

WHO IS A FIDUCIARY?

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WHO IS A FIDUCIARY?

I. Are You A Fiduciary? At what point in its efforts to assist an employer with the employer's responsibilities in relation to a 401(k) plan does an investment professional take on a fiduciary role under the ERISA? This is a critical question, since ERISA has rules governing fiduciaries that do not apply to non-fiduciary service providers.

ERISA fiduciaries are either named in the plan document or are identified by the function they perform for the plan. Since fiduciary status may be based on a person's conduct rather than his title, it is possible to be a fiduciary without being aware of it. Regardless of whether he has knowledge of his status, an ERISA fiduciary must (1) act for the exclusive purpose of providing retirement benefits to plan participants, (2) fulfill a duty of loyalty to the participants, (3) act prudently, and (4) avoid conflicts of interest and acts of self-dealing known as prohibited transactions.

The definition of a fiduciary includes any person who exercises any authority or control respecting the management or disposition of plan assets. Assuming that an investment professional lacks such control, he could also be a fiduciary to the extent that he renders advice for a fee or other direct or indirect compensation, with respect to any moneys or other properties of the plan, or has any authority or responsibility to do so. In other words, if you receive compensation for which you have the responsibility to provide investment advice or for which you actually provide investment advice, you will be a fiduciary.

Definition of Investment Advice Fiduciary. Section 3(21)(A)(ii) of ERISA includes within the definition of "fiduciary" a person that renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of a plan, or has any authority or responsibility to do so.¹ DOL regulations have amplified this definition by stating that a person will be viewed as rendering investment advice only if both of the following conditions are met: (1) the advice relates to the value of securities or other property or constitutes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property, and (2) either (a) the person has discretionary authority or control with respect to purchasing or selling securities or other property for the plan, or (b) the person renders advice to the plan on a regular basis under an agreement or understanding (written or otherwise) that the advice will be the primary basis for investment decisions with respect to plan assets, and that it will consist of individualized investment advice to the plan based on its particular needs. The particularized needs of the plan include such matters as investment policies or strategy, overall portfolio composition, and diversification of investments.²

¹ Under ERISA Section 3(21)(A)(i), the definition of a fiduciary also includes anyone who "exercises any authority or control respecting management or disposition" of plan assets.

² DOL Regulation Section 2510.3-21(c)(1).

As noted, to characterize a person rendering investment advice as a fiduciary, he or she must be compensated for the advice. The compensation may take the form of a fee paid by the plan or the plan sponsor or some other form of indirect compensation paid by a third party, such as a mutual fund. The receipt of a commission may be sufficient for this purpose, even though no payment has been specifically allocated to the provision of investment advice. Indirect forms of compensation, such as 12b-1 fees, soft-dollar arrangements and revenue sharing, pursuant to which an adviser receives something of value from an investment provider, would be taken into account for purposes of determining fiduciary status.

The test for determining fiduciary status is a functional one. In other words, if a person renders investment advice, as described above, for which he is compensated, he will be considered to be a fiduciary regardless of his title or official designation. The activities of many broker-dealers would cause them to be treated as plan fiduciaries.³ Nevertheless, not every broker would come within this definition, and we note that the regulation relating to investment advice fiduciaries has an exemption for stockbrokers that provides that a broker shall not be deemed to be a fiduciary solely because he executes transactions for the purchase or sale of securities on behalf of a plan in the ordinary course of business pursuant to the instructions of a plan fiduciary.⁴

Fiduciary Duty. The basic duty of a fiduciary under ERISA is to discharge his or her duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits for the participants and their beneficiaries and defraying reasonable administrative costs of the plan. Affirmative fiduciary duties include such responsibilities as selecting proper investments and monitoring them to ensure that they yield a reasonable return, properly diversifying investments, seeing to it that the plan has sufficient liquidity, and managing the administrative aspects of the plan.⁵

II. Hidden 401(k) Plan Fees and Expenses

A. Background. An important part of a fiduciary's responsibility includes identifying, understanding, and evaluating fees and expenses associated with plan investments, investment options and services. When they initially consider a new investment, fiduciaries should be aware of all hard dollar payments made directly by plans as well as "revenue sharing" and similar payments made indirectly by third parties. The latter are sometimes referred to as "hidden fees." Fiduciaries should also monitor such payments to determine if they continue to be reasonable. While the reasonableness of fees and expenses is a concern for all qualified plans, it is particularly important for 401(k) plans, because they generally bear a higher proportion of the fees and expenses. Monitoring fees and expenses is an ongoing fiduciary responsibility.

³ See *Ellis v. Rycenga Homes, Inc.*, No. 1:04-cv-694, 2007 WL 837224 (W.D. Mich. 2007), in which a broker's consultations on investment matters over a plan's 20-year history resulted in a summary judgment concluding that the broker was a plan fiduciary.

⁴ DOL Regulation Section 2510.3-21(d).

⁵ ERISA Sections 403(c)(1) and 404(a).

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

1. SEC Rule 28(e) Soft Dollars. Brokerage firms may charge extra commission that can be used by investment advisors and others to purchase services, such as, valuable investment research. Such excess commission must be reasonable with respect to the services provided. Illegal Rule 28(e) fees violate ERISA Sections 403(c)(1), 404(a)(1) and 406(a)(1)(D). Fiduciaries should know whether they are being charged Rule 28(e) fees._

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

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

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

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

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

7. Revenue Sharing Arrangements. Revenue sharing is the practice by mutual funds or other investment providers of paying other plan service providers,

e.g., the plan's recordkeeper or other third party administrator, for performing services that the mutual fund might otherwise be required to perform.

8. Float. Float refers to earnings retained by a service provider (usually a bank or brokerage company) that result from short-term investments in liquid accounts used to facilitate cash transactions. Funds held in these accounts could include funds to cover checks issued for benefit payments by benefit plans that are not yet presented for payment by the recipient, or uninvested funds awaiting investment instructions from a plan fiduciary. The Department of Labor requires service providers to inform plan fiduciaries of the existence of float and the circumstances under which it will be earned and retained. See FAB 2002-3.

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

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

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

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

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

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

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

b. Ruppert v. Principal Life Insurance Company S.D. ILL.
Complaint alleges that Principal is a fiduciary by virtue of providing investment advice to plan participants and that it committed violations of Sections 406(b)(1) and 406(b)(3) of ERISA by receiving revenue sharing payments from mutual funds. The complaint contains additional allegations that Principal's failure to disclose the existence of its revenue sharing arrangements to the plans and to participants was a fiduciary breach.

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

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

a. List of cases:

- i. Abbot v. Lockheed Martin Corp. (S.D. Ill.)
- ii. Beesley v. International Paper Company (S.D. Ill.)
- iii. George v. Kraft Foods Global, Inc. (S.D. Ill.)
- iv. Kanawi v. Bechtel corp. (N.D. Cal.)
- v. Loomis v. Exelon Corp. (N.D. Ill.) The claim for damages for investment losses in this case was dismissed on February 21, 2007.
- vi. Martin v. Caterpillar, Inc. (W.D. Mo.)
- vii. Spano v. Boeing Co. (S.D. Ill.)
- viii. Taylor v. United Technologies Corp. (D. Conn.)
- ix. Will v. General Dynamics corp. (S.D. Ill.)

- b. Issues.
 - i. Whether defendants acted prudently in selecting investment options.
 - ii. Whether defendants are entitled to protection under Section 404(c) of ERISA.
 - iii. Whether plan fiduciaries have a duty to seek mutual funds with the lowest expense ratios.
 - iv. Whether the protection of Section 404(c) of ERISA is lost as a result of the failure to fully disclose to participants the amounts and nature of direct as well as hidden fees.
 - v. Whether the failure to disclose direct and hidden fees to participants constitutes a fiduciary breach.

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

- a. List of cases:
 - i. Hecker v. Deere & Co. (W.D. Wis.)
 - ii. Renfro v. Unisys Corp. (C.D. Cal.)
 - iii. Kennedy v. ABB, Inc. (W.D. Mo.)

4. Implications of Hidden Fee Cases.

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

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

c. Additional law suits are likely to be filed and some copycat claims have already been made.

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

D. Department of Labor Initiatives on Disclosure.

1. Form 5500 Reporting.

a. Current Rule. Fees and expenses paid by the plan must be disclosed on the Form 5500 using either the Schedule A which is used to report commissions or related fees paid to insurance companies or the Schedule C which is used to report fees paid to service providers. Service providers, such as insurance companies, have traditionally narrowly interpreted their duty to disclose. For example, investment management fees, soft dollars and internal fund expenses are not disclosed on either Schedule A or C of the Form 5500. There is little reporting of hidden fees.

b. Proposal. In July of 2006, the Department of Labor proposed changes to Schedule C that would require reporting of virtually all “indirect compensation,” i.e., payments to plan service providers by third parties “in connection with that person’s position with the plan or services rendered to the plan.” This would effectively place the burden of obtaining such information on the plan administrator and in this regard does not necessarily require the cooperation of service providers.

2. Change to Prohibited Transaction Regulations. Plan service providers are parties in interest to a plan, and as such, must satisfy the statutory and regulatory conditions for exemption from the prohibited transaction rules. Under DOL Regulation Section 2550.408b-2(a), these conditions require the services to be “necessary,” that the arrangement under which they are provided be “reasonable,” and that no more than “reasonable compensation” be paid for the services. The Department of Labor is reported to be considering a proposal to amend this regulation to make disclosure by the service provider a condition of exemption. The required disclosure would likely be designed to ensure that service providers furnish a plan fiduciary with information sufficient to allow the plan fiduciary to determine

- a. Whether the plan is paying reasonable fees for services,
- b. Whether the service provider’s total compensation, including indirect payments from third parties, is reasonable, and
- c. Whether the service provider’s advice is affected by conflicts of interest.

E. Best Practices. The Department of Labor (“DOL”) has made it clear that in enforcing ERISA they will not judge fiduciaries on the results they achieve, but on the processes they follow. Such processes should not be static but should change with the times. For example, processes that were appropriate in 1974 would not necessarily be appropriate in 2007, because fiduciaries are being held to increasingly greater expectations. So, as standards for fiduciaries evolve, fiduciaries should take the steps to withstand a challenge from the DOL. Such steps include the following:

1. Contracts. Have contracts detailing responsibilities of all parties.
2. Identify Fees. Make a concerted effort to learn how much the plan and participants are actually paying in fees and expenses. Obtain an exact dollar breakdown of the amounts being charged.
3. Disclosure. Make sure that all fees, including soft dollar and revenue sharing arrangements, are fully disclosed to participants.
4. Draft and Follow a Written Investment Policy Statement. ERISA requires an investment policy. While not required to be in writing, it is easier to demonstrate compliance with the policy statement if it is in writing. A policy statement should include clear standards for choosing investments, how they will be monitored and what triggers must occur to place an investment manager on a watch list. The roles of interested parties should also be clearly stated. The policy should contain enough detail so that the DOL (or a plaintiff’s counsel) can clearly understand how or why an investment decision was made. The investment policy should be reviewed annually and modified as necessary.
5. Document Reviews of Investment Vehicles. Fiduciaries should document their reviews of investment vehicles, including negotiations related to direct as well as hidden fees. Such documentation should address key questions or discussions, and decisions made. The ability to provide documentation demonstrates a thoughtful process and alleviates the need to rely on memory.
6. Continuous Monitoring. Continuous monitoring should be the standard for all plans, and when appropriate, quarterly reporting for all but the smallest plans. Monitoring should directly reference back to the investment policy. Monitoring should also include a broad range of qualitative and quantitative metrics for each fund and/or manager. Fiduciaries should understand what the analysis means for the plan and the participants (*e.g.*, what are the fees? are they reasonable with respect to the services being provided?)
7. Utilize an Independent Third Party Investment Expert. Vendors often provide reporting and recommendations for analysis, placing funds on watch or replacing funds. However, there is an inherent conflict of interest when vendors report on proprietary funds, sub-advised funds and even nonproprietary funds where long-term business relationships and revenue agreements entwine with the investment decision process. As a result, fiduciaries should consider using the advice of an independent third party investment expert.

8. Replace Funds that Do Not Meet Investment Criteria. Many fiduciaries are reluctant to make decisions to replace poorly performing funds, and as a result, often add investment vehicles without removing the fund that the new investment vehicle was intended to replace. This could demonstrate an unwillingness on the fiduciary's part to perform his or her duties as required under ERISA.

9. Expense Ratios/Fees. An investment's expense ratio or manager's fees should not be above the median of its peer group (exceptions may be made for funds or managers with superior performance).

10. Conduct Fiduciary Audit. When appropriate, the fiduciary should hire an independent third party to conduct a fiduciary audit. A fiduciary audit should be conducted when vendors fail to adequately disclose fees or fees do not seem reasonable.

III. Do You Need Professional Liability Insurance? Under ERISA, fiduciaries may be held personally responsible for losses resulting from a breach of their responsibilities in the administration of employee benefit plans, the handling of plan assets or the rendering of investment advice. Professional liability insurance is not required by ERISA but is strongly recommended, since retirement plans and fiduciaries are increasingly the prey of litigation.

Professional liability insurance (which may also be called errors and omission insurance and may be combined with other coverages, such as directors and officers insurance or employment practices liability insurance) should be distinguished from fidelity bonds that must be obtained by certain fiduciaries that handle plan assets and that protect a plan in the event of fiduciary dishonesty but offer no protection for fiduciaries themselves. In addition, it should not be confused with fiduciary liability insurance that is purchased by a plan sponsor.

When buying professional liability insurance, you should evaluate the insurance carriers based on their experience, claims handling and financial strength. Three of the most prominent carriers in the field today are Chubb, the Hartford and AIG.

In addition to the characteristics of the carrier, it is imperative that you thoroughly analyze the terms of the policy before you buy. You should make sure that the definition of professional services that are covered by the policy is broad enough to cover all of your firm's activities.

You must also determine whether you can live with the policy's exclusions. In certain cases, identifying exclusions will not be difficult. For example, most policies will contain an endorsement (*i.e.*, an additional schedule or addendum to the policy) excluding late trading and market timing activities. Nevertheless, such an endorsement can often be deleted through negotiation if the insured has a good history on the issue. In today's environment, an endorsement that precludes coverage of liability arising from soft dollar or revenue sharing arrangements may be more difficult to negotiate away. However, while it may require the assistance of a skilled broker and detailed disclosure of a fiduciary's soft dollar practices, it is still possible to have such an exclusion removed.

Not all exclusions appear in separate policy endorsements, and prospective purchasers of professional liability insurance must carefully read the policy itself for embedded exclusionary language. You should consider avoiding a policy that contains language excluding complaints arising out of disputes over fees, commissions, or compensation.

IV. The Benefits of a Fiduciary Audit. In today's environment, the financial integrity of employee benefit plans is subject to heightened scrutiny. ERISA requires most plans with 100 or more eligible participants to undergo an annual audit as part of the plan's obligation to file an annual Form 5500. Typically, the accounting firm prepares a plan financial statement which includes a representation that the plan has been operated in accordance with its terms and applicable law. Plans with fewer than 100 eligible participants may also be subject to the audit requirement if they fail to meet certain conditions relating to their plan investments, bonding, and disclosure requirements.

If the audit or resulting plan financial statements are found to be inadequate, the Department of Labor will reject the Form 5500 and treat it as if it had not been filed. The likelihood of this occurring has increased, since the Department began an enforcement initiative in April of 2005 in response to unacceptably high levels of audit failure. One of the common audit deficiencies noted by the Department of Labor relates to an accounting firm's failure to document an understanding of the plan's internal controls. It is important to understand that internal controls are not the numbers resulting from a financial audit but the process by which they are determined. Thus, it has become more important than ever for plans to have effective procedures in place with respect to matters such as administration and investments.

The enhanced role of internal controls is seen in Section 404 of Sarbanes-Oxley which requires the management of public companies to establish, maintain, and assess the effectiveness of internal control procedures for financial reporting, and also requires public accounting firms to attest to and report on management's assessment. These requirements presumably extend to benefit expenses included in a company's financial statements. And while Sarbanes-Oxley is not technically applicable to private employers and tax-exempts, the standards it has established are rapidly becoming the norm for such employers.

One response to the increasing demand for the creation and oversight of plan controls is the establishment of a fiduciary self-audit procedure. Third party specialists can be engaged to perform an independent review of a plan's controls. Among other things, this would include a review of the minutes of benefit and investment committees to ensure that decisions are fully and accurately documented. Contracts and fee arrangements with third-party service providers would be examined with the objective of avoiding conflicts of interest. By attending to such matters, a fiduciary audit would safeguard plan assets and also enable plan sponsors to identify and correct violations of tax qualification and ERISA requirements before an audit by the Internal Revenue Service or the Department of Labor. In short, a well designed fiduciary audit assists plan sponsors and other fiduciaries in fulfilling their fiduciary responsibilities.