disclosure of plan administrative and investment-related fee and expense information should be adopted or modified, or other actions should be taken, to ensure that participants and beneficiaries have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings. The request for information is posted at http://www.dol.gov/ebsa/regs/fedreg/proposed/2007007884.htm.

4. **GAO report on fee disclosure:** In November 2006, the Government Accountability Office (GAO) published Report GAO-07-21 entitled

“Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees.” The report is available at www.gao.gov/htext/d0721.html. The report recommends that the DOL require plan sponsors to report a summary of all fees that are paid out of plan assets or by participants.

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