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Client Advisory

Newly Filed Class Action Lawsuits Give 401(k) Fiduciaries a Reason to Reexamine Expenses

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The lawsuits. Recently, well-publicized class action lawsuits were filed against the fiduciaries of several 401(k) plans maintained by large employers. These suits allege numerous breaches of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), grounded in the amount of fees paid by the plans for investment management and other services. There are a variety of alleged breaches, and the same claims were not made for each plan, but the common theme is that the plan's fiduciaries, through inattention or lack of knowledge, allowed the plans to pay too much for the services of third-party providers, thus causing losses to participants and beneficiaries, by reducing the net performance of their investments by the amount of the excess fees.

ERISA background for the claims. The definition of "fiduciary" under ERISA is operational: a person (and person here is defined broadly to include individuals and institutions) has fiduciary status with respect to a plan to the extent of its (i) exercise of discretionary authority or control in management of a plan; (ii) exercise of any authority or control respecting management or disposition of the plan's assets; (iii) providing investment advice for a fee or other compensation (direct or indirect) with respect to money or other property of the plan (or having authority or responsibility to do so); or (iv) having discretionary authority or responsibility respecting administration of the plan.

Fiduciaries are required to discharge their duties "solely in the interest of the participants and beneficiaries," and "for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan." In addition, fiduciaries are held to a "prudent man" standard of conduct in exercising their duties. Causing or allowing a plan to pay more than necessary for plan expenses, thus reducing the amount available to participants, is arguably a breach of these duties.

A central claim in the complaints is that, where a person has fiduciary power and exercises (or fails to exercise such power) and the result is greater expenses borne by plan participants and beneficiaries, there has been a fiduciary breach. ERISA provides that fiduciaries are subject to personal liability for losses to a plan caused by their breaches, and the complaints seek recovery for reduction of participants' accounts attributable to the breach. In addition, they seek recovery under ERISA's co-fiduciary liability rules from other fiduciaries, such as board of directors members who appoint the committee that selects plan investments.

Specifics of the suits. Each of the complaints we have examined involves one or more 401(k) plans which provide for participant self direction of investments among various investment funds such as mutual funds, collective funds, and company stock funds. Each complaint alleges that participants bear some or all of the expenses of recordkeeping, asset management and other services, either through the expenses charged by the investment funds, or through direct charges to their accounts. The complaints allege that plan fiduciaries caused these expenses to be higher than was necessary by failing to identify or address fee arrangements including the following:

Inappropriate share class. Many mutual funds offer multiple classes of the same fund, with key differences being which investors may purchase it, and the level of expenses ("expense ratio") charged by the fund. If a plan was entitled to a share class with a lower expense ratio, but, instead, the fiduciaries responsible for investment selection maintained investment in a more expensive share class of the same fund, it can be alleged that participants' investment returns were reduced by the fiduciaries' failure to identify and obtain a share class with a lower expense ratio.

Failure to utilize "revenue sharing." Some mutual funds and other commingled investment vehicles have a portion of their expense ratio available to pay third parties for services related to the sale and purchase of shares of the fund. These amounts include "Rule 12b-1 fees" and "subtransfer agency fees," and are commonly referred to as "revenue sharing amounts." Revenue sharing amounts may be payable to third-party service providers such as recordkeepers or trustees, or to the plan itself. If a plan uses investment options that pay revenue sharing amounts and the plan's fiduciaries do not identify and capture that revenue sharing for the benefit of the plan, it can be alleged that this was a fiduciary breach that caused participants' accounts to be charged for expenses that might otherwise have been paid with revenue sharing.

Paying for "active management" that mimics index investing. Much investment management occurs through "active managers" who seek to use analysis and insights to achieve superior performance for their portfolios. By contrast, "index funds" consist of a portfolio of stocks which replicate an index of securities (such as the S&P 500) and seek to match its performance. Because index funds do not involve research or trading activity like actively managed funds, their expense ratios tend to be lower. The comparison of active vs. passive management has been the subject of much financial literature, but, if an active manager's performance is consistently parallel or similar to that of an index fund investing in the same category of securities, do plan fiduciaries have a duty to at least consider replacing the former with the latter, so that participants will get the same returns, with lesser fees? That is an allegation made in some of the 401(k) class actions.

Implications for fiduciaries of other plans. These are not the only allegations found in these cases, but they illustrate the issues raised by plaintiffs in those cases. What can other plan fiduciaries learn from these suits – which will certainly not be the only ones filed?

First, proper governance of any employee benefit plan requires attention to the expenses that are being charged against the plan and what the plan is receiving in return. These expenses must be identified, and benchmarked to determine whether they are reasonable, given the size and type of plan, and the amount of services that it requires. Fiduciaries may choose to prepare a "total fee disclosure" questionnaire, which each third-party vendor is required to complete. This will help plan fiduciaries identify the total amounts being paid, directly and indirectly, by the plan. Third party consultants may be able to assist in this process, bringing a knowledge of industry practices and the experience of other plans. In addition, the U.S. Department of Labor has a publication, "Understanding Retirement Plan Fees And Expenses," available at: www.dol.gov/ebsa/publications.

Second, the internal fiduciaries of a plan are not the only ones affected by fee issues. If a plan uses a third-party advisor to select or advise on plan investments, that advisor will likely be a fiduciary under ERISA's operational definition. Thus all advice provided by the advisor is subject to ERISA's fiduciary standards, and it must fully disclose any conflicts of interest. For example, the advisor cannot provide advice that would be to its benefit at the expense of the plan, such as selection of fund classes that causes the advisor to receive additional payments from the funds selected.

Finally, these issues are not unique to the plans of large employers. Consider a 1,000 participant 401(k) plan with $100 million in assets, all invested in mutual funds. If the plan uses "investor" class shares of all of the mutual funds and could, for the last three years, have switched to "institutional" shares of the same funds, with an average expense ratio of 15 basis points* less than the investor class, a claim for payment of excessive fees might be made. Share classes, their availability and their expenses are disclosed in a mutual fund's prospectus. One could allege that, simply by reading the fund prospectuses and asking for a change, the fiduciaries responsible for investment options could have saved the plan's participants, in the aggregate, over $400,000 – not an insignificant amount.

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* A basis point is 1/100 of one percent: 100 basis points equal one percent.

Therefore, for every plan, fresh attention should be paid to the plan's governance structure, specifically, who the fiduciaries responsible for selection and monitoring of plan investments are. Next, the procedures to identify and benchmark plan expenses and returns, as set out in the plans investment policy statement or elsewhere, should be reviewed, and expanded or updated as appropriate. The plan should also provide for oversight to ensure that these structures and policies are being carried out.

We Can Help

If you have questions about the class actions described in this Advisory, or any of the issues discussed here, please contact any of the following Katten Muchin Rosenman LLP attorneys:

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