

## 401(K) INVESTMENT ISSUES

### *Revenue Sharing Litigation:*

### *A Threat to 401(k) Plans*

*Revenue sharing has become a major subject of litigation against 401(k) plan sponsors and plan providers. This article focuses on the litigation involving plan providers, that is, the entities that offer 401(k) packages, including recordkeeping, to the marketplace. We examine in detail Haddock v. Nationwide Financial Services, Inc., in which there is a published court opinion on the issues of fiduciary status and prohibited transactions related to revenue sharing.*

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Revenue sharing lawsuits against plan providers (entities offering 401(k) packages, including recordkeeping, to the marketplace) are mainly class actions claiming that the receipt and retention of revenue sharing payments breached the providers' fiduciary duties to their client plans. In this article, we examine in detail one of the earliest cases in which the issue was raised: *Haddock v. Nationwide Financial Services, Inc.* [419 F. Supp. 2d 156 (D. Conn. 2006)] This is the only case to date in which there is a published court opinion on the issues of fiduciary status and prohibited transactions related to revenue sharing. Even then, the court's opinion relates only to preliminary procedural matters and is not a judgment on the facts.

In analyzing the revenue sharing issue, it is important to keep in mind that revenue sharing payments—from mutual funds and their managers to plan

providers—is a common practice in the 401(k) industry. These payments reduce the costs of 401(k) plans, in some cases on a dollar-for-dollar basis and in others as an unallocated subsidy. Because the payments make plans affordable to employers, particularly small and mid-sized companies, they have been one of the major factors in the popularity and growth of 401(k) plans.

We focus on the *Haddock* case because of the important implications it and similar cases that have since been filed hold for the entire 401(k) marketplace. Although this is one of the first lawsuits to address squarely the issue of revenue sharing, it is now just one of many. An important fact that may distinguish this case from others is that the revenue sharing arrangements were disclosed to the plans and participants. [*Id.* at 163] Thus, the case does not involve the issue of "hidden payments" that has been the basis for other lawsuits involving fees received by plan providers.

#### Significance of the Case

The *Haddock* case began in 2001, when several 401(k) plan trustees filed a lawsuit against Nationwide Financial Services and Nationwide Life Insurance Company (collectively "Nationwide"), the provider for their plans. The plans had invested in variable annuity contracts that held mutual funds in separate accounts at Nationwide. The trustees claimed that the contractual arrangements with the mutual fund companies and the retention of revenue-sharing payments from those funds constituted a breach of fiduciary duty and prohibited transactions under ERISA.

In 2006, after nearly five years of procedural wrangling, a federal district judge ruled that the *Haddock*

lawsuit could go forward to trial. (The next step is not a trial, though. The attorneys defending Nationwide have filed a motion to dismiss the case, which is now pending before the court. To further complicate matters, the judge has not yet certified the case as a class action, which we anticipate will be a contested issue.) The procedural decision did not determine whether the receipt of the payments violates ERISA.

The case is significant because, if ultimately decided in favor of the plans, it will pose a serious threat to the business model being used by most 401(k) providers.

We refer to plan providers and recordkeepers generally as providers or plan providers because, in many cases, the entity that offers the core 401(k) services to the marketplace also performs the recordkeeping function or out sources that service. The provider who limits the investments included in its 401(k) offering, as Nationwide did in this case, we refer to as a packaged provider, because it provides a package of investments and services. One unique aspect of a packaged provider is that it can remove an investment in its package, even though an investment is being used by a client plan. This is discussed in more detail later in this article.

If the courts determine that the receipt of revenue sharing payments by providers poses fiduciary and prohibited transaction issues under ERISA, the financial impact will be substantial and may require a significant change in the relationships between plan providers, sponsors and fiduciaries, and mutual funds and their managers.

### Background: The Facts

There has not been an actual finding of wrongdoing by Nationwide in the *Haddock* case. The reported decision was a ruling on a motion for summary judgment. In such a motion, one party—in this case, Nationwide—argues that there is no fundamental dispute as to the facts (referred to as “no triable issue of fact”) and that, even if you view the facts in a light most favorable to the other party—in this case, the trustees—Nationwide is entitled to a judgment in its favor. In ruling on the motion, the judge concluded only that the plans would have an opportunity to try to prove their case at a trial (*i.e.*, that there were triable issues of fact).

This discussion of the case is drawn entirely from the published decision. We have not included all of the facts or analyses in the opinion, but only those portions that are relevant to the issue of revenue sharing. Further, evidence introduced at trial may show

that the actual facts are different from the plaintiffs’ assertions. But for purposes of this article, we assume that the stated facts are correct.

Nationwide offers a variety of investment vehicles, including group and individual variable annuities, through which plans and individual participants may invest in a range of mutual funds. Because individual annuities are typically used in 403(b) arrangements and not 401(k) plans, we focus our discussion on group variable annuities. The issues raised by the *Haddock* case extend, however, beyond group annuity contracts because of the prevalence of revenue sharing, including shareholder servicing fees paid in the open architecture environment.

In a packaged provider arrangement, only the mutual funds selected by the provider are available in the provider’s offering, in this case through an annuity contract. (We refer to this as the provider’s “product.”) From the available funds, the plan sponsors or other fiduciaries select a subset of those funds for their plans. (To distinguish them from others who serve as fiduciaries, we refer to the officers of plan sponsors who serve as fiduciaries as the plan sponsor fiduciaries.) The participants chose from the subset of funds for the investment of their accounts. The packaged provider retains the authority to delete and substitute funds from the investment options in the product.

In the *Haddock* case, as is typical with group annuity contracts, the participant deferrals and employer contributions from multiple plans and participants were held in separate accounts the judge referred to as variable accounts. These accounts were divided into numerous subaccounts corresponding to a specific investment option (*e.g.*, the large cap growth fund or the international fund), which are known in the industry as omnibus accounts. These subaccounts received allocations from multiple plans and participants. When instructed to do so by a plan or its participants, Nationwide bought or sold mutual fund shares from the specific subaccounts to adjust the combined holdings of all plans and participants. Shares of these subaccounts were allocated to individual plans and participants.

According to the decision, beginning in the mid-1990s, Nationwide negotiated agreements with mutual funds or their management companies to receive payments based on a percentage of the assets invested in the mutual funds. (These payments are generally referred to as revenue sharing.) Nationwide explained in the court proceedings that

it received these payments for providing services to the mutual funds and their management companies, such as recordkeeping of holdings and distribution of information.

In the normal retail setting, a mutual fund must maintain records of who owns its shares and periodically provide its shareholders with information regarding their accounts (often referred to as the transfer agent function and shareholder services). In the omnibus account setting, the mutual fund treats a plan provider as a single shareholder and does not keep track of the beneficial (or ultimate) owners of its shares—that is, the participants. Thus, some of the services that Nationwide performed were the transfer agent and shareholder service functions normally performed by the mutual fund itself: maintaining the records of which plans and which participant accounts own shares in each fund (generally referred to as recordkeeping), implementing transactions when directed, and providing participants with information about the value of their shares and about their transactions. The transfer agent and servicing payments are intended to offset the costs for these services that would otherwise be charged to the plans or the participants.

Nevertheless, the *Haddock* judge stated that:

a fact-finder viewing the evidence in the light most favorable to the [plaintiff trustees, which was required at this stage of the case] could conclude that the contracts were a guise for making payments to Nationwide or that Nationwide provided only nominal services and that the payments were not consideration for those services. [*Id.* at 162]

### Background: The Alleged Violations

The trustees asserted two bases for their position, contending that:

1. The revenue-sharing payments were plan assets, and it was a violation of ERISA for a provider to retain them.
2. A packaged provider is a fiduciary under ERISA Section 3(21)(A)(i) (which defines a fiduciary as a person who “exercises any authority or control respecting management or disposition of [a plan’s] assets...”) and, regardless of whether revenue sharing amounts are plan assets, the provider engaged in an act of self-dealing by receiving the revenue-sharing in exchange for including the mutual funds in its product offering.

The judge did not reach a conclusion on either issue. Rather, he concluded that the issues should be decided at a trial on the facts.

### Fiduciary Status

In holding that the case should go forward to a trial, the judge noted that the trustees’ claims hinged on whether Nationwide was an ERISA fiduciary and whether, in receiving the revenue sharing, it did so in a fiduciary capacity. Although he discussed the issue of whether the revenue sharing payments were plan assets, he ultimately concluded that, regardless of whether or not they were plan assets, the receipt of such payments by a fiduciary could be a prohibited transaction. In light of this conclusion, we examine only the issues of whether a packaged provider is a fiduciary and whether its receipt of revenue sharing is a prohibited transaction and leave for another day the analysis of whether the revenue sharing payments are or are not plan assets.

Without deciding the fiduciary issue, the judge noted that a provider of a package of investments and services “does exercise some control over the selection of mutual funds that are available for the Plan’s and participants’ investments” and that such a provider “may be a fiduciary to the extent that it exercises authority or control over plan assets by determining and altering which mutual funds are available.” [*Id.* at 166] He stated that a “reasonable fact-finder” could conclude that such a provider was a fiduciary because of its control. [*Id.* at 165] In support of his ruling that this *could* make a packaged provider a fiduciary, the judge cited to DOL Advisory Opinion 97-16A (referred to as the “Aetna Opinion,” discussed later in this article).

### Prohibited Transactions

As noted, the judge also concluded that even if the revenue sharing payments were not plan assets, there was still the potential for a prohibited transaction, because if a packaged provider “is an ERISA fiduciary, it may not engage in a prohibited transaction even if the payments [it] receives are not themselves plan assets.” [*Id.* at 171] The judge focused the discussion of this issue on ERISA Section 406(b)(3), which prohibits a fiduciary from receiving payments “for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.” Because the revenue sharing payments were at least indirectly sourced in plan assets, that is, the Nationwide variable accounts

(which the judge said were “indisputably plan assets”), the judge concluded that the revenue sharing payments did not need to be plan assets in order to find 406(b) prohibited transactions.

## Discussion

### The Function of Revenue Sharing

Most plan providers and recordkeepers receive revenue-sharing payments. Why? There are two reasons:

1. By receiving payments from the investments offered through the providers' platforms, the providers are able to reduce or offset recordkeeping and other costs for 401(k) plans.
2. The providers render essential services to the mutual funds.

Through an omnibus account, a provider may invest millions (sometimes hundreds of millions) of dollars in a mutual fund on behalf of thousands of plans and participants. As noted earlier in this article, from the mutual fund's perspective, it has one shareholder, the plan provider. The mutual fund is relieved of the cost of keeping track of large numbers of individual shareholders (*i.e.*, the hundreds or thousands of individual plans that hold shares in the fund and the thousands or even millions of participant accounts invested in the fund) because the provider performs that service. The mutual fund also may be relieved of the cost of marketing the mutual fund to these plans and participants, because the fund is included in a packaged provider's product offering. Thus, the mutual fund is not required to expend the amounts it would normally pay in marketing costs to obtain assets, in shareholder services to support the holding of the fund shares, and in transfer agency costs to keep track of who owns the mutual fund shares.

Because the provider is performing these functions for the mutual fund, the mutual fund pays for the cost of these services through revenue sharing to the provider to offset the provider's costs for performing the services.

Contrary to the assertion by the trustees in the *Haddock* case, these are valuable services to both the mutual funds and the plans that invest in the provider's product. If the provider did not receive the revenue sharing—in the form of 12b-1 fees, sub-transfer agency fees, and other shareholder servicing fees—the cost of the provider's services to the plans, and ultimately to the participants, would be higher because

the plans, and therefore the participants, would have to pay the provider directly. On the other hand, with revenue sharing, no increase in charges by the mutual fund or decrease in the return on the mutual fund shares results from the revenue sharing given to the provider because the mutual fund is paying for the services either way—therefore, charging the shareholders for these costs in any event.

### Providers as Fiduciaries

Some plan providers specifically agree to take on a fiduciary role, often a limited one, for plans that engage them to provide investments, recordkeeping, and other services. Setting those situations aside, a packaged provider is not generally a fiduciary because it does not meet the definition of a fiduciary under ERISA Section 3(21)(A). The relevant parts of Section 3(21)(A) provide that a person is a fiduciary to the extent it possesses or exercises discretion over plan management or exercises actual control over plan assets. Although a packaged provider selects the mutual funds or other investments offered through its product, as noted by the *Haddock* judge, the fiduciaries of individual plans select the particular funds to be offered as investments for their plans.

In determining whether a packaged provider is a fiduciary, we examine several different situations:

*The provider has not previously provided any investments or services to a plan.* The plan sponsor's fiduciaries have the discretion to select the provider and the funds offered by the provider. Before being selected to provide services and investments to a plan (*i.e.*, the provider has no existing relationship with the plan), a packaged provider is not in a position to exercise discretion or control over the plan or its assets. Thus, the provider cannot be a fiduciary to that plan under the Section 3(21)(A) definition. As noted by the court in *Krear v. 19 Named Fiduciaries*:

When a person who has no relationship to an ERISA plan is negotiating a contract with that plan, he has no authority over or responsibility to the plan and presumably is unable to exercise any control over the trustees' decision whether or not, and on what terms, to enter into an agreement with him. Such a person is not an ERISA fiduciary with respect to the terms of the agreement for his compensation. [810 F.2d 1250, 1259 (2d Cir 1987)]

Thus, prior to the establishment of a formal, contractual relationship between a plan and a packaged provider, their roles are that of vendor and buyer.

This conclusion is also implicit in the DOL's Aetna Advisory Opinion (97-16A). If Aetna had become an investment fiduciary by offering its 401(k) product to the market, the issue of whether it became a fiduciary by removing and replacing investments would have been moot, because it already would have been an investment fiduciary.

*The provider takes no action to remove and replace any funds on its platform that are selected by a plan.* In this situation, after the relationship is established with the plan and the plan sponsor fiduciaries have selected mutual funds from the provider's product, the packaged provider takes no action to remove or replace any of the funds in its product. That is, the product purchased by the plan remains unchanged after the contractual relationship is created. In this situation, the provider has not exercised any control over the retention, removal, or replacement of the funds in the plan. As a result, it has not exercised any control over the plan assets, and it has not become a fiduciary.

*The provider removes and replaces funds on its platform that have been selected by a plan.* A packaged provider may retain the contractual right to remove or substitute mutual funds included in its product and may, in exercising that contractual right, remove and replace a fund that has been selected by one or more client plans. Arguably, in so doing, the provider is exercising discretion or control over assets in a plan because it has effectively caused the liquidation and removal of an investment option and, possibly, its replacement by and reinvestment in another option.

Whether or not this constitutes a fiduciary act depends on how the removal and replacement is carried out. In discussing this issue, the *Haddock* judge cited the Aetna Advisory Opinion, which is the leading authority on this issue. In that advisory opinion, the DOL analyzed whether Aetna became a fiduciary when it removed and replaced funds in its group annuity contracts. Aetna gave advance notice to the plans that it intended to take that action, provided them with relevant information, and gave the plan sponsor fiduciaries an opportunity to reject the change and to move the plan to a different provider. The DOL held that, by giving the choice to the plan fiduciaries—together with adequate information and reasonable time to evaluate it—Aetna was not exercising discretion or control over plan assets. Because the fiduciaries of the individual plans had a reasonable opportunity to accept or reject the action being taken by Aetna, in effect the fiduciaries made the decision

about the funds to be offered by their plans. As a result, Aetna's action in removing and replacing funds in its product was not a fiduciary act. The DOL's holding in the opinion leaves no room for doubt:

It is the view of the Department that a person would not be exercising discretionary authority or control over the management of a plan or its assets solely as a result of deleting or substituting a fund from a program of investment options and services offered to plans, provided that the appropriate plan fiduciary in fact makes the decision to accept or reject the change.

The effect of this guidance is that packaged providers can remove and replace investments to maintain or improve the quality of their product without becoming fiduciaries, if they transfer the final decision back to the plan fiduciaries.

The advisory opinion further provided that, if the steps outlined in the opinion were followed, the plan fiduciaries would be deemed to have approved the change if they did not object within a reasonable time period. In other words, silence would be deemed to be acceptance and, as a result, the change would be considered to have been made by the plan sponsor fiduciaries and not by the provider.

The facts to be developed at trial in the *Haddock* case will determine whether Nationwide employed an approach in which the plan fiduciaries effectively made the decisions about replacing funds held by their plans under the Aetna model or another process (the Aetna approach is not necessarily the exclusive means of avoiding fiduciary status for a packaged provider). If the *Haddock* court concludes that removal and replacement of funds makes a packaged provider a fiduciary even if the ultimate decision is transferred to the plan sponsor fiduciaries, it would create significant problems for the 401(k) industry and, ultimately, for plan sponsors, particularly for smaller plans. From a provider perspective, packaged providers need to manage their product offerings to maintain their competitive position in the marketplace for both their existing client plans and for prospective plan sponsors. From a plan sponsor perspective, the ability of providers—especially of packaged providers to small plans—to update and improve their packages of investments and services is invaluable in maintaining and enhancing the plans and ultimately the retirement benefits of the participants. For a variety of reasons, including revenue sharing and the prohibited transactions rules, it is difficult for packaged providers to offer those services

as fiduciaries—that is, unless there is a non-fiduciary process, like the one described in the Aetna Advisory Opinion.

*The provider offers investments that are not selected by a plan.* A packaged provider cannot be a fiduciary with respect to funds on its platform that are not selected by a plan inasmuch as the plan has no assets invested in those funds. This logic extends to the removal and replacing of funds included in the product, but not selected by a plan, and to the addition of new funds to the provider's product.

### **Prohibited Transaction Issues**

Although our analysis is that, with the use of proper procedures, a packaged provider does not become a fiduciary, it is important to understand the consequences of the opposite conclusion.

If a packaged provider is found to be a fiduciary because of the removal and replacement of mutual funds from the product, the court will need to determine whether there were prohibited transactions under ERISA Sections 406(b)(1) and 406(b)(3). Section 406(b)(1) prohibits a fiduciary from acting in its self-interest in dealing with plan assets; that is, it may not use its fiduciary authority to cause itself to receive additional compensation. Section 406(b)(3) prohibits a fiduciary from

receiving compensation from a third party in connection with transactions involving plan assets.

There are open issues in this case concerning causation and the calculation of the amounts of any prohibited transactions. The general rule for correcting a prohibited transaction is that the "amount involved" (that is, the revenue sharing at issue) must be restored to the plans. The amounts of revenue sharing paid to 401(k) providers are large—very large—and any decision that required that the payments be taken from the providers and paid into the affected 401(k) plans would be devastating to the 401(k) community.

### **Conclusion**

Revenue sharing received by providers from mutual funds and other investments is Part of the fabric of the 401(k) marketplace. The revenue sharing reduces the cost of administering plans. The *Haddock* case comes at a critical juncture for 401(k) plans in light of inquiries by Congress, the SEC, and the DOL regarding the amount and proper disclosure of service provider compensation. An adverse decision in the trial will be highly disruptive to the 401(k) community and could prove detrimental to participants in small to mid-sized plans by shifting more plan administrative costs to their accounts. ■