

# Impact of New Fiduciary Rules on an Excess Fee Lawsuit

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The Department of Labor (DOL) has issued new rules on fiduciary investment advice that go into effect April 10, 2017. In the meantime, the drumbeat of new lawsuits against 401(k) plans, their sponsors, and investment and service providers continues. A case in point is a recent class action filed by participants in the Delta Airlines 401(k) plan against Fidelity charging that it engineered kickbacks from Financial Engines derived from the latter's furnishing participant-level investment advice. The suit also charges that Fidelity received excessive compensation derived from revenue sharing paid by unrelated mutual funds in which plan participants chose to invest through Fidelity's brokerage window. Interestingly, neither the plan sponsor nor Financial Engines have yet been named as defendants. This article will discuss how these claims may fare under current regulatory guidance and under the DOL's new fiduciary rule once it goes into effect.

*Revenue Sharing from Provider of Computerized Advice.* The eye-catching gist of the new lawsuit, *Fleming v. Fidelity Management Trust Company*, filed May 20, 2016, is that Fidelity contracted with Financial Engines to provide computerized investment advice services to individual plan participants for which Financial Engines was to receive a fee of 45 basis points of the amount invested by a participant under the computerized advice program; however, according to the plaintiffs, Financial Engines forwarded half of this fee, that is, 22.5 basis points, to Fidelity in order to participate on the Fidelity investment platform. Participants arguably received little or no value for this addition to the fee for Financial Engines' services.

*Selection of Person to Provide Investment Advice is Fiduciary Act.* The plaintiffs asserted that Fidelity, which furnished the platform, as well as recordkeeping and trustee services is an ERISA fiduciary, because it picked Financial Engines to be the exclusive provider of computerized investment advice. The

new advice definition clarifies that recommendations relating to the selection of other persons to provide investment advice are included as fiduciary advice. The DOL maintains that this has always been its position, and it will certainly be the case going forward. However, certain advisors have just as resolutely maintained that the old rule did not include such recommendations, so it will be interesting to see if Fidelity relies on this distinction in its defense.

*Self-Dealing or Plan Sponsor Approval.* The complaint also alleged that, as a fiduciary, Fidelity engaged in classic self-dealing under ERISA's prohibited transaction rules by negotiating the terms of Financial Engine's engagement that resulted in revenue sharing payments to itself. The complaint states that Fidelity not only hired Financial Engines, but also controlled negotiation of the terms and conditions of its engagement, specifically the terms requiring the payment of revenue sharing to Fidelity. If true, however, this would be damning, although it would also be unusual, since the involvement and approval of the plan sponsor is generally sought for arrangements involving advice to be rendered to employees. If Fidelity merely informed the employer that Financial Engines was available to provide participant-level advice if Delta wished to make this feature available and disclosed its fee arrangement with Financial Engines, the plaintiff's theory of fiduciary breach falls apart. Even if Delta had delegated the responsibility of establishing an investment advice program to Fidelity, it would be incumbent on the employer to periodically review the arrangement to ensure its fiduciary compliance.

*Availability of BIC Exemption.* As a regulatory matter, a fiduciary, such as Fidelity, cannot use its fiduciary authority to cause a plan or a third party to pay an additional fee to the fiduciary which may affect its best judgement as a fiduciary. This presumably includes third-party revenue sharing, such as the Financial Engines payments to Fidelity. Under the Best

Interest Contract Exemption issued in connection with the new fiduciary rule, however, fiduciary advisors meeting the exemption's terms would be permitted to receive such otherwise prohibited compensation if they meet the terms of the exemption. On the other hand, the exemption is not available if the advisor has discretionary control with respect to recommended transactions, as seemed to be implied by the plaintiffs in the new *Fidelity* case, although this requires verification.

Even if Fidelity needed to seek Delta's approval and lacked discretion to hire Financial Engines on its own, another preliminary issue relates to the requirement that advice covered by the BIC exemption be rendered to (i) a plan participant or beneficiary, (ii) an IRA owner, or (iii) a plan or IRA fiduciary which is not an institutional advisor or has less than \$50 million under management. Since Fidelity's recommendation to hire Financial Engines was not rendered to the plan's participants, but to Delta, which sponsors a 401(k) plan with assets of nearly \$8 billion, it seems unlikely that the BIC exemption would apply to such a large plan.

*Alternatives for Avoiding Prohibited Transactions.* Existing alternatives to the prohibited transaction exemptions issued or revised in the DOL's recent spate of guidance may also be available to comply with the prohibited transaction rules. Instead of using the BIC exemption, a fiduciary advisor could levelize its variable compensation and third-party payments, which would prevent the occurrence of a prohibited transaction. This would require identifying all sources of variable compensation and taking steps to ensure that no amount varies based on the particular investment product chosen for investment. This would likely require Fidelity to restructure revenue sharing payments so that they are flat dollar amounts.

In addition to fee leveling, the SunAmerica opinion and its statutory analog would enable a fiduciary advisor to recommend its proprietary funds, as long as the applicable advice has been generated by an independent computer model. Like the BIC exemption, however, reliance on the computer-based exemptions depends on the compensation earned by the advisor and its affiliates being reasonable.

*Plaintiffs' View of Revenue Sharing.* The complaint in the new Fidelity case seems to make the two-fold argument that revenue sharing received by Fidelity is a violation of its fiduciary duties, as well as the prohibited transaction rules, first by its very existence, but also because the amounts are excessive. These arguments are made not only with respect to revenue sharing payments by Financial Engines, but also revenue sharing coming from mutual funds in which participants invested through the plan's brokerage account window. Fidelity allegedly manipulated this revenue by investing only in retail shares instead of institutional shares. The first assertion is incorrect as evidenced by the new fiduciary rules which specifically allow variable compensation and third-party payments if investor protections are in place. The second question, the reasonableness of an advisor's overall compensation, including amounts paid directly by the plan and indirectly by third parties, would seem to be a factual question which will ultimately be resolved by the court. This is also a matter for which the plan sponsor is responsible pursuant to its monitoring duties.

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