ON GUARD

Increased litigation leads plan sponsors to take a defensive stance in monitoring and evaluating fees

WHEN monitoring investment and recordkeeping fees, a plan sponsor would be smart to remember the recurring themes of recent 401(k) participant fee lawsuits.

"If you haven't paid any attention to these issues as a sponsor, you're a little behind the game. But it's never too late," says Sam Henson, director, legislative and regulatory affairs at adviser Lockton Retirement Services in Kansas City, Missouri. Most 401(k) fee lawsuits so far have targeted large, well-known companies. "But there are only so many mega plans in the country, and so these suits are starting to move down-market," he says. "It doesn't matter whether you have $10 billion in your plan or $10 million: Everybody has the same fiduciary obligations."

The settlements in some recent fee litigations "have been pretty astronomical," says Emily Seymour Costin, a partner at law firm Alston & Bird LLP in Washington, D.C. "We have recently seen settlements ranging from $15 million to upward of $60 million. It is definitely worth your time to understand these issues—and to adjust, if necessary, your processes to monitor fees."

COMMON THEMES

These themes frequently have arisen in recent fee lawsuits:

Share-class selection. Investment-focused lawsuits often center on the theme that a plan has not obtained the best-cost share class, says Benjamin Grosz, an attorney at Ivins, Phillips & Barker, also in Washington. "A common claim is that a plan offered a retail share-class fund when there was an institutional share class of the same fund available," he says. "For plans large enough to be in an institutional share class, that can be problematic if the sponsor never asked for access to the institutional share-class fund." Plaintiffs also have alleged that a plan already in such a fund had enough assets to be qualified to access an even lower-cost institutional share class of the same fund, he says.

Fiduciaries need to review share-class access issues regularly and document that investigation. "If a fund was picked several years ago, assets may have increased enough for the plan to be eligible now for a lower-cost share class," Costin says.

Illustration by Chris Buzelli

Fiduciaries have an obligation to leverage a plan's buying power, Henson says. "Even for small plans, we are seeing the necessary asset size [required] to get into institutional share classes come way down, probably because there is so much competition among fund providers," he says. "So, today, if you have retail share classes in your plan, you better have a very good reason for that or you are a 'moving target' [for potential lawsuits]."

Sponsors should look at an investment's net cost to participants, says Bradford Campbell, counsel at Drinker Biddle & Reath LLP, in Washington, D.C.

"We have seen allegations in suits that a plan should always be in the cheapest share class. That is not true," he says. "A higher-cost share class actually may cost your participants less, because it may produce revenue sharing that offsets administrative expenses. It is not always true that the lowest-cost share class is the lowest cost for participants overall."

Active vs. passive funds. Some suits allege a fiduciary-duty breach by offering an actively managed fund when the plan instead could get comparable or better performance from a less costly index fund for the same asset class. "It's an easy thing for plaintiffs' attorneys to assert right now," Henson says. "Because the market has been so strong for so long, almost any index fund [the performance of] looks good. So it's harder now to justify the premiums paid for active management."

These lawsuits have created a misconception among some sponsors that passive investments are an inherently better choice for plans than active investments—again, not true, Campbell says. "The law allows sponsors to pick either one, based on a prudent process of evaluating the alternatives. But the litigation is saying that the cheapest is always best. The plaintiff's bar is trying to change the fiduciary standard for fees from 'reasonable' to 'cheapest.'"

The knee-jerk reaction from some sponsors to contemplate moving to an all-passive lineup has surprised Greg Marsh, managing director, corporate retirement plans at Bridgehaven Financial Advisors in Warren, New Jersey. "Many of these knee-jerk reactions aren't necessarily in the best interest of plan participants: They are in the best interests of plan sponsors," he says.

Active funds can make sense as a lineup choice, Marsh says, if a sponsor can document sound reasoning such as historical outperformance in bear markets. "It comes down to having a documented, well-thought-out process for evaluating investments," he says. "If you are comparing active and passive options within an asset class, if the active fund outperforms the passive by 300 or 400 basis points [bps] in each major time period you benchmark, then the active fund becomes a strong candidate for an investment option, even if the fee is 30 basis points more." Many of his clients offer both an active option and a passive option within the main asset classes on their investment menu. "These sponsors say, 'It should be the participants' choice, not our choice,'" he adds.

Stable-value fund suitability. "We sometimes joke with clients that you are damned if you do offer a stable value fund, because there have been recent cases alleging that a plan's stable value fund was not transparent [about what the fund manager earns]. And you're damned if you offer a money market fund instead, because there

WRITE IT DOWN

PLAN SPONSORS should not just take prudent steps to avoid fee issues but document these prudent processes.

A well-thought-out investment policy statement (IPS) can help a sponsor avoid potential legal problems. "Starting off with the right amount of flexibility in the statement, and then reviewing it annually, is very important," says Carol Buckmann of law firm Cohen & Buckmann P.C. "Some of these statements detail every little step taken in doing an investment review, and that's not the best way to do it. You want the plan's fiduciaries to have some flexibility in making decisions. You don't want an IPS that locks you in to taking a particular action all the time." For example, sponsors may have certain criteria that drive funds to be put on a watch list, but they need flexibility on the best timing to replace the funds on that list.

Plan Sponsors also should have detailed minutes of committee meetings, as well as backup data that helps explain decisions made, Buckmann says. "Hopefully the plan has an investment professional who is providing reports and analysis," she says. "The starting point is to have those reports summarizing [investment and fee] reviews. Then the sponsor needs to document the decisions made in response to the reviews and set out its reasons for a decision."

Asked about the key elements to include in committee meeting minutes, Emily Seymour Costin of Alston & Bird LLP talks about documenting the issues a committee has considered before taking action, as well as the pros and cons discussed on each issue. "Most importantly, document the discussion of what is in the best interest of participants," she says.

Also, committees should document decisions to *not* take a course of action, Costin says. For instance, if a plan's investment consultant recommends switching funds in an asset class and the committee decides to wait, the minutes should document the discussion of why and how that served the plan participants' best interest. "If no action is taken on an investment consultant's recommendation, that is going to be very difficult to defend down the road if there is no documentation of why," she says.

Remember that legally, fiduciary prudence is a process-based test, says Bradford Campbell of Drinker Biddle & Reath LLP. "If you didn't write it down, it didn't happen," he says of the legal need to document. "The best response to this fee litigation should be more attention to your process. A strong process really is your best defense." —*JW*

have been suits alleging that a plan's money market fund doesn't provide the return a stable value fund does," says Anne Becker, a partner at law firm McDermott Will & Emery LLP in Chicago.

Some suits have alleged that a sponsor breached its fiduciary duty by not adequately evaluating whether a stable value fund charged reasonable fees for the low-yielding investment, Becker says. Allegations also have surfaced that a sponsor did not adequately benchmark its stable value fund against comparable investment alternatives to determine fee reasonableness, she says. "Our advice would be to get advice from an investment consultant or other expert and understand that expert's advice," she says.

Out-of-line recordkeeping charges. Lawsuits are not just focusing on investment fees but have expanded to recordkeeping charges as well. "The claims have included that a plan fiduciary did not do an RFP [request for proposals] frequently enough, or that a plan didn't get any competitive bids for a recordkeeping contract—it just stuck with the incumbent," Grosz says.

Marsh finds that his new sponsor clients often need considerable help understanding their plan's fees paid to a recordkeeper hired years ago. "I'd say that 80%-plus of the time I walk into a prospective new client's office, they don't understand how they got into the fee arrangement they have and why it's important that they understand it," he says. "We help a sponsor understand, 'You agreed to a fee structure based on a set of services. What services does your contact include, and what services are you actually getting?'" For example, if participants pay fees according to a recordkeeping contract stipulating four days of on-site education annually, has the provider actually followed through on that?

Sponsors have a relatively clear legal path to adequately address recordkeeper-fee issues, Henson says. "When you initially select your recordkeeper, you need a prudent process behind that selection, and the selection should be based on comparison shopping," he says. "Then you can benchmark fees regularly, based on your plan's demographics, to get an ongoing sense of what should the plan be paying? If your fees fall on the high end, that means you need documentation on file to demonstrate the justification for the higher fees, or you have to have a conversation with your vendor about a fee adjustment."

Asset-based recordkeeping fees. "The biggest takeaway from the recordkeeping suits is not just the level of fees, but the fee structure," Grosz says. Suits have been filed against plans that structure recordkeeping fees on an asset basis, with the recordkeeper getting paid some percentage of participants' assets. "That can lead to problems if a sponsor does not monitor the fee reasonableness closely," he says. "A plan's asset-based fee might be reasonable when the contract is first signed, but if the market then goes up 20%, the recordkeeper just got a 20% raise without doing anything more. And, as participants put money into their accounts over time, the recordkeeper's fees also go up, for not doing any more work."

Using an asset-based fee creates more responsibility for the sponsor to closely monitor the ongoing reasonableness and renegotiate as needed, Grosz says. "All things being equal, in most cases it is a best practice now to pay recordkeeping fees on a per-participant basis instead," he says. "Sponsors should be evaluating that question regularly: What fee structure makes the most sense for their plan?"

Many of Marsh's clients are considering switching to a flat, per-participant recordkeeping fee. "I think it could be problematic to charge recordkeeping fees as a percentage of participants' assets," he says. "I don't think it's fair that if you have been at a company for 20 years, saving for retirement all along, you now pay a disproportionate percentage of the administrative fees because you have a larger account balance."

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Excessive revenue-sharing payments. Some suits have alleged that revenue sharing paid as a percentage of a plan's assets overcompensates a plan's recordkeeper, Becker says. "As a plan's assets grow over time, if the fiduciary did not re-evaluate the recordkeeper's revenue-sharing agreements to take advantage of economies of scale, there could be allegations that [they] went unchecked," she says.

Many larger plans have avoided these problems by moving away from revenue sharing entirely, says Carol Buckmann, founding partner at law firm Cohen & Buckmann P.C. in New York City. "Plan sponsors need to monitor the amount of revenue sharing very closely now," she says. "ERISA [Employee Retirement Income Security Act] says that you have to pay no more than reasonable fees for the services provided. If revenue sharing is applied to fees for administrative services, then the sponsor has an obligation to monitor the payments to make sure that participants are not paying the recordkeeper more than a reasonable amount—directly and indirectly—for the services provided."

Marsh has some clients moving to R6 share classes that pay no revenue sharing, and others that continue utilizing revenue sharing but made changes. "I think it's very prudent, when a plan works with a provider that does revenue sharing, to do per-capita revenue-share rebating," he says. "If an investment pays revenue sharing, all of [it] should get rebated back to the participants who have allocations in those investments." —*Judy Ward*