

Message From The Firm

For 2008, plan sponsors have a number of issues to consider for improving their 401(k) plans and to better manage their fiduciary risks.

Among those issues are:

- 1. Whether to implement the new fiduciary protections afforded by qualified default investment alternatives (or QDIAs) for participants who default—or, in other words, fail to give investment directions.** From my perspective, it is inconceivable that any plan that experiences a significant number of defaults—regardless of whether automatically enrolled or not—would fail to obtain these substantial fiduciary protections.
- 2. Whether to automatically enroll.** Automatic enrollment is now favored in the law. Furthermore, it is a godsend to plan sponsors who have struggled with increasing their participation levels and/or with passing their ADP tests. Based on data I have seen, automatic enrollment is being embraced by large- and mid-sized plans. In addition, we hear—primarily from providers—of an uptake in the use of automatic enrollment by small plans.
- 3. Whether to use safe harbor automatic enrollment.** Unfortunately, I have heard that safe harbor automatically enrolled plans are not being widely adopted. Apparently, the problems are that those plans must automatically enroll old employees who never participated, well as new employees. As a result, the mandated matching contribution is too expensive for many companies to bear. However, for companies with good cash flow and solid balance sheets, it is a plan design that is advantageous in terms of compliance with the tax rules and in terms of the benefits provided to participants.
- 4. Whether to offer investment advice to participants.** The Pension Protection Act creates a new category of “fiduciary adviser.” However, the DOL has not issued

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Design Issues for Automatically Enrolled Plans

By Fred Reish (FredReish@Reish.com)



As we work with plan sponsors who are converting to automatic enrollment, we are finding that the individual circumstances

of a plan sponsor affect the design of the plan. As a result, we believe that, as the 401(k) community gains experience with automatic enrollment, a variety of automatic plan designs will emerge to cope with specific circumstances.

This article discusses three cases involving our clients. The first is for a company that had a high level of turnover; the second is for a company that had low deferral rates for currently participating employees; and the third is for a company that was worried about the cost of matching contributions.

The High Turnover Case

The first situation involved a client in the retail industry, where turnover rates during the first year are very high. The company was reluctant to convert to automatic enrollment because of a concern about the administrative difficulty and cost of automatically enrolling participants, when many of them will leave within a matter of weeks or months . . . resulting in a large number of distributions of small amounts.

In order to obtain the benefits of automatic enrollment for its long-term employees, but to avoid the cost and difficulty of short-term turnover, the eligibility provisions of its plan were designed as follows:

- For voluntary enrollment, employees could begin participating on the first of a month following one month of employment.
- For automatic enrollment, all employees who had not voluntarily enrolled would be automatically enrolled following one year of employment. (Of course, any automatically enrolled employee could opt out of participation.)

By deferring the automatic enrollment date, the company was able to avoid most of the turnover while, at the same time, allowing concerned employees to voluntarily participate at an earlier date. In addition, the company was able to design a plan that will cover substantially all of its long-term workforce.

As a word of caution, there are unanswered questions about this plan design if a plan sponsor wants to (i) use the safe harbor design, or (ii) to take advantage of the 90-day withdrawal provision or the extended

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Seminar on Proposed Regulation on Disclosure of Fees and Revenue Sharing

Next Sunday, February 10th, at the 401k Summit in Orlando, Florida, Fred Reish, Bruce Ashton and Debra Davis will be conducting a seminar on the new 408(b)(2) regulation. The seminar will focus on the requirements under the proposed regulation for RIAs and financial advisers to disclose their revenues, both direct and indirect, prior to entering into a contract or arrangement with a plan.

The impact of the proposed regulation, when finalized, will be substantial. It will require every investment adviser and financial adviser to have a written contract with client plans that explains the services rendered, the revenues received, and any potential conflicts of interest. We believe that the consequence will be an enhanced focus on fees which will require a more detailed and thorough explanation of the value received for those fees, that is, of the services provided to the plan and the participants by RIAs and financial advisers.

The session will begin at 9:00 a.m. and will go for 50 minutes. It will be held in Grand Ballroom #9 in the Orlando World Center Marriott.

Limitation on Liability in Service Provider Agreements



By Bruce Ashton (BruceAshton@Reish.com)

Service providers sometimes try to limit their liability for mistakes through provisions in their service contracts. These provisions raise a number of questions that plan sponsors need to consider.

1. Is such a provision in the best interests of the participants in the plan? In addressing this issue, the Department of Labor has said that it is not a breach of fiduciary duty for a plan sponsor to enter into a contract with a provision that limits the liability of a service provider. It went on to say, however, that the plan sponsor must take into account whether the plan could engage a different service provider who could provide the same level and quality of service at a similar cost without such a limitation on liability. In other words, the plan fiduciaries must carefully consider the prudence of agreeing to such a limitation.
2. Is the service provider a fiduciary under ERISA? If so, ERISA Section 410(a) specifically prohibits a fiduciary from obtaining a release from prospective liability (such a provision is “void as against public policy.”). In other words, a provision that seeks to limit fiduciary’s liability is unenforceable under the law.
3. If the service provider is not a fiduciary, is the limitation reasonable? Assuming the plan sponsor determines that it is appropriate to agree to a limitation, the next issue is whether, if the service provider makes a mistake and incurs liability, would the plan be adequately compensated for any reasonably likely loss or damage under the limitation? If not, the limit should be eliminated or increased. Consider three examples:
 - a. The agreement may provide that the service provider will indemnify the plan and plan sponsor for its gross negligence or willful misconduct. Without getting into the technicalities of the law, “gross” negligence requires a more significant disregard for proper standards of conduct than “simple” negligence. To better protect the plan and plan sponsor, the word “gross” should be eliminated.
 - b. The agreement may provide a limit on the service provider’s liability equal to the amount of its annual fees (or perhaps a multiple, such as two times). Suppose the annual fee is \$10,000. Under such a provision, the service provider’s liability for damages caused by its negligence or bad acts could be as little as \$10,000 (or \$20,000 if the limit is two times the fee). The plan sponsor must consider whether this amount is likely to compensate the plan adequately for a mistake made by the service provider.
 - c. The agreement may provide that, if information is provided by the service provider – e.g., a trust account or participant statements, it will be deemed accepted and the service provider will have no liability for mistakes made in the information after a period of time. This is a kind of contractual “statute of limitations.” Often, the service provider seeks to limit the time period to 60 or 90 days. This would mean that the plan sponsor must not only review the information, but essentially re-do the service provider’s work to verify the information – and must do so promptly after receipt of the information. In representing plan sponsors, we generally reject this

type of proposed limitation, though sometimes it is agreed to if the time period is long enough to permit a realistic review of the information by another party, such as a plan auditor.

While there is nothing inherently wrong with a liability limitation provision, it is one which the plan sponsor should carefully consider and negotiate in an attempt to either eliminate it or to increase the limit if the provision is otherwise deemed acceptable. ❖

CEFEX Advisory Council

In January, Fred Reish was appointed to the Advisory Council for CEFEX, the Centre for Fiduciary Excellence.

CEFEX is an international organization that provides an independent certification process for fiduciaries. The certification is granted, if a fiduciary organization is qualified, after a detailed fiduciary assessment. The certification provides assurance to investors, including the fiduciaries of retirement plans, that a fiduciary has demonstrated adherence to a standard set of fiduciary practices.

The role of the Advisory Council is to provide recommendations to CEFEX regarding its certification standards and procedures.

Best Lawyers in America

The *Best Lawyers* organization has notified our firm that Fred Reish and Bruce Ashton were selected to be among the *Best Lawyers in America* for 2008. Both Fred and Bruce have been on the list for several years and this reflects a continuing recognition of their contributions to the benefits community.

Best Lawyers selects attorneys for that recognition based on an exhaustive and rigorous peer review process. In other words, inclusion on the list is the ultimate compliment for a lawyer, since it is based primarily on the opinions of other lawyers.

The firm appreciates this recognition and congratulates both Fred and Bruce.

Questions on Qualified Default Investment Alternatives



By Stephanie Bennett (StephanieBennett@Reish.com)

One of our clients recently raised the following questions about Qualified Default Investment Alternatives (QDIAs):

1. I know that a stable value investment can be grandfathered, but can a stable value investment be used as a short-term QDIA?
2. Can amounts invested in a money market fund prior to the December 24, 2007 be grandfathered under the new QDIA regulation?
3. If a plan has participants that are defaulted in a money market, why would the plan necessarily want to move them into a QDIA since the relief provided by the regulation only extends to losses and that is less of an issue with the money market?

The QDIA regulation provides guidance on the first question. The regulation defines a short-term QDIA as:

“(iv)(A) Subject to paragraph (e)(4)(iv)(B) of this section, an investment product or fund designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. Such investment product shall for purposes of this paragraph (e)(4)(iv):

(1) Seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product; and

(2) Be offered by a State or federally regulated financial institution.

(B) An investment product described in this paragraph (e)(4)(iv) shall constitute a qualified default investment alternative for purposes of paragraph (e) of this section for not more than 120 days after the date of the participant’s first elective contribution (as determined under section 414(w)(2)(B) of the Code).”

Based on the definition in the regulation,

we advised our client that, to the extent that a stable value investment meets that definition it qualifies. However, if there are fees or restrictions imposed on transfers within the first 90 days it poses a problem. In addition, there might be market value adjustments when the money is transferred from the short-term QDIA to a long-term QDIA by the plan sponsor, which would raise fiduciary responsibility issues.

The answer to the second question is no. The grandfather relief under the regulation is only available for stable value investments that meet the definition in the regulation. The regulation requires that, to be a grandfathered QDIA, the investment must “guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds.” So that rules out a money market fund.

The last question required clarification on the measure of losses in a suit for fiduciary breach. Basically, the client’s misunderstanding of the calculation of losses led him to believe that since there is minimal risk of loss with a money market fund there was also minimal risk of liability. The measure of loss for fiduciary breach is usually the difference between the performance of the actual investments and the return that would have been earned on a well-selected portfolio. We pointed out that, just because an investment will not ordinarily suffer real-world losses, it does not mean that it is prudent under ERISA for accumulating retirement benefits.

For example, in the preamble to the QDIA regulation the DOL explained: “It is the view of the Department that investments made on behalf of defaulted participants ought to and often will be long-term investments and that investment of defaulted participants’ contributions and earnings in money market and stable value funds will not over the long-term produce rates of return as favorable as those generated by products, portfolios and services included as qualified default investment alternatives, thereby decreasing the likelihood that participants

invested in capital preservation products will have adequate retirement savings.”

As a word of caution, that language may serve to support future claims by plaintiffs’ attorneys regarding the prudence of investments in money markets or stable value over the long-term. ♦

Message from the Firm

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the guidance needed to fully implement the PPA provisions. Once that guidance has been issued, though, I expect that the marketplace will be flooded with participant advice programs. Then, it will be up to plan sponsors to determine whether to solve the ongoing problem of poor participant investing through investment advice, investment management, QDIAs, target maturity funds, or other investments and services in the marketplace. Thus, while the advisory community is excited about the prospects of providing investment services to participants, the reality is that the success of those programs depend on whether they are embraced by plan sponsors, initially, and then by participants.

5. How to respond to the private litigation and DOL focus on fees, expenses and revenue sharing. *I think that, by now, it is obvious to all but the most inattentive that plan sponsors need to understand the fees and expenses that are being paid by their plans and the investments, as well as to understand the amounts being received by service providers—typically through payments from the mutual funds included in the plans. Any plan sponsor who is not actively reviewing those costs and payments is taking an unnecessary risk.*

All in all, 2008 promises to be an interesting and active year. There is a great deal of change occurring, including proposed laws, governmental guidance, and new products and services.

As some say, when the rate of change outside an organization is faster than the rate of change inside the organization, the organization is in trouble. Applying that principle to plan sponsors and fiduciaries, it is clear that they need to be attentive to these changes and to be acting accordingly.

The articles in this newsletter discuss several of the issues summarized above, as well suggesting solutions for some of the problems.

-Fred Reish

When a Distribution Upon Termination Must be Halted



By Heather Bader-Abrigo (HeatherAbrigo@Reish.com)

Recently, a client contacted us because an employee, who had recently been laid off and requested a distribution from the plan, was rehired in another department of the same company. The client requested our assistance in determining whether the employee could receive the distribution despite the fact that she been rehired.

In order to determine whether the company could proceed with the distribution, it was necessary to look at the terms of the plan document. The plan document set forth the following events that the participant must satisfy in order to receive a distribution: (i) the employee's separation from service, death, or disability, (ii) the employee's attainment of age 59 ½; or (iii) upon experiencing certain hardships

set forth in the plan. The participant had requested the distribution on the basis of a separation of service and it was necessary to determine whether the employee's original termination but subsequent rehiring, in fact, constituted a "separation from service."

Internal Revenue Service ("IRS") Information Letter 2000-0245 discussed such a situation and provides guidance on what constitutes a "separation of service." In IRS Information Letter 2000-0245, an employee wanted to take a distribution from her account upon her retirement but wanted to be rehired as a part-time employee. The IRS Information Letter opined that:

Whether a participant has experienced a separation from service when she changes from full-time to part-time employment

with one employer, such a change apparently would not qualify as a separation from service. *This is because the employer/employee relationship is not completely severed, but is simply modified when the employee changes her work schedule.* (emphasis added)

The IRS Information Letter also provided that "[i]f a 401(k) plan makes a distribution to a participant due to a separation from service and it is determined that a separation from service did not actually occur, the 401(k) plan may be disqualified under 401(a) and 401(k)."

We concluded that there was not a "separation of service" due to the following facts: (i) only a few weeks had lapsed from the date of termination to the date the employee was rehired; (ii) upon being terminated there was a discussion that the transfer to another department may occur; and (iii) essentially, the employee/employer relationship had not been severed. In light of the qualification issues when an improper distribution is made to a participant, we advised the client not to make the distribution. ❖

Design Issues

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ADP refund provision. However, for regular automatically enrolled plans, the split eligibility periods will work.

Low Levels of Deferrals

In the second situation, a large company in the real estate industry converted to automatic enrollment for all of its employees. In addition, the company wanted to adopt automatic year-to-year increases in deferral rates, so that participating employees would accumulate substantial retirement benefits (sometimes called "step up" or "escalator" deferral increases). However, the company was concerned that many of its long-term participants were deferring at low rates—and perhaps weren't aware of the need to defer at much higher rates in order to end up with a reasonable level of benefits.

To remedy that situation, the company decided that, for all currently participating employees (as well as for future

participants), their deferral rates would increase at 1% per year until they reached 10% of pay.

For example, new employees would be automatically enrolled at 4% of pay and increased 1% per year until they reached 10% of pay. However, if a current participant were already deferring at 5%, that employee's deferrals would be increased 1% per year, from that point, up to a maximum automatic rate of 10%.

Of course, employees could always opt out of the automatic enrollment and/or the automatic deferral increases. In addition, if employees wanted to defer more than 10% of their pay, they could do so voluntarily.

By the way, a general rule of thumb in the benefits community is that the average employee should be deferring at least 12% of pay in order to have substantial benefits at retirement.

Matching Cost Concerns

In the third situation, the company was concerned about the cost of adopting a safe harbor automatically enrolled plan. That is because the company wanted to use the matching contribution alternative

and, if automatic enrollment resulted in a 90% participation rate (which it often does), the contribution cost would be too high. On the other hand, the company wanted the benefit of satisfying the ADP test (or discrimination testing) under the safe harbor.

Our client worked with a consultant to test various plan designs for automatic enrollment. In doing the testing, they realized that, even without the matching contributions required by the safe harbor rules, the ADP test could be satisfied with an automatically enrolled plan. As a result, the plan sponsor was able to pass the ADP test, but without the matching cost of the safe harbor design. The moral to that story is that automatic enrollment, in and of itself, goes a long ways towards satisfying ADP testing.

Conclusion

These cases illustrate that automatic enrollment is not a "one trick pony." It is a versatile tool that, in the hands of knowledgeable advisers, can produce a plan design that is good for employees, affordable for the plan sponsor, and compliant with legal standards. ❖

401(k) Expense Recapture



By Fred Reish (FredReish@Reish.com)

The recent focus on fees and expenses is causing many employers to closely examine the fees and expenses of their plans.

As a result, some employers have been able to negotiate reduced fees.

Generally, a plan has three major categories of expenses. Those are:

- Investments.
- Recordkeeping and compliance.
- Advice, including investment adviser fees and broker's commissions.

For investments, high fees tend to fall into two categories. The first is that the expense ratio of one or more of the mutual funds is excessive. That can easily happen as a plan grows in size. For example, one share class may be appropriate for a small plan, but as the plan grows, a lower-priced share class may be proper. Obviously, plan sponsors, or their advisers, need to be attentive to that issue or their 401(k) plans could inadvertently be paying excessive fees. The second common area of excessive investment fees involves so-called "wrap" fees. While wrap fees are not per se inappropriate or overly expensive, they can be and, in our experience, they sometimes are. For example, we have seen cases where the total annual fees in a group annuity contract are 3% per year, or more. To properly evaluate these fees, the first step for a plan sponsor is to know the total annual fees. The second is to obtain information on the charges for similar plans (e.g., plans with similar assets and numbers of participants) . . . the competitive marketplace does a good job of establishing reasonable prices. Those two steps are rudimentary; a more sophisticated analysis can be done with expert advice.

With regard to fees and commissions for advice, when plan sponsors are writing checks for the advice, the cost is usually reasonable. However, where the fees or commissions are embedded in the investment products (and particularly where they are difficult to find and

calculate), many plan sponsors do not know what they are paying. In those cases, plans often pay too much for the services they are receiving—thereby hurting their participants. Further, as a plan grows, the fees and commissions should become increasingly smaller as a percent of the assets. That is because the services required to operate a plan do not tend to grow proportionately with the assets. However, many advisers base their fees and commissions on a percentage of the assets in the plan, which is appropriate to a point, but which thereafter can be overly expensive. In those cases, lower fees and commissions can be negotiated either directly with the adviser or through the use of share classes that pay less compensation and, as a result, are less expensive to the plan and the participants.

With regard to the plan provider/recordkeeper, those expenses are usually either fixed or vary based on the number of participants, or both. In other words, the expenses are not based on the assets in the plan. However, plan providers are often—perhaps almost universally—the recipients of payments, such as 12b-1 fees, subtransfer agency fees and/or shareholder servicing fees—which are based on a percentage of assets. Since part or all of the revenue is based on a percentage of assets, but the costs are not, it is just a matter of time before a plan grows large enough that it is overpaying. Unfortunately, it is difficult for plan sponsors to know the true costs of recordkeeping. Nonetheless, plan sponsors should—and can—with the help of an adviser who specializes in 401(k) plans. In those cases, once a provider has recouped its operating costs, plus a reasonable profit, the balance of the revenue sharing should be restored to the plan. When the balance is restored, it is often done as a cash payment into the plan, which is sometimes called an "ERISA budget account" or an "expense recapture account." That money is then available to pay other expenses of the plan or to be allocated to the participants. Either way, it ultimately improves the benefits for the participants. That is the fiduciary's job. ❖

Academic Studies On Participant Behavior

As a part of our support for academic research concerning participant investment behavior (including our support of research by Professor Shlomo Benartzi of UCLA), we regularly post important academic and industry studies on our website.

We have recently posted a study entitled "Red, Yellow, and Green: A Taxonomy of 401(k) Portfolio Choices." The authors summarize the study as follows:

One measure of financial literacy is the quality of portfolio decision-making in 401(k) plans. Applying a qualitative framework to a dataset of nearly three million 401(k) accounts, we estimate that 43% construct "green" portfolios with balanced exposure to diversified equities, while 26% construct "yellow" portfolios with possibly too-aggressive or too-conservative equity holdings. Another three in 10 participants make egregious errors and have "red" portfolios—either holding zero in equities or over concentrating their account in employer stock. Using a subset of our sample, we estimate the costs of portfolio errors (and the potential gain from improved allocations) at roughly 60 to 350 basis points in expected real return per year, depending on the initial portfolio held. Low income, low wealth and female participants are more likely to experience the largest gains from better portfolios, given their tendency to hold less aggressive portfolios.

To put this study in context, most industry data shows that 401(k) plans are invested about 65% in equities and about 35% in fixed income, which seems balanced and reasonable. However, when the analysis is done at the account level, rather than the plan level, it turns out that part of the average is based on accounts that are invested too conservatively and accounts that are invested too aggressively. In other words, the averages mask the problem.

Hopefully, the current focus on target maturity funds, risk-based lifestyle funds and managed accounts will help solve the problem.

To view or print a copy of the study, visit our website at <http://www.reish.com/publications/pdf/edyellowgreen.pdf>.

Dealing with Back-End Charges In Service Agreements



By *Bruce Ashton (BruceAshton@Reish.com)*

Clients often ask us to review agreements related to their 401(k) plans. Unfortunately, we are sometimes consulted only after a problem has come up.

Nearly half the problems we see revolve around back-end charges. The charges have various names: surrender charges, contingent deferred sales charges (CDSC), market value adjustments, etc. So long as they are reasonable, we see nothing inherently wrong with them; but all too often, that's not the case.

The justification for a surrender charge or CDSC is that the provider has incurred a cost at the outset that it expects to recoup through its normal contract charges over time. However, if the contract is terminated early, the provider needs to recoup any unrecovered expenses at that time. Thus, in the reasonable situation, the amount of the back-end charge should decline over time and ultimately disappear, for example, within three years or so.

Market value adjustments arise in the context of an investment with a guaranteed fixed rate of return. If interest rates change and the plan surrenders the guaranteed contract, the investment provider may lose money on the transaction, if interest rates have increased and, therefore, the value of the underlying bonds has decreased, so the market adjustment charge is designed to protect the provider from that change, since they are liable for the agreed-on fixed return.

The issue for plan sponsors is whether the charges or adjustments are reasonable. We seen situations in which the back-end charge is perpetual and applies to each new dollar coming into the plan. In our view, there is no reasonable justification for this type of charge. Where the plan sponsor is entering into a new relationship, to avoid the problem, it needs to take three steps:

- Find out if there are back-end charges, and if so, how they are structured.
- Negotiate with the provider to either remove the charge entirely or have it apply on a more reasonable basis.

- If the provider is unwilling to negotiate, seek a different provider.

If the plan sponsor does not have the experience, time or expertise to take these steps, it should employ an experienced adviser to assist it.

With respect to market adjustment charges, the plan sponsor should understand whether or not they will be imposed and under what circumstances and seek to negotiate with the provider over whether the adjustment works both ways - that is, will the plan's investment go either up or down depending on how interest rates fluctuate? Is the amount of the adjustment reasonable or too much for the purpose of protecting the provider from interest rate swings? Is the formula for the adjustment in writing or does the provider have discretion? If the provider will not negotiate reasonable terms, the plan sponsor should seek investments from a different provider.

The key point is to be aware that these kinds of charges may be imposed. They are not necessarily bad but can be under some circumstances, and it is up to the sponsor to understand the charges and avoid improper ones. ❖

Fee Litigation and Revenue Sharing

As almost everyone in the 401(k) community knows, there are a number of class action lawsuits concerning fees, expenses and revenue sharing. Of those cases, perhaps the most dangerous are the ones that have been filed against plan providers because of their receipt of revenue sharing (which most often takes the form of subtransfer agency fees and shareholder servicing fees).

When I say "dangerous," I am not referring to the possibility of the

plaintiffs prevailing in the litigation, but instead to the possible negative impact of a plaintiffs' victory.

It is not well understood—but it is a fact—that revenue sharing paid by mutual funds covers most of the cost of the platforms for 401(k) plans. Without that revenue sharing, the cost of plans, and particularly of small plans, would be much higher . . . perhaps prohibitively high for a small business. As a result, if plaintiffs' victories in those lawsuits limit the ability of mutual funds and other

investment providers to subsidize 401(k) platforms, the cost to plan sponsors would increase dramatically. That would almost certainly reduce the appeal and the affordability of 401(k) plans to small employers, resulting in fewer plans and, therefore, less benefits for employees.

Attached to this email newsletter is an article that Bruce Ashton and I wrote for the Journal of Pension Benefits concerning one such case.

Around the Firm

Speeches: At the Los Angeles Benefits Conference on January 23rd-25th, Nick White presented “EPCRS—Guidance for Smaller Companies and Other Emerging Issues,” and Fred Reish spoke on “The Future of Fiduciary Obligation” and “Retirement in Search of A Plan: The Evolution of 401(k) Plans.” Additionally, Bruce Ashton moderated “IRS Employee Plans Examination and Enforcement,” Debra Davis moderated “Plan Expenses” and Marty Heming moderated “DOL Investigation Update” at the conference. Debra presented “Disclosure Requirement for Service Provider Compensation” at the San Diego Chapter of the Western Pension and Benefits Conference on January 15th.

Quote: Fred was quoted in the article “Quick Tips: Limiting Liability in Retirement Plans,” published in SmartMoney.com on January 3rd. Debra was quoted in the article “Going Solo,” published in the January issue of the *Plan Sponsor* magazine. Fred was quoted in the article “Choose Your Designated Hitter,” published in the *Planadviser* magazine on December 31st. He was also quoted in the article “Investing by Default,” published in the December issue of the *Plan Sponsor*.

Articles: Fred’s column in the December issue of the *Plan Sponsor* magazine addressed the topic of “Process Serving.” Nick wrote an article entitled “Greater of Formulas: Do They Violate the Accrual Rules?,” published in the December issue of the *Pension Plan Fix-It Handbook*.

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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.

BY FRED REISH AND
BRUCE ASHTON

Fred Reish is chair of the employee benefits practice at Reish Luftman Reicher & Cohen in Los Angeles. Fred has been named the most influential person in America on 401(k) issues. He has made fiduciary presentations on behalf of Nationwide and has provided legal services to Nationwide concerning fiduciary issues.

Bruce Ashton is a partner in the law firm of Reish Luftman Reicher & Cohen, specializing in employee benefits. His practice focuses on all aspects of employee benefits issues. Bruce was president of ASPPA for the 2003–2004 term, and from 1998 through 2002 he served as the co-chair of ASPPA's Government Affairs Committee.

Revue 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 record-keeping), 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. ■