The Evolution of ERISA's Fiduciary Standard and Its Impact on 401(k) Committees

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ERISA's fiduciary rule was effective on January 1, 1975. However, its history has been more of a moving picture than a snapshot. That is, it has evolved from its early days — where it primarily affected the fiduciaries of defined benefit plans — to its current version, where it also applies to the quality and costs of investments and service providers for participant-directed plans.

This article focuses on recent developments in that evolution and how those developments affect the fiduciaries (usually plan committees) of participant-directed plans. Specifically, the article discusses:

- The court decisions in Tibble v. Edison International[1] ("Edison International") and Braden v. Wal-Mart Stores[2] ("Wal-Mart") and their impact on the fiduciary process for selecting mutual fund share classes. This includes the evaluation of revenue sharing paid by mutual funds and the use of that revenue sharing.
- 408(b)(2) disclosure requirements for service providers, and the fiduciary duty to prudently evaluate the compensation of service providers… both initially and on an ongoing basis. This topic includes a discussion of the Tussey v. ABB[3] ("ABB") case and the fiduciary liability of the 401(k) committee members for failure to calculate and evaluate the total compensation of the recordkeeper.
- The importance of a fee and expense policy statement, similar to an investment policy statement (IPS), to help plan committees fulfill their obligations to oversee investment expenses, revenue sharing and the allocation of costs and revenue sharing.

[1]Tibble v. Edison Int'l, 729 F.3d 1110 (9th Cir. 2013) cert. granted in part, 135 S. Ct. 43, 189 L. Ed. 2d 895 (2014) and vacated, 135 S. Ct. 1823 (2015).

[2]Braden v. Wal-Mart Stores, Inc., 590 F.Supp. 2d 1159 (W.D. Mo. 2008) vacated and remanded, 588 F.3d 585 (8th Cir. 2009).

[3]Tussey v. ABB, Inc., 746 F.3d 327 (8th Cir. 2014) cert. denied, 135 S. Ct. 477, 190 L. Ed. 2d 358 (2014).

The Duty to Understand and Evaluate Share Classes

The fiduciaries of participant-directed plans — such as 401(k) and 403(b) plans — have long understood that they are duty-bound to select reasonably priced investments for their plans.[4]

For example, when a committee reviews its plan's investment lineup of, e.g., mutual funds, it typically looks at information provided by an investment consultant concerning the expense ratios of the mutual funds and comparing them to the expense ratios of other funds in the same investment category. And, as a general rule, if the expense ratios were below the average, committee members felt comfortable selecting or retaining the fund.

For many years, that approach seemed to work. However, the Wal-Mart and Edison International cases have introduced new considerations… and, if fiduciaries fail to consider those changes, they do so at their own peril.

The first, and most important, concept is that committees need to take advantage of the "purchasing power" of their plans. While a $10,000,000 plan may have little choice in the matter (that is, it may be limited to retail shares), a larger plan (for example, a $500,000,000 plan) would have a range of choices. Plan committees need to understand the share classes that are available to their plans and need to evaluate those share classes through a prudent process.

As background, a mutual fund is simply a pool of assets. However, an investor may be able to purchase a more expensive, or less expensive, interest in the same pool of investments. Those ownership interests are called share classes. The retail share class, commonly called A shares, are available to retail investors and, therefore, are among the more expensive share classes. On the other hand, institutional share classes (commonly called I shares) are available to investors with more money. The expense ratios for I shares are usually much lower than for A shares.

But, that's not the end of the story. A mutual fund may have five, 10 or 15 share classes. Depending on the amount to be invested, the nature of the investor, and other considerations, a particular share class may or may not be available to the investor. The key is to know about the range of share classes, the criteria for each, and the features of each.

Obviously, if an investor was primarily concerned with the cost, the investor would buy the lowest cost share class available to him, since the underlying investments for all of the share classes are the same.

The same principal applies to committees when they select the investment lineup for their plans. However, the issues for a plan committee are more complex. For a given plan, there may be several available share classes. How does a committee choose among them? The first step in a prudent process is to consider the plan's purchasing power. All other things being equal, the plan should select the lowest-cost share class. But, "things" are not always equal. For example, a committee can properly consider the revenue sharing paid by a mutual fund, its manager or its affiliates (collectively, a mutual fund) to the plan's recordkeeper. For example, assume that the A share of a mutual fund has an expense ratio of 1% per year, but a quarter of that, or 25 basis points, is paid to the recordkeeper to help defray the expenses of operating the plan. Then, compare that to an I share of the same mutual fund, which has an 80 basis point (or .80%) expense ratio. Clearly, the expense ratio of the I share is much cheaper. However, the true cost to the plan is more for the I share than for the A share, since the 25 basis points of revenue sharing effectively reduces the net cost of the A share to 75 basis points, or .75%. So, on closer analysis, the retail share is less expensive than the institutional share.

[4]See, e.g., ERISA §404(a)(1)(A)(ii), which mandates that fiduciaries act "for the exclusive purpose of . . . deferring reasonable expenses of administering the plan…".

As that illustrates, the job of a committee, working together with its investment consultant, is to know the available share classes and to analyze them in terms of the net cost to the plan. As the Department of Labor said in its brief in the Edison International case, it is imprudent to waste participants' money.[5]

Unfortunately, though, this story doesn't end here. In the Edison International case, the committee defended itself by saying that institutional shares weren't available to the plan, because the mutual fund prospectus said that I shares required a minimum investment, which was less than what the participants invested in those funds. However, the expert witnesses for both the participants and for the committee (that is, for the plaintiffs and the defendants) testified that, if the committee had asked, the mutual funds would have waived the minimum and allowed the plan to invest in institutional shares. Because of that expert testimony, the trial court judge found that there was a "duty to ask." That is, the committee had a duty to understand which share classes were available and which were not.

By the way, the prudent man rule says that fiduciaries must act

> "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and **familiar with such matters** would use…."[6]

In other words, a fiduciary is measured by the standard of a hypothetical, knowledgeable investor who is familiar with such matters. In the Edison International case, that meant that the committee members needed to be familiar enough with the workings of mutual funds to know that, if they asked, the plan might be able to invest in the institutional shares.

What should a committee do? As a result of the Edison International and Wal-Mart decisions, committees should review all of the investments in their plan lineups, make sure they understand which share classes are in the plan and then work with the plan's investment consultant to determine that they have the appropriate share classes. Because of the Edison International and Wal-Mart decisions, there is fiduciary duty for plans to use their purchasing power to avoid overpaying for investments.

[5]Brief for the Secretary of Labor as Amicus Curiae in Support of Plaintiffs-Appellants, Tibble v. Edison Int'l, 729 F.3d 1110 (9th Cir. 2013) cert. granted in part, 135 S. Ct. 43, 189 L. Ed. 2d 895 (2014) and vacated, 135 S. Ct. 1823 (2015), 2011 WL 2178417 (C.A.9).

[6]ERISA §404(a)(1)(B).

The Duty to Know and Evaluate the Compensation of Service Providers

It is well accepted that plan fiduciaries — such as plan committees — have a duty to prudently select and monitor their plan's service providers, considering both services and compensation. That is the long-standing position of the Department of Labor, and the courts have agreed.

For the most part, committees have understood that responsibility and have done a good job of vetting their service providers, including their plan's recordkeepers. However, as 401(k) plans grew in popularity, and as revenue sharing from mutual funds to recordkeepers developed in the mid-1990s, the job of evaluating compensation of recordkeepers became more complicated. That is because the lack of clear disclosure of those payments made it difficult, perhaps impossible, for committees to properly do their job. Revenue sharing is sometimes called "indirect" payments, because it is not paid directly from the plan or the plan sponsor. Over time, the Department of Labor (DOL) became aware of the revenue sharing payments and of the difficulty of committees in evaluating those payments. As a result, the DOL developed disclosure requirements under section 408(b)(2) of ERISA. In effect, the DOL said that a service provider's agreement and compensation would not be "reasonable" (and, therefore, would be prohibited) if the service provider did not properly disclose the receipt of those payments. Those requirements, which were adopted through a regulation, mandated the disclosures by service providers on or before July 1, 2012.

The goal of the DOL was not to put a burden on service providers, but instead to force them to provide plan committees with the information needed for the committees to make informed decisions. As a result, after the disclosures were made, the burden shifted to plan committees to properly evaluate the disclosures and the information about direct and indirect compensation for recordkeepers and other service providers. That is now part of the committee's job, both in the initial selection of service providers and in the periodic monitoring of those providers. The initial review of the disclosure should have occurred in the second half of 2012 or perhaps the first half of 2013. As an industry rule of thumb (but not a legal requirement), many people believe that the review should be done approximately every three years, absent special circumstances (such as plan mergers or spin-offs). That means that, if your committee's last review of service provider compensation was in late 2012 or early 2013, it's time to do it again.

Based on the decisions of both the trial court and the court of appeals in the ABB case, in order to properly evaluate the compensation of service providers, plan committees need to look at "market data." In other words, while the law may require disclosures and prudent processes, it is the competitive marketplace that provides the data to be used in the evaluation process. As a practical matter, the two most common ways of gathering market data are benchmarking services and request for proposals.

1 Step One

So, as a starting point, a committee needs to have market data about cost and compensation for similar services for similarly situated plans.

The key is to have good-quality peer group information.

2 Step Two

The second step is to calculate the dollar amount of the compensation being received by your service providers, for example, your recordkeeper. That would then be compared against the market data about compensation of recordkeepers for similar plans. (Typically, in determining whether a plan is "similar," or in your "peer group," the two most important factors — but not the only factors — are the total assets in your plan and the number of participants covered by the plan.)

If the market costs for similar services for a plan of your size are about the same as your plan, then you are probably paying reasonable amounts. The point is not to be less expensive than the average, but instead to be within the "range of reasonableness" for similar services for similar plans.

If your plan's service provider is more expensive than the average, it may be justified… or it may not. Is your plan receiving more services, or higher-quality services, than other similar plans? If you are receiving higher-quality services that should be reflected in the results your plan is producing, compared to other companies in the same industry. For example, do you have higher participation rates or higher deferral rates?

These are just suggestions about the type of factors to evaluate. The point is that committees need to engage in a reasonable evaluation of the services and the results they are producing. The risk is not that a committee will, after a thoughtful analysis, make a bad decision. The fiduciary risk is for a committee that does not perform the analysis. Where committees are doing their job, the courts tend to grant them considerable leeway and, generally, a court will not substitute its judgment for that of a committee.

What happened in the ABB case? According to the opinions, the ABB committee failed to calculate the amount of the money that the recordkeeper was receiving (mostly or entirely through indirect payments, such as revenue sharing). Unfortunately for the committee, it had a report from its consultant about the reasonable compensation that a recordkeeper should receive in comparable circumstances, and it was millions of dollars less than the compensation that their recordkeeper actually received. In other words, there were two problems. The first is that the committee did not calculate the dollar amount that the recordkeeper was receiving. The second was that the committee did not compare that amount to market data (which it had in its consultant's report).

Forewarned is forearmed. Plan committees should periodically calculate the total dollar amounts being received by their recordkeepers and compare it to current market data.

The rule of thumb is that the calculations and comparisons should be done approximately every three years.

The Importance of Fee and Expense Policy Statements

Most plan committees have investment policy statements to help them fulfill their fiduciary responsibilities to prudently select and monitor their plan's investments.

However, most ERISA litigation is not about the quality of investments. Instead, it is about expensive share classes, expense ratios of investments, and payments, (and especially indirect payments (e.g., revenue sharing).

In a nutshell, litigation has been quantitative, rather than qualitative.

While it is a good practice, and good risk management to prudently evaluate the quality of a plan's investments, it is not enough. Instead, committees need to have a "quantitative policy" or, in other words, a fee and expense policy.

Neither an investment policy statement nor a fee and expense policy statement is required by the law. It is possible for committees to engage in prudent process, and fulfill their fiduciary responsibilities, without either. By going through the process of formally developing policies, committee members will learn what the issues are and will make decisions that are appropriate for their plans. Then, by reducing the policies to writing, the statement will be a roadmap for future compliance.

A fee and expense policy statement should, at the least, cover the following:

- The expense ratios and share classes for the plan's investments.
- The costs of their plan's (i) administrative services (such as recordkeeping, investment consultant, and accountant); and (ii) individual expenses, that is, the expenses charged to participant accounts (such as loan fees, distribution costs and so on).
- The allocation of costs. Should the plan's administrative costs be allocated (i) pro rata (i.e., in proportion to account balances); (ii) per capita (i.e., equally to each participant); (iii) paid by revenue sharing from the investments; or (iv) a combination of the foregoing.
- The allocation of revenue sharing (for example, should the revenue sharing be used to pay plan expenses or should it be allocated back to participants?); if allocated to the participants, should it be done in proportion to account balances, or should it be returned to the participants that held the investments that generated the revenue sharing?

There is considerable latitude for plan committees to make those decisions. However, it is a fiduciary duty for the committee to engage in a prudent process and make decisions about each of those points. The larger risk is not that a committee will make a bad decision; instead, it is that the committee will not engage in a process to make the decision. If a committee thoughtfully makes decisions, after gathering and evaluating the relevant information, the Department of Labor and the courts will ordinarily defer to the committee decision. However, where a committee has not gone through a thoughtful and documented process to make decisions, there is no basis for deference.

The lessons learned from the Edison International, Wal-Mart and ABB cases are that committees need to engage in thoughtful processes to make decisions. Where committee members lack the knowledge to make an informed decision, they should hire knowledgeable consultants. While the use of a consultant is not a rubber stamp for fiduciary compliance, it is a material factor for determining whether a committee is engaged in a prudent process.

Conclusions

The responsibilities of plan committees have increased. However, there is a pathway to compliance.

The three topics in this article cover issues that should be on committee agendas. The topics need to be discussed, information needs to be gathered, advice from consultants needs to be obtained and thoughtful decisions need to be made. That is the best protection.

1 **The Duty to Understand and Evaluate Share Classes**

2 **The Duty to Know and Evaluate the Compensation of Service Providers**

3 **The Importance of Fee and Expense Policy Statements**

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Biography

C. Frederick Reish is a partner in Drinker Biddle's Employee Benefits & Executive Compensation Practice Group, Chair of the Financial Services ERISA Team and a member of the Retirement Income Team.

His practice focuses on fiduciary issues, prohibited transactions, tax qualification and retirement income. He works with both private and public sector entities and their plans and fiduciaries; represents plans, employers and fiduciaries before the governing agencies (e.g., the IRS and the DOL); consults with banks, trust companies, insurance companies and mutual fund management companies on 401(k) investment products and issues related to plan investments and retirement income; and represents broker-dealers and registered investment advisers on issues related to fiduciary status and compliance, prohibited transactions and internal procedures.

Fred serves as a consultant and expert witness on ERISA litigation and FINRA arbitration, with a focus on cases involving broker-dealers, registered investment advisers, financial service companies and other service providers. Fred's experience includes advising insurance companies and investment managers of the development of products and services that are consistent with ERISA's fiduciary standards and prohibited transaction restrictions, including retirement income investments and guarantees. Fred is also a consultant member of the Institutional Retirement Income Council (IRIC), which focuses on retirement income issues and products.

Professional Recognition and Awards.

Fred has received a number of awards for his contributions to benefits education, communication and service, including:

- Selection by ***PLANADVISER*** magazine as one of the five "Legends" of the retirement industry and with retirement advisers.
- The American Society of Pension Professionals & Actuaries (ASPPA)/ Morningstar 401(k) Leadership Award for directly and positively influencing the ability of Americans to build successful retirements.
- Selection by ***PLANSPONSOR*** magazine as one of the 15 Legends in the development of retirement plans.
- Recognition by 401kWire as the 401(k) Industry's Most Influential Person for 2007 (and has, for every year of that survey, been in the top 10).
- Recipient of the IRS Director's Award and the IRS Commissioner's Award for his contributions to employee benefits education.
- Received Lifetime Achievement Awards from ***PLANSPONSOR*** magazine and from ***Institutional Investor*** for his contributions to the benefits community.
- Received the Eidson Founders Award from ASPPA for his significant contributions to that organization and to the benefits community.
- Received the Alumni Service Award from Arizona State University.

On behalf of ASPPA, he has co-authored amicus curiae briefs with the Supreme Court of the United States in the case of Patterson v. Shumate and with the Tax Court in the case of Citrus Valley Estates v. Commissioner of Internal Revenue.

Publications.

Fred has written four books and over 350 articles on fiduciary responsibility, prohibited transactions, IRS and DOL audits, and pension plan disputes. He authors a monthly column on 401(k) fiduciary responsibility for ***PLANSPONSOR*** magazine and has written a quarterly column on that subject for the ***Journal of Pension Benefits***.

As an experienced lawyer on benefits matters, Fred is frequently quoted by both professional and public publications, including ***The Wall Street Journal, Fortune, Forbes, Inc., CFO Magazine, The New York Times, Washington Post, Los Angeles Times, USA Today, Institutional Investor, PLANSPONSOR,*** and ***Pensions & Investments.***

Speaking Engagements.

Fred is a nationally known speaker on fiduciary responsibility, technical compliance matters and litigation issues. He has spoken at the annual conferences of the American Bar Association, the American Society of Pension Professionals and Actuaries, the Western Pension and Benefits Conference, the Enrolled Actuaries Conference, the International Foundation of Employee Benefit Plans, and the National Institute of Pension Administrators.

Education.

Fred received a J.D. from the University of Arizona James E. Rogers College of Law and B.S. from Arizona State University.

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