

# perspective

## ERISA for Money Managers: A Practical Workshop

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Spencer

ERISA FIDUCIARY LITIGATION  
AND ENFORCEMENT UPDATE  
New York, New York  
April 17, 2008



# 401(k) Fees and Expenses Litigation Update



**Morgan Lewis/White & Case**

# Background to Current Wave of 401(k) Fees Litigation

- The Schlichter Blitzkreig
  - Say ten times fast!
  - Since September 2006, St. Louis—based Schlichter, Bogard & Denton has targeted 15 Fortune 200 companies and is poised to go after, at last count, another 17 major corporations.
  - Losing steam?
- Three Phases of the Initial Assault
  - Newspaper ad
  - Statutory request
  - Complaint

# Background to Current Wave of 401(k) Fees Litigation

Newspaper ad  
soliciting  
participants to  
contact firm.

**- ATTENTION -**  
**Employees**

If you are a retiree or a current participant  
we would like to speak with you about your  
pension benefits.

Please call:  
**J. BRAD WILMOTH**

Law Offices of  
**SCHLICHTER BOGARD & DENTON**  
(800) 873-5297

This is a paid legal advertisement by:

Schlichter Bogard & Denton  
2661 North Illinois, Ste. 187  
Swansea, Illinois 62226

H12801

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# Background to Current Wave of 401(k) Fees Litigation

## Statutory request for information – Sections 104(b) and 404(c)

NOV - 3 2006

**SCHLICHTER, BOGARD & DENTON**  
ATTORNEYS AT LAW  
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(618) 632-3329  
**ROBERT S. BOGARD**  
OF COUNSEL

November 2, 2006

**VIA FEDERAL EXPRESS**  
Plan Administrator

Dear Plan Administrator:

We represent Timothy (authorization enclosed), a participant in the Retirement Investment and Savings Management Plan for Employees of . We are writing pursuant to ERISA §§104(b)(4), 404(c) and 29 C.F.R. § 2550. 404(c)-1(b)(2) to request the information and documents described below. We believe the participant has the right to know the fees and expenses that are charged directly to his account and also to know the fees or expenses that are removed from the revenue of his investments. Further, it is your duty under ERISA to provide this information.

If you require reimbursement for copies, please let me know as soon as possible and I will forward it to you. For the most recent year, and for the 5 years previous, please send:

- All documents under which the Plan is established or operated, including but not limited to the Plan document, current Summary Plan Description, latest complete Annual Report (not a summary), trust agreements, and contracts with service providers;
- All investment guidelines or directives;
- List each service provider to the Plan and the Master Trusts, including but not limited to pension consultants, investment managers, record keepers, brokers, administrators, and trustees. Additionally, identify the compensation received by each service provider, including but not limited to all forms of compensation

# Background to Current Wave of 401(k) Fees Litigation

## Class action complaint

Case 3:06-cv-00903-DRH-PMF Document 2-1 Filed 11/08/2006 Page 1 of 13

UNITED STATES DISTRICT COURT  
FOR THE SOUTHERN DISTRICT OF ILLINOIS

JOSEPH RUPPERT, as Trustee of and on behalf of )  
FAIRMOUNT PARK, INC. RETIREMENT )  
SAVINGS PLAN, and on behalf of all others )  
similarly situated, )  
Plaintiff, ) Civil Action No.06-903-DRH  
vs. )  
PRINCIPAL LIFE INSURANCE CO., )  
Defendant. ) CLASS ACTION

COMPLAINT

Comes now Plaintiff Joseph Ruppert, through his counsel, as Trustee of and on behalf of the Fairmount Park, Inc. Retirement Savings Plan and on behalf of all others similarly situated, and for his Complaint against Defendant Principal Life Insurance Co., states as follows:

PARTIES

1. Plaintiff Joseph Ruppert is a trustee of the Fairmount Park, Inc. Retirement Savings Plan. Ruppert brings this action in his capacity as trustee of and on behalf of the Fairmount Plan.
2. Defendant Principal Life Insurance Co. is an Iowa corporation with its principal place of business in Des Moines, Iowa. Defendant advertises its services, solicits retirement plan business and serves as a full service retirement plan service provider for retirement plans located throughout the country, including in the Southern District of Illinois.

JURISDICTION AND VENUE

3. This Court has jurisdiction over this action pursuant to 28 U.S.C. § 1331 and ERISA § 502(e)(1)(2) (29 U.S.C. § 1132 (e)(1)(2)).

# Background to Current Wave of 401(k) Fees Litigation

- Second Wave?
  - *Keller Rohrback is “investigating” two large plan sponsors – [www.erisafraud.com](http://www.erisafraud.com)*
  - *Lynn Sarko told EmploymentLaw360 that the first wave is only the beginning of the attack and that plaintiffs attorneys will focus on vendors, investment companies and other service providers.*
  - Every “k” plan in the nation subject to challenge – underemployed plaintiffs’ lawyers join the fray, lured by attorneys’ fee awards?
  - *Losing steam (II)?*

# The Claims vs. Plan Sponsor Fiduciaries

- Fiduciaries **failed to ensure** that direct and indirect **compensation** paid to service providers was **reasonable**
  - 404(a) – general prudence requirements
- Fiduciaries **failed to conduct a reasonable investigation** into the payments that service providers receive from mutual funds
  - 404(a)
- Fiduciaries **failed to disclose** certain payments, namely “revenue sharing,” to plan participants
  - 404(a), 404(c) and accompanying regulations

# The Claims vs. Plan Sponsor Fiduciaries

- Fiduciaries **allowed the plan to overpay** for investment management services by offering actively managed funds, and by offering retail funds instead of lower-cost institutional funds
  - 404(a)

# The Claims vs. Service Providers

- Service provider is a **fiduciary** because it exercises some control over the selection and offering of particular mutual funds. Problem acute where “bundled” provider insists on inclusion of own funds on the “platform”?
  - 404(a)

# The Claims vs. Service Providers

- Plaintiffs allege that revenue-sharing payments are **plan assets** for purposes of prohibited transaction rules. They advocate a “functional test” for defining plan assets: whether the item in question may be used to benefit the fiduciary at the expense of plan participants. E.g., *Haddock v. Nationwide* (D. Ct.).
  - 406(a); 406(b)(1)
  - But see DOL’s Deere brief stating such investments are not plan assets

# The Claims vs. Service Providers

- Service provider (if a fiduciary) engaged in **prohibited transaction** because it received consideration (revenue sharing) from a party dealing with the plan (the mutual funds) in connection with a transaction involving assets of the plan
  - 406(b)(3)
- 408(b)(2) – OK if reasonable compensation is paid

# The Claims in These Suits, Redux

- Revenue-sharing payments excessive
  - A misnomer where money paid from fund in recordkeeper's "family"?
- Retail vs. institutional shares?
- Mutual funds vs. individually managed accounts?

# The Claims in These Suits, Redux

- Employer stock funds
  - Excessive fees charged, assumption is that the employer stock fund is the ultimate “passive” investment?
  - Liquidity requirements either excessive or limitations ignored, reducing investment returns?
- Not quite a “claim,” but Schlichter firm consistently makes demand for juries
  - Grounded upon interpretation of Great West – if (a)(3) remedies can only equitable, leaves open possibility of jury on (a)(2)?

# The Fur Begins to Fly

- Presently at least fifteen putative class actions pending around the country
- Varying timelines
  - Exelon stayed pending outcome of Deere appeal
- Schlichter firm aggressively litigating – broad discovery and expansive limitations period
  - 6 year SOL per ERISA § 413, no “fraud or concealment?”
  - Using DB plan’s fees/expenses as benchmarks?

# The Fur Begins to Fly

- Aggressive positions taken by experts (contents subject to confidentiality agreements)

## 404(c) To The Rescue, Once Again?



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## 404(c) To The Rescue, Once Again?

- DC/401(k) plans – Congress intended to shift investment risks to employees (as opposed to traditional defined benefit plans)
- General prudence requirement – 404(a) – “with the care, skill, prudence and diligence [of] a prudent man”

## 404(c) To The Rescue, Once Again?

- 404(c) as to individual account plans, no fiduciary liable “for any loss, or by reason of any breach, which results from such participant’s . . . exercise of control”
- DOL view narrow, but based on comments to “Preamble”

## 404(c) To The Rescue, Once Again?

- Fifth Circuit in EDS, vacating class certification in stock drop case on basis of 404(c), holds that individual causation issues preclude class treatment. See also Unisys Savings Plan (404(c) applies to threshold selection of imprudent plan investments). **Rejects DOL's reading of 404(c)**. But see DeFelice v. US Airways (4th Cir.).

## 404(c) To The Rescue, Once Again?

- Statutory and regulatory disclosure obligations regarding fees and expenses are minimal – does satisfaction of those disclosure requirements mean fiduciaries immunized from liability? Recall that EDS literal application of 404(c), citing Unisys Savings Plan. **Expect DOL to join the fray.**
- Question before Seventh Circuit in Dynegy.

## 404(c) To The Rescue, Once Again?

- The relatively minimal DOL disclosure requirements, including a requirement, that administrator provide documents “upon request”
- The Achilles heel in these actions? Government has acknowledged that the disclosure requirements do not reach revenue-sharing payments

# 404(c) To The Rescue, Once Again?

- GAO report on Fees and Expenses, Nov. 2006 – “The fee information that ERISA requires 401(k) plan sponsors to disclose is limited and does not provide participants with an easy comparison of investment options.”
- DOL Guidebook and 401(k) Fees and Expenses, 1998 – “There is generally no requirement in the law or Federal Code for a complete disclosure of investment expenses to plan participants.”

# 404(c) To The Rescue, Once Again?

- 29 C.F.R. § 2550.404c-1 – Administrator must disclose “a description of any transaction fees and expenses which affect . . . [the] account . . . (e.g., commissions, sales loads, deferred sales charges, redemption or exchange fees) and, upon request, a description of the annual operating expenses of each fund and the aggregate amount of such expenses expressed as a percentage of average net assets (the ‘expense ratio’).”
- If fiduciaries satisfy disclosure requirements, game, set, match?

## *Hecker v. Deere* (D. Wis.)

- Twenty three funds offered, with expense ratios from 7 to 101 basis points.
- Brokerage window allowing access to over 2500 publicly available mutual funds.
- Bottom line -- 404(c) bars the claims.
- “Where, as here, Congress has by statute and related regulation, created detailed rules governing disclosure requirements, it would be inappropriate to ignore and augment them using the general power to define fiduciary obligations.”

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## Hecker v. Deere (D. Wis.)

- “In assessing the likely return on an investment the fees netted against the return are certainly relevant, but knowing the subsequent distribution of those fees has no impact on the investment’s value.”
- “The only possible conclusion is that to the extent participants incurred excessive expenses, those losses were the result of participants exercising control over their investments within the meaning of the safe harbor [404(c)] provision.”

# Fun with class certification?



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# Certification of Fees and Expenses Claims

- *Grabek v. Northrop Grumman* (E.D. Cal. 2007).
  - Claims should not be certified because “the case is better taken care of by administrative agencies.”
  - No stay pending 9<sup>th</sup> Circuit ruling because “no good cause shown.”

# Defending 401(k) Fee Cases on Their Merits

- Miscellaneous Additional Factual Defenses
  - Did the fiduciaries adequately consider both direct and indirect payments to plan service providers? Don't have to be cheapest, as long as adequate procedures followed.
  - Problem of hindsight, and fiduciaries know what going on (DOL commentary).
  - How do fees and expenses compare to peer group plans?

# Defending 401(k) Fee Cases on Their Merits

- Again, maybe the wrong question. What is the overall performance of the plan? Of the funds?
- Likely issues for trial, will require testimony from experts.

# Best Practices: Procedural Prudence

- Clearly identify in writing who has what fiduciary responsibilities
  - Establish separate fiduciary and plan sponsor committees;
  - Don't name the company as a fiduciary or Plan administrator;
  - Establish Committee Charters and delegation procedures.

# Best Practices: Procedural Prudence

- The Investment Fiduciaries must understand 401(k) fees and expenses charged to plans.
  - Ask for an explanation of all fees and expenses charged for each investment option
  - Ask service providers to describe all compensation they receive in connection with work for the Plan, and use as offset to negotiated fees
  - Understand revenue sharing, management (advisory) fees, and distribution and/or service (12b-1) fees. This is especially important for plans with “bundled” investment management and record keeping

# Best Practices: Procedural Prudence

- Adopt or amend Investment Policies if necessary to
  - Consider performance net of fees
  - Monitor fees and expenses
- Consider whether investment options are provided in least expensive way, such as
  - Separate accounts
  - Commingled trusts

# Best Practices: Procedural Prudence

- Institutional funds and/or lowest share class
- Flat fee arrangements for record keeping and custody. (Note that asset-based fees can grow without additional services being provided.)
- Consider whether least expensive ways of providing investment options will meet Plan needs, such as
  - Whether Plan can satisfy applicable investment minimums

# Best Practices: Procedural Prudence

- Goal of beating benchmarks
- Whether prospectuses, public reporting, brand-name availability, and other positive features of mutual funds will benefit participants
- Consider Hiring an Investment Consultant to
  - Study and report on fees when selecting investment options
  - Monitor fees and expenses charged for each investment option

# Best Practices: Procedural Prudence

- Recommend appropriate fee and expense benchmarks
- Recommend appropriate mix of passive vs. active investments
- Ensure Plan meets 404(c) requirements
- Disclose to participants and beneficiaries all fee and expense arrangements
  - Upon request
  - On websites

# Best Practices: Procedural Prudence

- In writing
- At the plan level
- Regularly meet to monitor all fee and expense arrangements
  - At the plan level
  - At the individual investment level
  - Where possible, avoid cross-subsidies, or at a minimum disclose them

# Best Practices: Service Providers

- Disclose to Plan fiduciaries
  - All compensation received from parties other than Plan in connection with service provider's position with Plan or services rendered to it
  - This would include 12b-1 fees, shareholder services fees, shelf-space fees from affiliates of mutual funds, research and other soft-dollar benefits, finders' and placement fees, and "float"
  - This would be required under DOL's proposed changes to Form 5500, Schedule C and to the 408(b)(2) exemption

# Best Practices: Service Providers

- Ensure that Plan assets are deposited into investment accounts as soon as practicable
- If service provider provides record keeping or custodial services as well as investment management, suggest to Plan fiduciaries that they have independent investment advisor

# DOL Steps Up Disclosure Of Fees Paid From Plan Assets

- New Form 5500 Schedule C disclosures effective for plan years beginning on or after January 1, 2009
- Proposed new Prohibited Transaction Rules
- New disclosure rules for plan sponsors to participants is expected in early 2008

## New Form 5500 Schedule C Disclosures

- Schedule C now requires disclosure of compensation paid to service providers including gifts, awards, trips, brokerage commissions and fees (regardless of whether the broker is granted discretion), Rule 12b-1 fees, finder's fees, soft-dollar payments, and float income

## New Form 5500 Schedule C Disclosures

- The new rules do not require that the requested information be furnished to the administrator by the party receiving the fee or commission
- The plan administrator will need to coordinate with the service provider (e.g., investment manager) to compile this information

## New Form 5500 Schedule C Disclosures

- The plan administrator should report to the DOL any service provider who fails or refuses to provide this information
- The definition of “service provider” is broader than “party in interest and includes both
  - persons who receive direct and indirect compensation
  - persons providing services directly and indirectly to the plan

## New Form 5500 Schedule C Disclosures

- Payments of \$5,000 or more must be disclosed
- Previously, plans were required to disclose fees only with respect to the plan's 40 highest-paid service providers

# New Proposed Prohibited Transaction Exemption

- ERISA Section 406 prohibits all transactions with a plan covered by ERISA Service providers
- ERISA Section 408(b)(2) creates an exemption for reasonable compensation for necessary services
- The new exemption requires new disclosures

# Compensation Arrangements Most Susceptible To Conflicts Of Interest

- Service providers that provide services to employee benefits plans as a fiduciary under ERISA or the Investment Advisers Act of 1940
- Service providers that supply any of the following services:
  - banking
  - consulting

# Compensation Arrangements Most Susceptible To Conflicts Of Interest

- custodial
- insurance
- investment advisory
- investment management
- recordkeeping
- securities or other investment brokerage
- third-party administration services

# Compensation Arrangements Most Susceptible To Conflicts Of Interest

- Service providers receiving indirect compensation in connection with
  - accounting
  - actuarial
  - appraisal
  - auditing
  - legal
  - valuation services

## Specific Disclosures in the Contract or Arrangement

- The contract or arrangement must be in writing.
- The contract or arrangement must require the service provider to disclose services to be provided to the plan or compensation that it will receive in connection with the plan
  - See Form 5500 Schedule C for compensation to be disclosed

# Specific Disclosures in the Contract or Arrangement

- If it is not feasible for the service provider to disclose a monetary amount, the service provider may alternatively disclose the formula utilized, the percentage of the plan's assets, or a per capita charge for each participant or beneficiary
- If a service provider offers a bundled arrangement, then only the service provider actually providing the bundle must make the required disclosure in the contract or arrangement, subject to certain exceptions

## Specific Disclosures in the Contract or Arrangement

- The service provider must explain the method by which the service provider will receive its fees from the plan in the contract or arrangement, including a description of how prepaid fees will be calculated and refunded when the contract or arrangement ends.
- The service provider must represent in the contract or arrangement that the service provider has provided complete and accurate required disclosure information.

## Specific Disclosures in the Contract or Arrangement

- If the service provider fails to satisfy this representation, a plan fiduciary may be able to seek relief under the proposed class exemption.
- The proposed regulation requires disclosures that are intended to inform the plan fiduciary about the service provider's relationships and potential conflicts of interest with the plan.

# Specific Disclosures in the Contract or Arrangement

- The required service provider disclosures within the contract or arrangement include:
  - Disclosure of any financial or other interest in any transaction that the plan will be involved with in connection with the contract or arrangement
  - Disclosure of any relationships with other parties that may result in a conflict of interest, including any material financial, referral, or other relationship that the service provider has with other parties

# Specific Disclosures in the Contract or Arrangement

- Disclosure of any financial or other interest in any transaction that the plan will be involved with in connection with the contract or arrangement
- Disclosure of any relationships with other parties that may result in a conflict of interest, including any material financial, referral, or other relationship that the service provider has with other parties

# Specific Disclosures in the Contract or Arrangement

- Identification as to whether the service provider can alter its receivables from the plan without the prior approval of the plan fiduciary (e.g., float income) as well as a description of the nature of this compensation
- Indication as to whether the service provider possesses any processes to manage real or potential conflicts of interest

# Specific Disclosures in the Contract or Arrangement

- The contract or arrangement must also provide that
  - the service provider must notify the plan fiduciary of any material changes within 30 days of the service provider's knowledge of the change
  - the service provider warrants that it will furnish information requested by the plan fiduciary to comply with the plan's annual Form 5500 requirements

# Consequences for Non-Compliance

- If the requirements are not met, the contract or arrangement will be considered unreasonable under ERISA 408(b)(2) and therefore a prohibited transaction, subjecting the plan fiduciary and service provider to penalties and excise taxes.
- The proposed class exemption provides relief to plan fiduciaries where the service provider fails to satisfy its disclosure obligations.

# Relief for the Fiduciaries

- To qualify for relief
  - upon discovery by the plan fiduciary of the service provider's failure, the plan fiduciary must request in writing the required disclosures from the service provider
  - the plan fiduciary should consider whether under the circumstances it is necessary to terminate or continue the relationship with the service provider
  - if the service provider fails to comply with the plan fiduciary's written request within 90 days, the plan fiduciary must notify the DOL

## More to come!

- The final project concerning disclosures by plan sponsors to participants was expected in early 2008.

# perspective

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