BEST PRACTICES EVOLVING FROM ERISA LITIGATION

OPPENHEIMER FUNDS
RETIREMENT PLANS STRATEGIC PARTNER CONFERENCE

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Best Practices Evolving from ERISA Litigation

I. Identifying ERISA Fiduciaries. When does an investment professional take on a fiduciary role under ERISA? This is a critical question, since ERISA has rules governing fiduciaries that do not apply to non-fiduciary service providers. The first step in providing financial services with a defensive emphasis, as required in the hostile environment created by litigation over 401(k) fees, is to know which set of standards apply. 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.

A. Definition of a Functional Fiduciary. A fiduciary under ERISA includes any person who:

1. Exercises discretionary authority or control over the plan's management;

2. Exercises *any* authority or control over the management or disposition of the plan's assets;

3. Renders investment advice for a fee or other compensation with respect to plan funds or property; or

4. Has discretionary authority or responsibility with respect to plan administration.

B. Investment Advice. A person renders investment advice to a plan within the meaning of the above definition only if his activities are described by both of the following requirements:

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

a. Either

(i) The person has discretionary authority or control with respect to purchasing or selling securities or other property of the plan, or

(ii) The person renders advice to the plan on a regular basis under an agreement or understanding (written or otherwise) that it will be a primary basis for investment decisions, and that it will consist of individualized investment advice to the plan based on its particular needs.

2. A recommendation with regard to a plan service provider probably does not constitute investment advice, because it does not relate to the plan's purchase of securities or property. Similarly, if there is no discretionary control over investments, general advice relating to investment strategy, such as describing the asset classes that are consistent with long-term investing, does not fall within the definition of investment advice, because it is not geared to the particular needs of a plan.

C. Compensation. To make a person rendering investment advice a fiduciary, he or she must be compensated for the advice. The compensation may take the form of a fee or some other form of direct of indirect compensation. 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 soft-dollar arrangements and revenue sharing, pursuant to which an advisor receives something of value from an investment provider would be taken into account for purposes of determining fiduciary status.

D. Functional Test. The test for determining fiduciary status is a functional one. In other words, if a person or entity acts or possesses powers, as described in I.A, above, the person or entity will be deemed to be a fiduciary regardless of his title or official designation. Thus, if a person actually renders investment advice, as described above, for which he is compensated, he or she will be treated as a fiduciary.

E. Effect on RIAs. Most RIAs can be described under either I.A.2 or I.A.3.

F. Effect on Brokers. DOL Regulation Section 2510.3-21(d) has an exemption for stockbrokers that provides that a broker will 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. Therefore, broker-dealers that only engage in traditional broker-dealer activities are generally not fiduciaries, but their activities can cause them to cross the line. For example, in Ellis v. Rycenga Homes, Inc., No. 1:04-cv-694, 2007 WL 837224 (W.D. Mich. 2007), periodic meetings between a broker and a plan trustee to review plan investments over the course of a 20 year relationship which was the plan's only source of investment advice and which resulted in the plan's consistently following the broker's suggestions led to the court's holding that the broker and its broker-dealer were fiduciaries.

II. Fiduciary Duties.

A. Basic Duties. 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. ERISA Sections 403(c)(1) and 404(a).

B. Responsibility as to Fees and Expenses. 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 "indirect fees", since they are ultimately charged back to a participant's account. Fiduciaries should also monitor such payments to determine if they continue to be reasonable in comparison to industry standards. While the reasonableness of fees and expenses is a concern for all qualified plans, it is particularly important for 401(k) plans, because participant accounts generally bear a higher proportion of the fees and expenses. Monitoring fees and expenses is an ongoing fiduciary responsibility that has taken on new urgency as defensive tactic to claims raised by the plaintiffs' bar.

III. Overview of Participant Complaints in 401(k) Fee Litigation. Increased public and regulatory interest in 401(k) plan fees and expenses has resulted in the filing of lawsuits against some of the nation's largest employers and investment providers charging that they breached their fiduciary duties. Class action law suits brought against such defendants make the following allegations against the targeted employers, as well as against investment and service providers:

A. Failure to negotiate reasonable fees for administrative and investment services.

1. The class action complaints allege that the defendants failed to inform themselves of, understand, or monitor and control the hard dollar and revenue sharing payments made directly or indirectly by the plans.

a. Revenue sharing is the practice by mutual funds or other investment providers of paying other plan service providers, e.g., the plan recordkeeper or third party administrator, for performing services that the mutual fund might otherwise be required to perform.

b. Plaintiffs also argue that the selection of retail class mutual funds as investment options is inappropriate because they are more expensive than institutional class funds.

2. The complaints also allege that the defendants did not establish, implement or follow procedures to properly determine whether hard dollar and revenue sharing payments were reasonable and incurred solely for the benefit of plan participants.

3. Claims are sometimes made that revenue sharing is illegal or that revenue sharing is a plan asset. A variant on this theme is the claim that revenue sharing should, at the very least, be taken into account in evaluating the reasonableness of plan fees.

B. Fees and expenses not adequately disclosed to plan participants.

C. Investment alternatives consisting of company stock funds structured as unitized funds improperly result in higher transactional costs and lower investment returns due to the higher level of cash in the fund.

D. Failure to properly account for float retained by institutional trustees.

IV. 401(k) Fee Litigation. The complaints challenging investment and service provider fees were filed in several waves that reflected evolving and broadening theories as the plaintiffs' bar became more familiar with the nature of its target.

A. *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).

1. Haddock v. Nationwide Financial Services, Inc. (D. Conn. 2006). The court in this case initially 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:

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

b. 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

c. 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.

A motion to dismiss was denied in 2007. More recently, on November 6, 2009, the district court certified a class action in which the class would be made up of the trustees of approximately 25,000 plans holding Nationwide annuity products. With respect to the typicality of claims, the court held that the annuity contracts were sufficiently similar to justify a class, even though there were potential differences with respect to a defense and counterclaim based on each class member's alleged ratification of the revenue sharing payments made to Nationwide. The class certification in Haddock conflicts with Ruppert v. Principal Life (discussed below) where, under similar circumstances, the Ruppert court found numerous individualized fact issues for each plan and had, therefore, refused class certification. Nationwide has appealed the class certification on the ground that the fiduciary breach claims require individualized proof. It has also moved for class certification of its own counterclaim against the individual plaintiff trustees This counterclaim asserts that the ultimate responsibility to identify and monitor revenue sharing belonged to the trustees.

2. Ruppert v. Principal Life Insurance Company (S.D. Iowa.). The complaint in this case contains allegations that Principal's failure to disclose the existence of its revenue sharing arrangements to the plans and to participants was a fiduciary breach. The complaint asserts that Principal is a plan fiduciary by virtue of offering full service 401(k) plans to employers and by maintaining the ability to change plan investment offerings. It also alleges that Principal committed violations of Sections 406(b)(1) and 406(b)(3) of ERISA by receiving revenue sharing payments from mutual funds in its capacity as a fiduciary.

The plaintiff's motion for class certification was denied on August 27, 2008, because an intense plan by plan inquiry would have been required to evaluate the plaintiffs' claim that the defendant insurance company was a fiduciary as to each of the more than 25,000 different plans that plaintiff sought to include in the class. The denial of class status was appealed to the Eighth Circuit Court of Appeals which rejected the appeal on procedural grounds.

Principal subsequently moved for dismissal which was granted on November 5, 2009. As to the disclosure claim relating to Principal's receipt of revenue sharing, the court followed the Seventh Circuit decision of Hecker v. Deere (discussed below) in concluding that, while ERISA may require fiduciaries to inform plan participants and beneficiaries as to the aggregate amount of fees, it does not required specific identification of revenue sharing payments. This holding appears to conflict with the position taken by the Eighth Circuit Court of Appeals two weeks later in

Braden v. Wal-Mart (discussed below). It is to be noted that the Principal court is within the jurisdiction of the Eighth Circuit.

As to the plaintiffs' prohibited transaction claim, the Principal court, again relying on Hecker v. Deere, held that revenue sharing payments made from the assets of registered mutual funds are not plan assets and that, therefore, they cannot be the basis for a prohibited transaction claim. As to plan investments in unregistered funds, whose underlying assets generally are plan assets, the court held that if revenue sharing payments were reasonable in relation to Principal's services, there would be no violation of the prohibited transaction rules. The court then concluded that the plaintiffs had failed to plead that Principal's fees were unreasonable or too high.

3. Phones Plus, Inc. v. Hartford Financial Services (D. Conn.).

a. Plaintiffs' Allegations. The complaint was 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.

In Phones Plus, Inc. v. Hartford Financial Services Group, Inc. 2007 WL 3124733 (D. Conn. 2007), issued on October 23, 2007, the district court denied a motion to dismiss, and in so doing adopted a typically lenient approach to the plaintiff's pleadings.

The plaintiff, a sponsor of a 401(k) plan, alleged that Hartford Life Insurance Company and its holding company parent, as well as the 401(k) plan's investment adviser, had breached their fiduciary duties as a result of revenue sharing agreements that Hartford had entered into with various mutual fund companies. Hartford moved for dismissal on the ground that it was not a fiduciary and that, in any case, revenue sharing payments are not plan assets. The investment adviser also moved for dismissal on the ground that investigating Hartford's receipt of revenue sharing payments was beyond the limited scope of its fiduciary obligations as an investment adviser and that, in any event, it did not know of and did not receive any of the revenue sharing payments. The motions to dismiss with respect to both defendants were denied.

The most significant aspect of the Hartford decision may lie in the court's conclusion that it is possible to allege a set of facts (to be proven in subsequent phases of the case) under which revenue sharing payments are plan assets. The Seventh Circuit in Hecker v.

Deere recently has ruled to the contrary on this point, as has the district court in Principal v. Ruppert, discussed above.

As to Hartford Life's status as a fiduciary, the court ruled that the company's power to add, delete or substitute mutual funds to or from the plan's menu of funds could render it a fiduciary, notwithstanding Department of Labor Advisory Opinion 1997-16A that reached a contrary conclusion on similar facts. The court noted that the question of fiduciary status is inherently factual and depends on the particular actions or functions performed on behalf of the plan. The advisory opinion was held to be inapplicable, because its facts differed from the facts alleged by the plaintiff. For example, Hartford gave a plan only 30 days' advance notice when it proposed to make a change in its fund lineup, whereas under the advisory opinion the plan had been given 120 days to accept proposed changes or to reject them and terminate the contract.

The investment adviser's contention that it had no duty to investigate Hartford's receipt of revenue sharing was also rejected. The court indicated that the scope of the adviser's fiduciary duties was a matter to be determined by interpreting the terms of the advisory agreement. This enabled the court to conclude that the plaintiff had made allegations as to the adviser's obligation to investigate, discover, and inform the plaintiff of allegedly unlawful or excessive fees that might be substantiated during a trial. The investment adviser (Neuberger) notified the court that it had reached a settlement with the plaintiffs in November 2008 which was subsequently approved.

b. Settlement. In February 2010, The Hartford settled its long-running dispute with disaffected plan trustees over allegations that it had received payments from mutual funds that were allegedly made in exchange for offering the funds as investment options under Hartford's variable annuity contracts, rather than for Hartford's rendering of administrative services.

   i. Payment to Plaintiffs. Under the terms of the settlement, Hartford will deposit $13,775,000 in a fund to be divided among the 401(k) plans that used Hartford as a service provider from November 14, 2003 through the date of the settlement's approval. An additional $300,000 will be paid for administrative costs in effectuating the settlement.

   ii. Modification of Business Practices. The Hartford is also required to make a number of changes to its business practices relating to the allegations made by the plaintiffs.

Accordingly, under the settlement, The Hartford will eliminate language in its plan documents that restricts the type of property in which plan assets may be invested and will not enforce such language as a means of restricting the selection of investment options from the overall menu. In addition, Hartford will not enforce language in its annuity contracts or funding agreements that would otherwise allow it to invest assets in short-term money market instruments, cash or cash equivalents and will revise such contracts and agreements to clarify that Hartford does not have the right to substitute other investment options for those chosen by a plan, except in certain narrow circumstances, such as the unavailability of the option. The Hartford settlement further provides that all dividends and capital gains distributions on the shares of any mutual fund will be paid as additional shares of that fund, if available, and that Hartford will disclose such fact, as well as provide for customer instruction on the issue.

iii. Disclosure of Revenue Sharing. On the issue of revenue sharing, the Hartford settlement provides that new and existing customers will receive disclosure documents explaining that all of the mutual fund investment options on the Hartford overall menu make revenue sharing payments to Hartford or its affiliates. Further, Hartford must make available a list of all investment options offered to each particular plan, as well as the revenue sharing rate for such options, the published expense ratio for each option, an estimate of the dollar amount of revenue sharing per plan, and explanation of how the estimate was calculated, a narrative description of the revenue sharing and certain fees broken out by participant.

The forgoing changes are to be implemented within 60 days of the settlement's effective date.

B. The Second Wave – Cases Against Plan Sponsors. More than a dozen participant claims against plan sponsors and related plan fiduciaries were filed in September and October of 2006 by the law firm of Schlicter, Bogard & Denton, LLP 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 some 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.

1. Partial List of Cases

   a. Abbot v. Lockheed Martin Corp. (S.D. Ill.); on March 31, 2009, the court granted a partial summary judgment for the defendants pursuant to which the plaintiff's revenue sharing claims were dismissed.

   b. Beesley v. International Paper Company (S.D. Ill.); the claims contain the usual revenue sharing allegations with the difference that the investment vehicles consisted of separate accounts rather than mutual funds which are arguably governed by market forces, as argued in Hecker v. Deere. In January 2009, both sides moved for summary judgment.

   c. George v. Kraft Foods Global, Inc. (N.D. Ill.); On January 27, 2010, the defendants in this case obtained summary judgment dismissing the claims made against them. For a fuller discussion see IV.D.1.c, below

   d. Kanawi v. Bechtel Corp. (N.D. Cal.); this case was settled on November 20 2008. See Item IV.D.l.d.

   e. Loomis v. Exelon Corp. (N.D. Ill.); although class certification had been previously granted, the district court dismissed the case on December 9, 2009 relying on Hecker v. Deere which was controlling precedent for the court. The initial complaint had been similar to the complaint in Hecker and the facts were somewhat more favorable to the defendants, since the range of expense ratios offered was slightly lower than in Hecker. Therefore, the chief issue was whether the amendment of the complaint subsequent to Hecker would enable the case to continue. The gist of the amended complaint was that plan fees were excessive because, as newly detailed, no additional services were rendered to the plan. Moreover, the amended complaint asserted that the fees were excessive because they were asset-based. Nevertheless, this attempt to differentiate the claim from Hecker failed. Among other things, the court found that Hecker had expressly approved of a plan which calculated fees as a percentage of assets within a range similar to the range of fees in the Excelon case. In March

2010, the DOL filed an amicus brief in support of the plaintiffs' appeal of the dismissal, arguing that Hecker v. Deere was limited to its facts and did not establish that a particular range of fees was prudent. The DOL brief also asserted that the trial court in Excelon had imposed an unjustifiably high standard of pleading and in the process had incorrectly decided unresolved factual issues in favor of the defendants.

f. Martin v. Caterpillar, Inc. (W.D. Mo.); motion to dismiss second amended complaint denied on September 25, 2008 and class certification was subsequently granted; the defendants' motion for judgment on the pleadings was made in February 2009. A settlement of the Caterpillar case was announced on November 5, 2009. The terms of the settlement and its implications are discussed below in Item IV.D.2.a.

g. Spano v. Boeing Co. (S.D. Ill.); motion to dismiss denied on March 16, 2007; on August 17, 2009, the Seventh Circuit Court of Appeals issued an order consolidating the Boeing and International Paper cases with two other cases for purposes of reviewing class certification.

h. Taylor v. United Technologies Corp. (2d Cir.); summary judgment in favor of the defendant was granted on March 3, 2009; among other things, the court held that information on revenue sharing was not material and that the defendants did not breach their fiduciary duty in not disclosing its use to reduce the defendant's subsidization of plan expenses. On December 1, 2009, the Second Circuit Court of Appeals affirmed the district court's grant of summary judgment. A fuller discussion of the case appears at Item IV.D.1.b, below.

i Will v. General Dynamics Corp. (S.D. Ill.); the defendants' motion for summary judgment was denied in March 2009

2. Issues.

a. Whether defendants acted prudently in selecting investment options.

b. Whether defendants are entitled to protection under Section 404(c) of ERISA.

c. Whether plan fiduciaries have a duty to seek mutual funds with the lowest expense ratios.

d. 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 indirect fees.

e. Whether the failure to disclose direct and indirect fees to participants constitutes a fiduciary breach.

C. *New Tactics - Additional Complaints against Plan Sponsors Joining Providers*. In December of 2006, the Schlicter law firm filed 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.

1. List of Additional Cases:

a. Hecker v. Deere & Co. (W.D. Wis.); see discussion at Item IV. D.1.a.

b. Renfro v. Unisys Corp. (C.D. Cal.); the court has not ruled on defendant's motions to dismiss and for summary judgment.

c. Tussey v. ABB, Inc. (W.D. Mo.); Fidelity's motion to dismiss was denied in February 2008. All parties moved for summary judgment in March 2009.

D. Courts Show Caution in Denying Motions to Dismiss. Litigation challenging the fees and expenses paid by 401(k) plans continues to proliferate and represents a major threat to the industry. With the notable exception of cases, such as Hecker v. Deere, Taylor v. United Technologies and Loomis v. Excelon Corp., trial courts have been cautious in dismissing these lawsuits at an early stage. Despite the fact that preliminary rulings are not the same as a judgment on the merits, the lack of early dismissals seems to have encouraged the plaintiffs' bar to file even more class action lawsuits over fees. This should come as no surprise, since this type of litigation has the potential to generate enormous legal fees. This trend seemed to intensify as participants sought to recover 401(k) plan losses exacerbated by the current economic downturn. However, it may have been blunted by recent losses in the Hecker and Excelon cases.

1. Favorable Defense Rulings. Motions to dismiss or summary judgment in favor of defendants have been granted in the following cases:

a. Failure to State a Claim in Hecker v. Deere. Defendants in fee litigation lawsuits have routinely filed pre-discovery motions to dismiss which have generally been denied. The arguments for dismissal are based on the contention that the complaint fails to set forth facts that could give rise to a breach of fiduciary duty. Courts have been reluctant to dismiss a case before there has been fact finding that could support a claim. A major exception to this trend is Hecker v. Deere, 2007 WL 1874367 (W.D. Wis. 2007), which granted early stage motions to dismiss made by the employer, Deere & Company, and two Fidelity entities that were plan service providers.

Deere sponsored and administered 401(k) plans for its employees. The plans offered at least 20 Fidelity investment options while trustee, recordkeeping, and administrative functions were handled by Fidelity Management Trust Company and Fidelity Management and Research Company. (Significantly, the Deere plan also made available a brokerage window that provided participants with access to more than 2,500 other mutual funds.) The complaint alleged that the defendants violated their fiduciary duties in two ways: first, by providing investment options with excessive and unreasonable fees and costs; and, second, by failing to adequately disclose information about the fees and costs to plan participants. The District Court granted the defendants motion to dismiss which the plaintiffs then appealed to the Seventh Circuit Court of Appeals.

On February 12, 2009, the appellate court, in a landmark opinion, affirmed the dismissal, rejecting the plaintiff's first claim as to excessive fees on the ground that the mutual fund fees could not be excessive because they were offered to the general investing public with the result that expense ratios are set in response to market competition. The court stated that "[N]othing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)." The court also held that Deere's practice of limiting the funds' investment options to those offered by defendant Fidelity Investments was prudent given the diversity of those investment options, which included more than 20 Fidelity mutual funds as well as the brokerage window through which participants could invest in more than 2,500 other funds.

As to the plaintiff's second claim, the Seventh Circuit held that ERISA does not prohibit revenue sharing arrangements or compel their disclosure. The court also held that such payments did not constitute plan assets, because they were made from the assets of the mutual funds in question, not from the plan. The court found that the disclosure of total aggregate fees in fund prospectuses was adequate, stating that "the total fee, not the internal, post-collection distribution of the fee [to Fidelity affiliates], is the critical figure for someone interested in the cost of including a certain investment in her portfolio and the net value of that investment."

Finally, the Seventh Circuit appeared to hold that, given the array of investment options available through the brokerage window, the safe harbor defense provided by Section 404(c) of ERISA shielded the defendants from liability.

Although the Seventh Circuit quickly dismissed the case, the plaintiffs, supported by briefs from the DOL and other groups filed a petition for a rehearing by the full circuit. On June 24, 2009, the appeals court denied the petition, but, in so doing, it issued an addendum to its original opinion which appears to limit some of the more extreme implications of its analysis.

The DOL has taken a strong position that ERISA fiduciaries are always liable for the imprudent selection of investment options in 401(k) plans and that Section 404(c) is no defense against such liability. Accordingly, it vigorously argued that the Seventh Circuit's original Deere opinion had not give due deference to this point. The addendum responded by noting that the 404(c) issue was not involved in its primary holding that there was "no duty to scour the market to find the fund with the lowest imaginable fees" and that the fees in the particular funds that were the subject of the complaint "could not be deemed imprudent because they were offered at the same prices to the general public." The addendum indicated that these rulings did not necessarily contradict the Department's position with which the court nevertheless refused to agree. The court noted that it had intentionally avoided a broad ruling on the issue of 404(c) protection and that it had left the area open for future development. In the addendum, the court stated that, contrary to the Department's fears, its ruling was not broad enough to immunize from accountability a fiduciary that acts imprudently by selecting an overpriced portfolio of funds.

As to the Department's concern that, under Deere, a fiduciary can insulate itself from liability by the simple expedient of including a very large number of investment alternatives in the plan portfolio, the Seventh Circuit addendum, quoting the Department's brief, observed that the Deere opinion "was not intended to give a green light to such 'obvious, even reckless, imprudence in the selection of investments.'" The court explained that its opinion had been "tethered closely to the facts" that were before it and that the plaintiffs had failed to allege that any of the Deere plan's investment alternatives were unsound or reckless.

Notwithstanding its effort to narrow the Deere holding, when the dust settles, it appears that, in the Seventh Circuit's view, the selection, pursuant to a prudent and reasonable process, of a liberal number of investment options to be made available to plan participants would provide an impregnable defense to assertions of liability by participants.

As noted above, the Deere opinion will have a far-reaching influence on existing litigation, but it is less important as to ongoing conduct because of changes in the law that are already underway. On December 13, 2007, the Department of Labor issued proposed regulations that condition exemption from ERISA's prohibited transaction rules on extensive disclosure by plan service providers to plan fiduciaries. The DOL had previously amended the Form 5500 instructions to require reporting of plan fees by the plan sponsor. This was followed on July 23, 2008 by proposed regulations that would require plan fiduciaries to furnish participants with information as to fees, including a breakdown of fees into various categories of expense. It is possible, however, that certain aspects of the Seventh Circuit' decision, such as its position on the 404(c) defense, will be legislatively overruled.

On January 19, 2010, the U.S. Supreme Court declined to review the case, so for the moment, Deere stands as precedent which must be followed in the Seventh Circuit (Illinois, Indiana and Wisconsin) and which may be followed by courts elsewhere.

b. Summary Judgment for Defendants in Taylor v. United Technologies. As in other 401(k) fee cases, the plaintiffs in Taylor v. United Technologies Corp. 2009 WL 535779 (D.Conn., March 3, 2009) alleged that the company and the plan's investment and administrative committees breached their ERISA fiduciary duties by offering actively managed mutual funds with excessive fees and expenses as plan investment options and did not disclose the full information about such fees or otherwise investigate them. The district court granted summary judgment in favor of the defendants which was subsequently affirmed by the Second Circuit Court of Appeals on December 1, 2009 in a Summary Order that adopted the lower court's opinion. As a Summary Order, the Second Circuit's decision has limited precedential value, although it may be influential in stiffening the resolve of certain plan sponsors to defend their selection of plan investments. In the meantime, it is anticipated that the plaintiffs will seek a rehearing *en banc*, particularly in light of the Wal-Mart decision in favor of plaintiffs which was issued a few days before the Second Circuit's Summary Order and was not considered therein.

The United Technologies plaintiffs argued that the defendants had failed to engage in the extensive investigation that arguably should be required before the selection of any actively managed fund in view of the fact that an actively managed fund is not likely to outperform a lower priced index fund. However, the district court found that the plaintiffs had placed too much reliance on expert opinion and had failed to challenge the prudence of the actual selection process for any particular actively managed fund. Further, the court found that the defendants had, in fact, followed such a process in their selection of investment options.

Similar reasoning was applied to the plaintiffs' assertion that the mutual fund fees were excessive. Thus, the district court found that the plaintiffs had failed to challenge the fees of any particular plan investment option and that the defendants' fund selection process had included consideration of fees and expenses.

On the issue of sub-transfer agent fees, which were used to compensate the plan recordkeeper, the district court (and presumably the Second Circuit by virtue of its adoption of the district court opinion) ruled that such fees were not plan assets, but that, in any event, other service providers charged comparable fees. Consequently, the recordkeeper's fees were not unreasonable in light of the fact that the defendants had considered the sub-transfer agent fees, as well as fees paid directly to the recordkeeper, in evaluating the contract for recordkeeping services.

The district court rejected the plaintiffs' claims as to the inadequacy of disclosure regarding fees by holding that, in order to prevail, plaintiffs were required to establish that communications to participants were affirmatively false or misleading. Thus, the defendants' disclosure of the total expense ratio for each mutual fund was deemed to be sufficient.

c. George v. Kraft Foods Global, Inc. 2010 WL 331695 (N.D. Ill. Jan. 27, 2010) is a case in which the defendants successfully relied on Hecker v. Deere to obtain summary judgment. However, equally important, it shows the benefits of engaging in a prudent decision making process. This case is referred to as Kraft I to distinguish it from a similar but separate lawsuit (Kraft II) involving the same plaintiffs but adding defendants associated with the Altria Group, Inc., Kraft's former corporate parent. On December 17, 2009, the court in Kraft II dismissed certain claims against the Altria defendants based on the six year statute of limitations.

The claims in Kraft I were similar to those of other 401(k) fee cases, i.e., various plan administrative and investment bodies and their individual members had breached their fiduciary duties by (i) structuring the company stock funds as unitized funds, (ii) paying excessive recordkeeping fees, (iii) failing to properly account for float retained by the trustee, and (iv) failing to adequately disclose plan fees and expenses.

i. Unitized Company Stock Fund. The plaintiffs argued that the cash in the unitized company stock funds reduced investment returns and that such funds unfairly imposed the transactional costs incurred by frequent traders on all participants. However, the court concluded that the defendants' internal discussions showed that they had properly considered the pros (e.g., the ability to trade without delay) and cons of offering the stock as unitized funds and that these discussions were evidence of fiduciary prudence.

ii. Following Hecker v. Deere on Selection of Investment Options. The court also observed that participants had the ability to select at least seven investment alternatives other than the company stock funds. Based on Deere, it ruled that, in the absence of evidence that an investment alternative is "unsound or reckless, the provision of a large number of investment alternatives, with disclosures allowing participants to make an informed decision as to their investment choices, would preclude a finding that defendants breached their fiduciary duties."

iii. Procedure for Selecting Plan Service Providers. The Kraft I plaintiffs also argued that the defendants were responsible for allowing the plan to pay $28 million in excessive recordkeeping fees and were deficient in failing to request an RFP when deciding to renew the plan's recordkeeping arrangement with Hewitt. The court also rejected this argument, concluding that an RFP is not always necessary, particularly when the defendants had used consultants to benchmark Hewitt's fees and services. Once again focusing on the defendants' procedure, the court found that "based on the number of times they reviewed and renegotiated their contract with Hewitt and their utilization of various standard industry methods to determine the reasonableness of Hewitt's fees," there was no triable issue as to whether defendants used a reasonable decision-making process in making their contracts with Hewitt.

iv. Fee Disclosure. As to the claim that recordkeeping fees were inadequately disclosed, the court, again resorting to Deere, concluded that the critical information was the total fee charged by an investment option and that the quarterly reporting of investment option expense ratios, in which recordkeeping fees were embedded, was sufficient for this purpose. Further recordkeeping fees were disclosed on the Plan's Form 5500. Thus, the defendants' fiduciary duties with regard to disclosing recordkeeping fees had been satisfied.

v. Float. Finally, the Kraft I plaintiffs argued that the defendants had not obtained enough information about the trustee's (State Street Bank & Trust) float program to make an informed decision about State Street's compensation, as required by Department of Labor guidance. The court, however, concluded that the defendants had acquired adequate information about the float from State Street's invoices which indicated the circumstances in which float would be earned and retained as compensation, when float periods would begin and end, and the nature of the interest rate that would be applied to determine the float. While the invoices did not show float amounts, this was furnished by annual reports. Further, there had been at least one meeting with State Street to discuss float. Thus, defendants had not breached their fiduciary duty by allowing State Street to receive part of its compensation as float.

d. Kanawi v. Bechtel Corp. No. C 06-05566 (CRB) (N.D. Cal 2008) (subsequently settled, as noted above) was also favorable to the defendant in that Bechtel's motion for summary judgment was granted with respect to the plaintiff's claim that it had caused the plan to pay unnecessary mutual fund fees. The court held that the plaintiffs had failed to show that the plan had paid unnecessary layers of fees, because most of the plan-level fees had been paid by the employer rather than the plan. The same reasoning applied to the claim that fees paid to the investment adviser constituted a prohibited transaction. The court also reasoned that since the plan's fiduciaries met regularly to discuss the plan's investments and sought the advice of an outside consultant in such matters, the evidence did not support a conclusion that that the fees were unreasonable. Kanawi was a mixed result, however, since the court denied the defendant's motion for summary judgment with respect to a four month period when the plan paid advisory fees with plan assets. The court also denied defendant's motion for summary judgment based on a Section 404(c) defense, since there were factual issues as to whether the plan met the requirements of this defense.

e. Columbia Air Services, Inc. v. Fidelity Management Trust Co., 2008 WL 4457861 (D. Mass. 2008), the district court ruled favorably for the trustee-defendant which, it was claimed, had breached its duty of loyalty by receiving a share of mutual fund fees earned by funds advised by an investment adviser belonging to the same funds family as the trust company. However, the court held that the plaintiffs had failed to allege facts showing that the directed trustee was acting as a fiduciary in negotiating the terms of its engagement, including it compensation. Therefore, the claim was dismissed.

2. Notable Plaintiffs' Victories.

a. Caterpillar Settlement. More typical of early stage 401(k) fee litigation than the cases discussed above is the denial of defendant's motion to dismiss in Martin v. Caterpillar, No. 07-cv-1009 (C.D. Ill. 2008). The plaintiffs' claims in the Caterpillar case were also typical in that they alleged a breach of fiduciary duty arising from investment options with excessive and unreasonable fees and the failure to make adequate disclosures to plan participants. In addition, the plaintiffs alleged self-dealing arising from the plans' offering investment options that were advised by a wholly owned Caterpillar subsidiary. The court upheld the viability of the central complaint that the defendants had charged excessive fees although it agreed with the defendant and the court in Hecker v. Deere that ERISA does not require plan fiduciaries to disclose revenue sharing. In a surprising development, on November 5, 2009, the Caterpillar parties announced a $16.5 million settlement of the case without the admission of any wrongdoing by the defendants.

i. Payment of Settlement Proceeds. The net proceeds of the settlement (after deduction of attorneys' fees, expenses and settlement administration) will be allocated to the accounts of participants and former participants based on the length of time that a participant maintained an account in one of the Caterpillar plans. Distributions to the class will begin after the court grants final approval of the settlement and all appeal rights have been exhausted.

ii. Restriction on Retail Mutual Funds. As part of the Caterpillar settlement, the parties agreed that during a two-year settlement period, Evercore Trust Company, an independent fiduciary, will monitor the Caterpillar plans. Further, during this period, retail mutual funds will not be included as core investment options under the plans. The use of retail mutual funds, which generally have a higher fee structure than wholesale funds, separate accounts and collective trusts, is a common complaint in 401(k) fee cases. The Caterpillar settlement, once again, raises the question of whether plan sponsors should be using such funds if other investment options are available.

iii. Communications with Participants. During the two year settlement period, Caterpillar must also increase and enhance communications with employees about 401(k) investment options and associated fees.

iv. Company Stock Fund. Caterpillar must continue to limit its cash holdings in the company stock fund investment option.

v. Procedures for Engaging Plan Service Providers. Under the settlement, Caterpillar will undertake a request for proposal to select or retain the plans' recordkeeper. Further, if service contracts come up for renewal, Caterpillar will undertake requests for proposal.

An independent fiduciary must review and approve the settlement on behalf of the affected plans. Some wondered whether the settlement would encourage further 401(k) fee litigation while motivating some plan sponsors to settle their own cases. The early answer seems to be in the affirmative.

b. Braden v. Wal-Mart Stores, Inc. In this case, Wal-Mart was charged with breaching its duties of prudence and loyalty by selecting retail class mutual funds as plan investment options. These funds were generally more expensive than institutional class funds. The plaintiffs' complaint compared the plan's investment options with less expensive funds available in the marketplace. However, in October 2008, the district court held that this was not sufficient to allow the action to move forward, because there were no factual allegations that Wal-Mart had failed to investigate the funds or that the fund selection process was otherwise flawed. The district court reasoned that the mere existence of less expensive funds did not mean that the actual selection of more expensive funds was a breach of fiduciary duty. The court also dismissed claims that Wal-Mart had committed prohibited transactions involving revenue sharing, since revenue sharing is not inherently illegal or unreasonable. Finally, the district court dismissed the claim that Wal-Mart had failed to provide participants with complete and accurate information, since there was no duty to disclose revenue sharing and the information the plaintiffs sought was not material.

On November 25, 2009, the Eighth Circuit Court of Appeals vacated the district court's judgment and remanded the Wal-Mart case to the lower court for further proceedings. Braden v. Wal-Mart Stores, Inc., 2009 WL 4062105 (8th Cir. 2009). Generally, the appeals court faulted the lower court for imposing on the plaintiffs an overly rigorous standard of pleading. It concluded that the district court had drawn too many inferences in favor of the defendants and incorrectly placed on the plaintiffs the burden of rebutting possible lawful explanations as to why higher-cost mutual funds had been selected as plan investment options.

The Eighth Circuit held that the complaint's allegations, read as a whole, plausibly stated a claim that Wal-Mart's selection process for plan investment options was flawed. These allegations included assertions that (1) a plan the size of the Wal-Mart plan (one million participants and nearly $10 billion in assets) had the ability to obtain institutional class shares, but, instead, offered its participants higher-cost retail shares; (2) the majority of Wal-Mart plan funds charged 12b-1 fees, (3) the more expensive funds were retained even though they did not meet their performance benchmarks (4) funds made revenue sharing payments to the plan trustee, not for trustee services, but to be included in the investment line-up.

The Eighth Circuit distinguished Hecker v Deere on the ground that the plan in that case provided access to over 2,500 mutual funds, making it untenable to suggest that all of such investment options had excessive expense ratios. In contrast, the Wal-Mart plan offered a far narrower range of investments, making it more plausible that the Wal-Mart plan was imprudently managed.

On the disclosure issue, the Eighth Circuit held that plan fiduciaries are required to furnish plan participants with material information that could adversely affect the participants' interest in the plan and that a reasonable trier of fact could find that such material information includes the fact that plan funds charged higher fees than comparable funds to which an employer, such as Wal-Mart, had access.

As to the plaintiffs' prohibited transaction claim involving the receipt of undisclosed amounts of revenue sharing funds by the plan trustee, the Eighth Circuit held that that the complaint alleged sufficient facts to aver an arrangement amounting to the provision of services to a plan by a party in interest, and that this shifted the burden to Wal-Mart to show that no more than reasonable compensation was paid. The court observed that the trust agreement between Wal-Mart and the trustee required that the amount of revenue sharing be kept secret and that, in view of their monopoly on information, the defendants were in the best position to demonstrate the absence of self-dealing.

The Wal-Mart decision had an immediate effect. Thus, the plaintiffs in the Second Circuit case of Taylor v. United Technologies, discussed above at IV.D.1.b, whose appeal of a lower court dismissal had been denied on December 1, 2009, petitioned for a rehearing by the Second Circuit in light of Wal-Mart which had not been considered in the United Technologies decision. In the Wal-Mart case, itself, the defendants' petition for rehearing was denied on January 5, 2010.

c. Phones Plus, Inc. v. Hartford Financial Services (D. Conn.). See discussion of settlement at IV.A.3, above.

E. Class Certifications in 401(k) Fee Litigation. Most of the lawsuits over 401(k) fees are brought as class actions and, therefore, involve motions for class certification under Rule 23 of the Federal Rules of Civil Procedure. Rule 23(a) requires satisfaction of each of the following requirements: (1) a class of plaintiffs so numerous that joining all the members in the lawsuit is impracticable, (2) legal or factual questions that are common to the class, (3) claims or defenses that are typical of the class members, and (4) the representatives of the class that will fairly and adequately protect the interests of the class. Rule 23(b) contains additional detailed requirements that guard against inconsistent adjudications, provide that the sought after relief will be appropriate for the class as a whole, or ensure that questions of law or fact that are common to the class will predominate over questions only affecting individual members.

Most courts have almost routinely granted class certification in litigation over 401(k) fees. See IV.A.1 & 2, above, for particular judicial decisions. On the other hand, the Seventh Circuit has recently consolidated several cases for review on this issue. In addition, the Supreme Court's LaRue decision, discussed below, has given rise to the argument that, in view of participants' new ability to bring suits for individualized losses, it is no longer appropriate to certify such claims as class actions.

F. Implications of Indirect Fee Cases.

1. 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.

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

3. Some copycat claims have been made and additional law suits making similar claims are likely to be filed.

4. 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.

V. Other ERISA Litigation

A. Standing to Sue.

1. LaRue Case. The much anticipated question of whether an employee can sue to recover individual losses in his 401(k) plan account when the plan sponsor or other fiduciary mishandles his account has now been answered in the affirmative by the Supreme Court.

In LaRue v. De Wolff, Boberg & Associates, Inc., decided on February 20, 2008, the Supreme Court focused on Section 502(a)(2) of ERISA, a provision that allows participants and beneficiaries to sue for "appropriate relief under Section 409" of ERISA. Section 409, in turn, provides that any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed on fiduciaries by Title I of ERISA "shall be personally liable t*o make good to such plan any losses to the plan* resulting from each such breach …." (Italics added.) In LaRue, a plan participant sought to use these provisions to recover a loss of $150,000 suffered when the plan administrator failed to properly implement the participant's instructions as to how his account should be invested.

In reviewing LaRue's claim against the plan administrator, the Fourth Circuit Court of Appeals had affirmed a district court judgment for the defendant administrator on the ground that recovery under Section

502(a)(2) of ERISA must inure to the benefit of the plan as a whole, not to particular persons with rights under the plan. Why this should be so as a matter of policy was a focal point of the oral argument before the Supreme Court, with Justice Breyer posing the hypothetical situation of a 401(k) plan consisting of 1,000 diamonds, half of which were stolen by a corrupt trustee. Justice Breyer asked why it should matter whether the diamonds came from one central safe deposit box or whether they were kept in separate boxes and labeled with the names of individual participants.

In ruling for LaRue, the Supreme Court's opinion (by Justice Stevens) picked up on this theme stating that, "[w]hether a fiduciary breach diminishes plan assets payable to all participants and beneficiaries, or only persons tied to particular individual accounts, it creates the kind of harms that concerned the draftsmen of §409" and for which recovery under Section 502(a)(2) is available. A concurring opinion by Justice Thomas (in which Justice Scalia joined) noted that, "[b]ecause a defined contribution plan is essentially the sum of its parts, losses attributable to the account of an individual participant are necessarily 'losses to the plan' for purposes of §409(a)."

Comment: Plan sponsors and administrators should take the opportunity to review their plan and investment procedures and policies to ensure that participants' investment decisions are being implemented properly and in a timely manner. Plan sponsors and administrators should also take steps to ensure that appropriate investment records are being maintained. Self-audit procedures can be a helpful mechanism to ensure proper plan administration, both with regard to investments and as to the operation of the plan more generally.

2. Sixth Circuit Gives An Affirmative Answer to the Standing Question

In the meantime, the Sixth Circuit Court of Appeals, in Tullis v. UMB Bank, N.A., 2008 WL 215535 (6th Cir. 2008), has indicated its belief that a Section 502(a)(2) claimant need not seek relief in a representative capacity for the entire plan. In Tullis, two 401(k) plan participants sued a bank trustee, because it knew of, but failed to inform the participants of, fraud perpetrated by their investment advisors. The two participants requested the plan to bring suit against the bank for fiduciary breach, but the plan refused, citing an indemnity clause in the trust agreement holding the bank harmless. When the participants filed their own action, the district court granted a motion to dismiss, finding, among other things, that they lacked the standing to sue under Section 502(a)(2).

In reversing the lower court and upholding the plaintiffs' claims, the Sixth Circuit disagreed with the reasoning of the Fourth Circuit in LaRue and held that the goal of ERISA was to ensure that relief is available in cases of fiduciary breach. Basing its decision squarely on Section 502(a)(2) of ERISA, the Sixth Circuit concluded that the plain language of the statute compelled the conclusion that individual participants should have standing to seek recovery for plan assets without resort to a class action. There was no hint in the Sixth Circuit's opinion that the claim should have been made directly against the plan as a claim for benefits. This may be an early indication that the lower courts will not require claims of fiduciary breach by defined contribution plan participants to go forward only as an action against the plan.

3. Supreme Court Rules On Conflicts Of Interest And Lower Courts Respond

a. MetLife v. Glenn. Aside from LaRue v. De Wolff, Boberg & Associates, 128 S.Ct. 1020(2008), which was discussed above, the most significant judicial decision of 2009 was MetLife v. Glenn, 128 S.Ct. 2343 (2008) which was issued on June 19 and dealt with the consequences of a conflict of interest by a plan administrator. Although it involved a health and welfare plan, the MetLife decision could also have implications for pension and 401(k) plans.

In its 1989 decision, Firestone Tire & Rubber Co. v. Bruch, 489 US 101 (1989), the Supreme Court had held that, where a severance plan provided that its plan administrator had the discretion to determine benefits, a court should review the administrator's decision under an arbitrary-and-capricious standard. However, Firestone left open the question of how much an administrator's conflict of interest resulting from the fact that it would benefit financially from a claims denial should affect the level of a court's deference to the administrator's decision.

The MetLife decision addressed this question, holding that an insurance company that both makes decisions as to benefit eligibility and pays benefits is conflicted and that courts should consider such a conflict as one of any number of factors in reviewing the insurer's decision to deny benefits. MetLife served as both the insurer and the claims administrator for a long-term disability plan maintained by Sears Roebuck & Company. In the latter capacity, it denied a claim for benefits made by an employee with a heart condition on the ground that medical treatment had improved her condition to the point where she was no longer disabled. After exhausting her administrative appeals, the employee sued in district court which applied the arbitrary and capricious standard and upheld the denial of her claim.

On appeal, the Sixth Circuit Court of Appeals overturned the lower court citing language in Firestone that the arbitrary and capricious standard does not apply where the plan administrator has a conflict of interest. The Sixth Circuit's decision was appealed to the Supreme Court, a five-judge majority of which concluded that insurance companies that both decide and pay claims have an inherent conflict. On the issue of how the conflict should affect the Court reiterated its statement in Firestone that a conflict should "be weighed as a factor in determining whether there is an abuse of discretion." However, in the Court's view, the conflict should be just one factor among many in determining whether a plan fiduciary abused its discretion in making a claims determination. Thus, the standard of review need not automatically change from deferential to de novo merely because a conflict has been identified. The Court also declined to create any special rules shifting the burden of proof as a result of a conflict.

In a concurring opinion, Chief Justice Roberts stated that he would take a conflict into account only where there is evidence that the conflict affected the administrator's decision. Justice Scalia's dissent, which was joined by Justice Thomas, seemed to take this one step further by advocating that a conflict should be considered only where the conflict actually and improperly motivates the administrator's decision.

b. Circuit Courts Respond. Given the Supreme Court's failure to establish a bright-line test, some commentators wondered if much had changed as a result of the MetLife decision. However by the end of the year, at least three circuits had concluded that the MetLife decision required them to change their approach. In Doyle v. Liberty Life Assurance Co. of Boston, 2008 WL 4272748 (11th Cir. 2008), decided in September, the Eleventh Circuit concluded that MetLife had overruled its use of a heightened abuse of discretion standard that had shifted the burden to the plan administrator of showing that its decision was not affected by the alleged conflict.

In Champion v. Black & Decker (U.S.), Inc., 2008 WL 5377692 (4th Cir. 2008), the Fourth Circuit also found it necessary to abandon the modified abuse of discretion standard that it had previously applied to conflicted administrators. Further, all dual role administrators in the Eleventh Circuit will now be treated as conflicted whereas previously the Eleventh Circuit might not have found a conflict in such circumstances.

The most noteworthy example of changed standards may be found in the Second Circuit decision of McCauley v. First Unum Life Insurance Company, 2008 WL 5377680 (2nd Cir. 2008). The Second Circuit had previously applied a de novo standard of review when it was shown that a conflict existed and that the conflict affected the reasonableness of the administrator's denial of benefits. The court determined that in the future, these circumstances would not necessarily require de novo review. Under the new standard, the conflict must be weighed as a factor in determining whether the administrator abused its discretion. Applying this standard, the court granted the plaintiff's disability claim because the defendant insurance company's financial interest, its disregard of a medical report, and its history of biased claims administration required a finding that it had abused its discretion. The last factor is particularly significant, since it will likely be raised in subsequent claims denials by the same insurer.

If the reasoning in McCauley holds, a pattern of poorly reasoned decisions by a conflicted claims administrator could have a long life. It is one example of how MetLife and its offspring may make it more difficult for plans to defend claims for benefits. We note that one way of counteracting this effect would be to keep detailed records that refute the existence of circumstances showing that a conflict affected a benefits decision or that an administrator has a history of biased decisions. Further, in the case of in-house claims review committees, consideration should be given to excluding those with an interest in company finances from committee membership.

Another effect of MetLife that is beginning to be felt stems from its direction to examine all of the surrounding factors to determine whether an administrator has abused its discretion. This has caused the lower courts to open the door to additional discovery. For example, in Gessling v. Group Long Term Disability Plan for Employees of Sprint/United Management Company, 2008 WL 5070434 (S.D. Ind. 2008), a federal district court concluded that the MetLife decision had superseded Seventh Circuit precedent which would have limited discovery in benefit cases to the administrative record. This potential development also highlights the importance of detailed recordkeeping that demonstrates unbiased decision making.

B. Stock Drop Cases Churn On.

Courts have continued to review fiduciary responsibility in so-called stock drop cases targeting companies that required or allowed the investment of retirement plan assets in a nondiversified company stock fund offered as part of a 401(k) plan or ESOP. When such stock suffers a significant decline in value due to business exigencies, the employer is often sued based on the twin claims that the inclusion of an employer stock fund as an investment alternative was imprudent and that the employer failed to disclose to participants the business issues that led to such decline.

1. DiFelice v. US Airways Inc. One of the most significant recent decisions in this category was DiFelice v. US Airways Inc., 497 F.3d 410 (4th Cir. 2007), decided in August 2008. The Fourth Circuit Court of

Appeals held that US Airways did not breach its fiduciary duties by allowing 401(k) plan participants to continue investing in company stock during the period leading up to the company's bankruptcy filing.

US Airway's already tenuous financial condition was exacerbated by the attacks of September 11, 2001, and the price of its stock suffered a precipitous decline. The case focuses on the conduct of the company and its Pension Investment Committee, acting as the plan administrator, subsequent to this drop in the stock's price and up to the bankruptcy filing the following August. During this period, the company hoped to resurrect its fortunes by applying for a federally guaranteed loan, although its efforts in this regard eventually failed because of its inability to obtain concessions from labor, creditors and lessors. Shortly before applying for the loan, the company appointed an outside independent fiduciary for the company stock fund. During the critical period, the Pension Investment Committee continuously monitored the stock fund and held at least four meetings at which it considered whether to continue to offer the fund as a plan investment. The Committee also met with outside counsel who indicated that it was unnecessary to discontinue the fund at that time, perhaps relying on the fact that the stock price had experienced a slight rebound and, as of April, 2002, was holding steady. However, once US Airways filed for bankruptcy, the independent fiduciary directed the closure of the stock fund and transferred any of its remaining cash to the plan's money market fund.

US Airways employees brought a class action against the company, the independent fiduciary of the stock fund, and the plan's trustee. The Fourth Circuit rejected this claim, emphasizing that prudence is a matter of process not of hindsight. According to the Fourth Circuit, the relevant question is "whether the fiduciary engaged in a reasoned decision-making process consistent with that of a prudent man," and, based on the facts, it concluded that this question could be answered affirmatively.

2. Citigroup Case. Another significant decision is the holding in In re Citigroup ERISA Litigation (S.D.N.Y. 2009) that Citigroup did not breach its fiduciary duties when it continued to offer its stock as a 401(k) investment when the company was incurring losses as a result of the subprime mortgage crisis. The sharply worded opinion concluded that the plan document mandated that Citigroup's stock be offered as an investment option and that the plan fiduciaries had no discretion to eliminate the stock from the plan. The ruling appears to sanction the notion that an absolute defense to fiduciary claims in stock drop cases can be drafted into the plan document. Department of Labor officials were not long in reacting to the Citigroup decision, voicing their disagreement with the premise that

employer stock funds could be excepted from fiduciary standards by a drafting technique.

C. Fourth Circuit Raises Obstacles to Reforming Scrivener's Error

Fairly or not, life sometimes offers no second chances and the same may be said of certain decisions by ERISA advisers. Care must be taken to get it right the first time, as illustrated by Cross v. Bragg, 2009 WL 2196887 (4th Cir. 2009) in which the Fourth Circuit Court of Appeals refused to allow the reformation of a plan document which had been amended to include an erroneous benefit formula. When the error was recognized, the plan administrator, with the support of the plan's actuary, sought to characterize the inclusion of the erroneous formula as a scrivener's error. This action received IRS approval when the plan was submitted for a ruling under the IRS Employee Plans Compliance Resolution System. Nevertheless, several participants sued for the higher benefit resulting from the erroneous benefit formula.

The participants' prevailed at both the district court and the appellate level. The Fourth Circuit held that the power to correct a scrivener's error rests solely with the courts by virtue of their equity powers. In exercising this jurisdiction, courts are guided by principles of contract and trust law which, in the Fourth Circuit's view, require the party seeking reformation to show that the mistake was mutual, i.e., that the participants, as well as the plan sponsor had had a different intent as to the effect of the plan amendment when it was adopted. Evidence that the participants had not relied on the plan documents that included the error was not sufficient to establish a mutual mistake. (This approach seems to have an uninformed view of the amendment process which generally does not have participant involvement, other than in the case of multiemployer plans.) Nor was the reformation's approval by the IRS given deference by the court. The Cross decision will make it more difficult to correct scrivener's errors and, at least in the Fourth Circuit, eliminates reliance on IRS sanctioned document corrections.

D. Rollover Advice – Legal Challenge to Cross Selling.

Young v. Principal Financial Group, Inc. (S.D. Iowa, 2008). In the Principal case, a federal district court allowed claims by 401(k) plan participants to proceed against a financial services company whose agents had allegedly breached their ERISA fiduciary duties by encouraging plan participants to roll over their 401(k) assets into IRAs invested in the company's proprietary mutual funds. The letter from the company instructed them to call a 1-800 number to discuss how the changes in their employment status might affect their plan accounts. The telephone numbers directed the participants to the company's sales personnel rather than to pension counselors and the participants were advised to rollover their plan accounts into IRAs that were restricted to the company's investment vehicles thereby causing the participants to earn less and pay higher fees than if they had left their money in the 401(k) plan. While the court granted the defendant's motion to dismiss the participant's claims seeking recovery of losses to their 401(k) plan, because the plan had not incurred any loss, Principal's motion to dismiss fiduciary breach claims for which participants could seek an equitable remedy was denied. In March 2010, however, the court refused to certify a class action for such remaining claims. The denial of class certification was based on the fact whether or not the defendant was a fiduciary depended on its interactions (e.g., follow-up phone calls) with each individual plaintiff.

VI. Best Practices arising from 401(k) Fee Litigation. In light of 401(k) fee litigation and similar class actions, employers are beginning to adopt best practices that involve more aggressively negotiating and monitoring service provider fees. Employers have taken proactive steps to adopt the following standards which recognize that fiduciaries are judged not on the results they achieve but on the processes they follow and that such processes evolve over time. Financial advisers and broker-dealers should be aware of these best practices and prepared to assist in their implementation.

A. Identifying Fees. Plan sponsors will be making a more concerted effort to learn how much the plan and participants are actually paying in fees and expenses which include the actual expenditure of hard dollars, as well as indirect fees.. Although the proposed regulations under section 408(b)(2) of ERISA allow disclosure by formula, many plan sponsors will attempt to determine the actual dollar amount, even if it is an estimate.

1. Services. The services to which fees relate may include the following:

a. Trustee

b. Recordkeeping

c. Administration

d. Investment Advisory

e. Investment Management

f. Brokerage

g. Other

2. Types of Indirect Fees. There are at least eight kinds of indirect 401(k) plan fees and expenses that fiduciaries should be aware of:.

a. 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. Fees that are illegal under Rule 28(e) also 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._

b. 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.

c. 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.

d. 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.

e. 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.

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

g. 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.

h. 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 a 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. These funds are specifically designed as pension plan investments and often carry one or more of the above-referenced indirect fees.

B. Comparing Investment Management Fees or Expense Ratios against Benchmarks.

1. Objectives of Benchmarking. Plan sponsors will attempt to avoid paying above-average investment management fees or expense ratios unless the investment manager or mutual fund can demonstrate it is delivering above-average investment performance for the plan participants. benchmarking services can help employers meet their obligations under ERISA with respect to plan fees in the following ways:

a. Assist the employer in its efforts to identify and calculate all plan fees, including any "hidden" indirect compensation paid by the plan's investments (or investment providers).

b. Equip the employer with the ability to use benchmarking services as part of a prudent review process to evaluate and monitor the plan's services and fees on an ongoing basis.

c. Provide the employer with the competitive pricing information that a prudent expert might have, to help assess the reasonableness of the plan's current service arrangement.

2. Guidelines for Selecting Benchmarking Services. Benchmarking services are offered in many forms. Financial advisers should inform their plan sponsor clients that the decision to engage a benchmarking service provider is itself subject to the same fiduciary standards under ERISA which would apply to selecting service providers for the plan generally. In addition, financial advisers who work with plan sponsors should encourage them to make the following inquiries with respect to any prospective provider of benchmarking services:

a. What are the qualifications and credentials of the provider? How long and to how many clients has the provider been offering benchmarking services?

b. Does the provider offer benchmarking analyses for all of the plan's investment and administrative service fees? To what extent are benchmarking analyses provided separately for each individual fee (as opposed to total fees)?

c. Will the provider be able to identify all indirect compensation paid to the plan's service providers from the plan's investments and investment providers? Does the provider consider all indirect compensation paid with respect to the benchmark group of plans?

d. How reliable is the provider's data for the benchmark group of plans? Is data obtained directly from the various plans' recordkeepers? Does the data gathering method used by the provider prevent inaccurate data submission? Is stale and outdated data disregarded?

e. What is the size and profile of the plans included in the benchmark group? How many plans are included in the benchmark group? Can the benchmark group be customized?

f. Does the provider offer any benchmarking analyses with respect to the quality of the investment and administrative services provided to the plan?

g. In order to make a direct comparison, the actual fees of the various plans are often converted into a per-participant fee or asset-based fee. Does the provider use both per-participant fees and asset-based fees as baselines for its comparisons? If not, why?

h. After the benchmarking analyses are completed, what type of consulting services and support will be available to the plan fiduciary in interpreting such analyses?

C. Continuous Monitoring. Continuous monitoring will become a best practice standard. In addition to a broad range of qualitative and quantitative questions about the investment managers or mutual fund, plan sponsors will be asking whether the fees are reasonable with respect to investment performance and related services plan participants are receiving.

D. Documenting Reviews of Investment Vehicles and Fees. Plan sponsors will be documenting their reviews of investment vehicles, including negotiations related to service provider fees paid directly by the plan or plan sponsor or indirectly by the plan participants through a reduction in investment earnings. The documentation should demonstrate a thoughtful process addressing key questions or discussions, and decisions made.

E. Hiring Independent Third Party Investment Experts. More plan sponsors will employ independent third parties (e.g., benchmarking services or other consultants) to assist with reviewing the investment performance and fees of investment managers and related service providers. While these vendors typically provide reports and recommendations for analysis by the plan sponsor, there is an inherent conflict of interest when vendors report on proprietary funds or even nonproprietary funds where long-term business relationships and revenue agreements may influence the reports and recommendations.

F. Conducting Fiduciary Audit. When appropriate, more plan sponsors will be hiring an independent third party to conduct a fiduciary audit of the plan's outsider fiduciaries, particularly when vendors fail to adequately disclose fees or fees do not seem reasonable.

G. Fiduciary Manual. Use of a fiduciary manual is intended to help fiduciaries reach a better understanding of their responsibilities and to help them comply with ERISA's fiduciary standards. When properly designed, it serves as a reference tool (i.e., a guide for plan fiduciaries when they have questions, such as identifying fiduciaries or determining the scope of their responsibilities and liabilities). A fiduciary manual can also provide compliance tools that fiduciaries may use to monitor investments and service providers.

VII. Best Practices in Response to Rollover Litigation and DOL Guidance.

A. In Young v. Principal Financial Group, Inc. (S.D. Iowa, 2008), discussed at Item V.D, a federal district court allowed class action claims to proceed against a financial services company whose agents had allegedly breached their ERISA fiduciary duties by encouraging plan participants to roll over their 401(k) assets into IRAs invested in the company's proprietary mutual funds.

B. DOL Advisory Opinion 2005-23A addresses rollovers and distinguishes between two groups: (i) "a plan officer or someone who is already a plan fiduciary" and (ii) someone who is:

a. "neither chosen nor promoted by plan fiduciaries,"

b. "not otherwise a plan fiduciary,"

c. "not a plan fiduciary on some other basis," and

d. "not connected with the plan."

The advisory opinion then states that an advisor in the second group (i.e., someone who is not already a fiduciary) can recommend that a plan participant roll over his or her account balance to an IRA, even if the investment professional will earn fees on the IRA assets after the rollover. In this situation, ERISA's conflict of interest rules do not apply to the investment professional's rollover recommendation.

An adviser in the first group (i.e., "someone who is already a fiduciary") that recommends that a plan participant roll over his or her account balance to an IRA (or that "responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan") could violate ERISA's conflict of interest rules, if the adviser will earn fees on the IRA assets after a plan participant rolls over his or her account balance to the IRA.

C. Interpretive Bulletin 96-1 constitutes the DOL's recognition of a distinction between investment advice and investment education. The bulletin explains how investment education could be provided without providing investment advice that would make the provider an investment advice fiduciary. For example, the bulletin states that investment education includes informing plan participants about the impact of preretirement withdrawals on retirement income. The preamble to the bulletin further explains the importance of rollover education as follows: "Plan participants also need to be informed about the impact on retirement savings of preretirement withdrawals . . . The Department, therefore, encourages educational service providers to emphasize that participants should . . . if they change employment refrain from withdrawing their retirement savings, and opt instead to directly transfer or roll over their plan account into an IRA or other retirement vehicle. . . ." This indicates that an adviser providing a plan participant with general educational information about the availability of rollovers would not be providing investment advice.

D. Best Practice to Avoid Litigation or Regulatory Challenges in Rollover Matters. As discussed above, ERISA's conflict of interest rules prohibit an investment professional advising a plan sponsor or plan participants from recommending an IRA that will generate fees or other compensation for that investment professional. However, such an adviser may provide investment education about availability—

not advisability—of a rollover, even if the adviser will earn fees or other compensation from the participant's rollover IRA assets. To help investment advisers apply the distinction between investment education and advice, consideration should be given to adding language to investment advisory agreements and/or other documents along the following lines:

> "Rollovers to IRAs. If an adviser provides investment advice to a retirement plan sponsor or participants, the adviser cannot recommend an affiliated IRA. However, an adviser can educate participants concerning rollovers in general and describe the ability to withdraw funds from the retirement plan and to roll them over into affiliated and nonaffiliated IRAs generally. If a participant elects to work with the adviser outside of the plan regarding the participant's IRA assets, the adviser may receive variable compensation from third parties while working with the participant."

This disclosure language is based on DOL Advisory Opinion 2005-23A and Interpretative Bulletin 96-1.

VIII. Best Practices Relating to Financial Literacy of Plan Participants. In 1995, the U.S. Department of Labor launched a national pension education campaign whose theme was, "Save! Your Retirement Clock is Ticking." The aging U.S. population and the accelerating shift from defined benefit plans to defined contribution plans has made the issue of financial literacy increasingly important in ensuring a secure retirement income. The media, including television, radio, web sites, books, magazines and newspaper columns devote substantial attention to the topic. This has led policy makers to recommend measures that are rapidly evolving into a set of best practices that employers should consider adopting with respect to the administration of 401(k) and other individual account plans that place the responsibility and the risk of investment choice on the employee.

A. Prior Developments in Closing the Information Gap. As early as 1996, the Department of Labor acknowledged the importance of closing a so-called information gap by providing plan participants and beneficiaries with information designed to assist them in making investment and retirement-related decisions appropriate to their particular situations. To allay plan sponsor fears that such efforts might be interpreted as giving investment advice for which the plan sponsor could be held liable, the Department issued Interpretive Bulletin 96-1 which describes four "safe harbors" representing examples of the type of information, materials and educational services that can be furnished to participants without constituting investment advice. The Department noted that there could be many more such examples of investment education that did not reach the level of investment advice. Subsequently, the Department's so-called SunAmerica ruling (Advisory Opinion 2001-09A) implicitly recognized the need for advice by allowing investment providers to recommend asset allocation models to plan participants if the source of such advice is independent of the provider.

B. Pension Protection Act. In 2006, the U.S. Congress attempted to increase the availability of participant-level investment education and advice by enacting a new prohibited transaction exemption as part of the Pension Protection Act. To qualify for relief, an RIA, broker-dealer or other fiduciary adviser is required to ensure that their fees for providing advice will not vary based on any recommended investment options that are selected by a participant. Alternatively, the investment advice can be provided through the utilization of an objective computer model that is independently certified not to favor investment options that would result in greater fees for the adviser. Finalization of regulations implementing these provisions appears to be imminent.

C. Current Proposals Based on Existing Law. In the meantime, efforts to address the employee information gap are underway based on regulations that are already in place. While some employers were initially concerned about the risks that offering advice might entail, the prevailing concern has shifted to the risk of not offering it. In 2007, the ERISA Advisory Council formed a Working Group on Financial Literacy of Plan Participants and the Role of the Employer which has made a series of recommendations for consideration by the Secretary of Labor relating to participant education and advice. Included in the recommendations was a proposal for the Department's creation of a best practices grid that would point to the core financial literacy skills needed for the successful retirement of differently situated employees and a call for the expansion and updating of Interpretive Bulletin 96-1 to accommodate innovation in the financial marketplace.

The primary concern driving the Working Group, as well as attentive employers, is that, despite the ease and convenience of investing over the Internet, employees are not doing well in handling responsibility for their own retirement. The Working Group concluded that an effective educational program for plan participants requires giving them the tools to make sound investment decisions. The witnesses who appeared before the group testified unanimously that participants must have a familiarity with concepts such as the time value of money, asset allocation, risk management and taxation, as well as knowledge about the plan's investment options. It should be noted that general financial investment concepts will be within the safe harbor of Interpretive Bulletin 96-1 and will not be considered as the rendering of investment advice, provided that the information has no direct relationship to the plan's investment alternatives.

Although understanding investment basics is necessary, it is not enough, and participants also need to have a working knowledge of particular plan design features, such as the ramifications of the plan's various distribution options, the calculation of minimum withdrawals, and the rules relating to rollovers. It is to be noted that furnishing information as to the benefits of plan participation and/or increasing plan contributions, the effect of pre-retirement withdrawals on retirement income, the terms of the plan and how the plan operates are all matters that are within the safe harbor of Interpretive Bulletin 96-1.

The modern 401(k) plan demands active participant involvement. However, the Working Group discovered that participants and non-participants alike had no idea how much money will be required to provide an income stream at retirement that will support the participant's current standard of living. Further, participants frequently misunderstood concepts, such as life expectancies, investment returns and other variables that are elements of a proper retirement income replacement calculation. Consequently, it urged the Department to encourage, assist and facilitate the inclusion in plan communications of retirement income replacement calculations and final pay multiples on a per participant basis. As stated in the group's report, "Plan communications should encourage participants to have a numerical goal, whether as a result of a sophisticated or elementary formula, and repeat that message. At the very least, participants should be able to determine and have access to an estimated account balance necessary for retirement." Retirement calculators are not investment advice under Interpretive Bulletin 96-1; the Working Group's recommendations would extend this treatment to such matters as mandatory 20% tax withholding, the 10% penalty tax on early withdrawal, and calculations of guaranteed income for life.

D. <u>Delivery of Investment Education.</u> The Working Group found that third party education via the Internet is not being widely used. The reason for this is that employees want one-on-one help from a person they can trust. Generally speaking, they do not have the confidence to implement advice provided to them via on-line tools. Regarding the medium for delivering financial literacy training, all of the Working Group's witnesses agreed that face to face financial counseling works best. As to the timing of the message, it was agreed that several meetings and several counseling sessions over a lifetime work best for the purpose of modifying participant behavior and learning financial topics. Mandatory one-to-one counseling may be appropriate before certain events, such as retirement, making a lump sum withdrawal or electing the purchase of an annuity with plan assets.

In recognition of the fact that successful programs are continuous, many plan sponsors have adopted a comprehensive educational regimen that uses a variety of techniques, such as posters, voice messaging, email, seminars, individual counseling, asset allocation models and tools, and reference material on the company's intranet site. Because cost is likely to be an inhibiting factor, a standardized set of counseling and instructional materials may be developed to assist employee decision making.

The available literature indicates that employee response to workplace financial education programs is generally favorable. Some employers have reported that the reaction to pre-retirement planning seminars has been that the seminar was one of the best benefits offered. Employees frequently comment that the employer should have provided the program much earlier. Studies have found that employees who attended training workshops subsequently increased their participation rate in 401(k) plans. While other strategies, such as automatic enrollment, might produce a similar result, studies have also shown that such financial education is effective in eliminating bad financial habits. This is critical because, in the end, training and communication must pave the way to action that leads to retirement income adequacy.

E. Beneficial Effects of Financial Education Programs. Employers should recognize that they are primarily responsible for helping employees transition from work to retirement. Financial education programs are one means of furnishing this assistance, and because they increase the efficacy of retirement savings, as well the rate of plan participation, will be added to the list of plan sponsor best practices. From a plan sponsor's perspective, these programs have the added beneficial effect of reducing unwise investment decisions by employees that could ultimately be the basis of a legal action because of the feeling that the company had not adequately vetted investment alternatives or had somehow mishandled the retirement plan. Financial advisers and investment providers may be called on to assist employers in designing and/or implementing an appropriate program.

IX. Department of Labor Initiatives on Disclosure.

A. Form 5500 Reporting.

1. Plan Years before 2009. Fees and expenses paid by the plan are required to be disclosed on the Form 5500 using either the Schedule A to report commissions or related fees paid to insurance companies or the Schedule C to report fees paid to service providers. Service providers, such as insurance companies and mutual funds, have traditionally interpreted their duty to disclose narrowly. For example, investment management fees, soft dollars and internal fund expenses were not disclosed on either Schedules A or C of the Form 5500, and there was little reporting of indirect fees.

2. Regulatory Change for 2009 Plan Year. The Department of Labor has issued final regulations that revise Schedule C of Form 5500 to require reporting by large plans of virtually all direct and indirect compensation of $5,000 or more to any person. This change will be effective for plan years beginning on or after January 1, 2009. The burden of obtaining such information rests on the plan administrator. By itself, this change would not require the cooperation of service providers. However, such cooperation would be strongly encouraged, if not required, when the proposed regulations under Section 408(b)(2) of ERISA are implemented.

3. Applicable Only to Large Plans. The requirement to file Schedule C applies only to plans that cover 100 or more employees.

4. Definition of Reportable Compensation. Money and any other thing of value, such as gifts, awards, and trips, received directly or indirectly from the plan, including fees charged as a percentage of assets and deducted from investment returns, must be reported.

   a. Direct Compensation. Payments by the plan out of a plan account, charges to plan forfeiture accounts and fee recapture accounts, charges to a plan trust account before allocations are made to individual participant accounts, and direct charges to individual participant accounts.

   b. Indirect Compensation. Compensation from sources other than payments made directly from the plan or plan sponsor in connection with services rendered to the plan or the recipient's position with the plan. Examples of reportable indirect compensation include fees and expense reimbursement payments charged against the fund or account in which the plan invests and reflected in the value of the plan's investment. Other examples are finder's fees, float revenue, brokerage commissions, research or other products or services received from a broker-dealer or other third party in connection with securities transactions (i.e., soft dollars), and certain transaction-based fees.

   c. Excludible Non-Monetary Compensation. Gifts or meals that are deductible by the payor and not taxable to the recipient, provided that the gift or gratuity is valued at less than $50 and the aggregate value of such gifts from a single source in a calendar year is less than $100. Gifts valued at less than $10 do not need to be counted toward the $100 limit. Gifts received by one person from multiple employees of one entity must be treated as originating from a single source.

   d. Special Rule for Payments to Bundled Service Provider. A bundled service arrangement includes a transaction in which the plan receives a range of services either directly from an investment provider, through affiliates or subcontractors or through a combination. Direct payments by a plan under such an arrangement need not be allocated among the affiliates or contractors unless the amount paid to an affiliate or contractor is set on a per transaction basis, such as a brokerage commission. Similarly revenue sharing payments by investment providers need not be so allocated unless they come within one of the exceptions described below.

e. Exceptions. The following compensation arrangements must be reported as separate compensation, even if paid from mutual fund management fees:

i. Fees charged to the plan's investment and reflected in the net value of the investment. Included in this category would be management fees paid by mutual funds to their investment advisers, float revenue, commissions (including soft dollars), finder's fees, 12b-1 distribution fees, and shareholder servicing fees.

ii. Payments of commissions and other transaction based fees, finder's fees, float, soft dollars and other non-monetary compensation to the following recipients: plan fiduciaries, contract administrators, providers of consulting or investment advisory services either at the plan or the participant level, providers of investment management services, brokers, and recordkeepers.

5. Alternative Reporting Option. "Eligible indirect compensation" will not be reported on Schedule C. In lieu of reporting on Schedule C, information about eligible indirect compensation will be provided to the plan and only the fact that a service provider received this type of compensation will be reported.

a. Indirect Compensation. Fees or expense reimbursement payments charged to investment funds and reflected in the value of the investment or return on investment of the participating plan or its participants are included in the definition. Also included are finder's fees, soft dollar revenue, float, and/or brokerage commissions or other transaction-based fees for transactions or services involving the plan that were not paid directly by the plan or plan sponsor (whether or not they are capitalized as investment costs).

i. For purposes of the above definition, investment funds include mutual funds, bank common and collective trusts, insurance company pooled separate accounts, and separately managed investment accounts that contain assets of an individual plan.

ii. Indirect compensation may be reported on the basis of the service provider's fiscal year.

iii. The DOL has indicated that fees for compliance services received by a recordkeeper from a mutual fund agent are reportable as indirect compensation but do not qualify for the alternative reporting option.

b. Written Disclosures. For indirect compensation to be eligible indirect compensation, written disclosures must be made to the plan. This disclosure must cover the following matters:

i. the existence of the indirect compensation,

ii. the services provided for the indirect compensation or the purpose of the payment,

iii. the amount (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation,

iv. the identity of the party or parties paying and receiving the compensation.

v. if the compensation relates to a bundled arrangement, a description each element of indirect compensation that would be required to be separately reported if there were no reliance on the alternative reporting option.

c. Service providers who use the alternative reporting method will be responsible for maintaining records to demonstrate compliance with these requirements.

B. Expanded Information Disclosure Requirements to Participants.

On July 23, 2008, the Department of Labor issued proposed regulations which, if adopted, will expand the information that plan sponsors must disclose to participants and beneficiaries in participant-directed individual account plans. The DOL proposed that the regulations be effective for plan years beginning on or after January 1, 2009. Four categories of information will have to be disclosed to participants before or when they become eligible to participate in a plan and then annually. The first three are plan-related and the fourth is investment-related. In some cases dollar amounts actually charged against a participant's account will need to be disclosed quarterly after enrollment in the plan. The four categories of information are:

1. General Plan Investment Information. This includes how participants and beneficiaries may give investment instructions. Participants will have to be notified of material changes to the plan within 30 days after the date of adoption of such changes.

2. Administrative Expenses. Participants and beneficiaries must be given an explanation of any fees and expenses such as for legal, accounting and recordkeeping services.

3. Individual Expenses. Disclosure for information relating to individual expenses such as for qualified domestic relations order, a participant loan or investment advice services.

4. Investment-Related Information. Participants and beneficiaries must be furnished with certain basic information regarding the plan's investment options, performance history and any fees and expenses associated with their investments.

These rules will apply to designated investment alternatives offered by a plan but do not apply to brokerage windows or self-directed brokerage accounts.

Certain information which is currently required, such as copies of investment prospectuses or summaries, would only have to be provided upon request.

C. Proposed Regulations under ERISA Section 408(b)(2). The DOL has proposed amending its regulations to require service providers to disclose in writing their fees and conflict of interests. If adopted as proposed, the new regulations will impose significant administrative burdens on service providers and expose them to risk of legal liability for failure to disclose their fees and conflicts of interest.

1. Service Providers Affected. The proposed rules are limited to the following service providers:

a. Fiduciaries under ERISA or under the Investment Advisors Act of 1940;

b. Providers of securities brokerage or investment advice (whether to the plan or plan participants), investment management, custodial, recordkeeping, consulting, or third party administration services, regardless of whether they receive the compensation directly from the plan or plan sponsor, or indirectly from third parties, or

c. Providers of accounting, actuarial, appraisal, auditing, legal or valuation services but only if they receive any compensation indirectly from third parties.

Service providers who are plan fiduciaries (e.g., investment advice fiduciaries) and service providers involved with plan administration or investments are subject to the new disclosure rules in all events. However, accounting, actuarial, legal, and similar professional service providers are subject to the new disclosure rules only if they receive indirect compensation. According to the DOL, the distinction is based on its belief that the service providers subject to the enhanced disclosure requirements are most likely to have conflicts of interest.

2. Affected Plans. Although the focus of the proposed 408(b)(2) regulations is 401(k) fees, the proposal applies to services provided to health or other welfare plans as well as 401(k) and other retirement plans.

3. Fee Disclosures. An affected service provider must disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, all services to be provided to the plan and, with respect to each such service:

   a. the fees to be received by the service provider (expressed as a specific monetary amount or formula, percentage of the plan's assets, or per capita charge);

   b. whether the service provider will bill the plan, deduct fees directly from plan accounts, or reduce the plan's investment earnings to pay the fees, and

   c. how any prepaid fees will be calculated and refunded when a contract terminates.

4. Types of Fees. For purposes of the proposed rule, fees include money or any other thing of monetary value (e.g., gifts, awards, and trips) to be received by the service provider (or its affiliate) directly from the plan or plan sponsor, or indirectly from third parties (i.e., from any party other than the plan or the plan sponsor), in connection with the services to be provided pursuant to a contract or arrangement with the plan or because of the service provider's position with the plan. Fees may include direct or indirect compensation to the service provider.

   a. Direct compensation is compensation received by a service provider directly from the plan sponsor or plan.

   b. Indirect compensation is compensation received by a service provide from a third party (i.e., not the plan sponsor or the plan). Revenue sharing would be example of indirect compensation. Indirect compensation is typically paid from the plan's investments (or the plan's investment providers) to the plan's service providers. Thus, indirect compensation in the context of DC plans is actually a cost that is ultimately borne by participants.

5. Special Rule for Bundled Services. If a service provider offers a bundle of services to the plan that is priced as a package, rather than on a service-by-service basis, then only the service provider offering the bundled services must provide the required disclosures. In addition, the bundled service provider is not required to disclose the fee allocation among the services except for fees separately charged:

a. against a plan's investment (e.g., management fees paid to a mutual fund's investment adviser) or

b. on a transaction basis (e.g., brokerage commissions).

The exception that permits bundled providers to aggregate their costs may not survive in the final version of the regulations. This would require bundled providers to break out their revenues into categories, such as investment management, administration and recordkeeping, transactional costs and other charges.

6. Conflict of Interest Disclosures. An affected service provider must disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, information about different types of relationships or interests that raise conflicts of interests for the service provider in performing plan services. The service providers must disclose whether they:

a. will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisers Act of 1940;

b. expect to participate in, or otherwise acquire an interest in, any transaction to be entered into by the plan in connection with the services and, if so, a description of the transaction and the service provider's participation or interest therein;

c. have any material financial, referral, or other relationship or arrangement with other parties (e.g., a money manager, broker) that creates or may create a conflict of interest, and if so, a description of such relationship or arrangement;

d. will be able to affect its own compensation or fees, from whatever source, without the prior approval of the plan sponsor or similar plan fiduciary; and

e. have any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent either compensation or fees or the relationships or arrangements from adversely affecting the provision of services, and if so, an explanation of these policies or procedures.

7. <u>Timing and Format of Disclosures.</u> There is no specified timeframe to disclose the information other than prior to entering into the contract. All of the required disclosures need not be contained in the service contract and may be provided in electronic format. The service contract must include a representation by the service provider that, before the contract was entered into, all the required conflicts of interest information was provided to the responsible plan fiduciary. During the term of the contract, any "material" change to the previously furnished information must be disclosed within 30 days of the service provider's knowledge of the change.

8. <u>Curing Disclosure Failures.</u> A service provider's failure to comply with the disclosure obligations under the proposed 408(b)(2) regulations would result in a prohibited transaction. Because the prohibited transaction could adversely affect the plan sponsor or similar plan fiduciary, the DOL has also proposed a class exemption that would provide relieve for them. There is no relief for a service provider that fails to comply with the proposed disclosure regulations.

9. <u>No Conflict of Interest Relief for Fiduciaries</u>. The proposed regulations do not imply that service providers who are fiduciaries can cure conflicts of interest by disclosing them as they do under the Investment Advisers Act of 1940.

   The proposal provides a narrow exemption that allows the use of plan assets to pay for reasonable fees, but it does <u>not</u> provide an additional exemption for fiduciary conflicts of interest. The new rule is designed to force non-fiduciary service providers to disclose their conflict of interests, even though they are not subject to the conflicts of interest rules that apply to fiduciaries.

10. <u>Effective Date</u>. The DOL has indicated that the regulations may be finalized as early as May 2010. While an earlier effective date is possible, it is likely that the new rule will go into effect on January 1, 2011. This might preempt fee disclosure legislation pending in Congress. However, it would also mean that service providers would be required to amend or create service agreements to reflect the new rules by the effective date.

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