Nowhere to Hide on Hidden 401(k) Fees

With plan participants increasingly litigious, plan sponsors must take care that investment and administration expenses are "reasonable."

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Under ERISA, CFOs and other retirement-plan fiduciaries are required to understand the fees and expenses charged and the services provided to the plan. While ERISA does not specify a permissible level of fees, the Section 404(a) fiduciary rules require that fees charged to a plan be "reasonable."

Not only is there potential fiduciary liability for failure to examine this issue, but also the ERISA Section 404(c) safe harbor (which insulates a plan sponsor from ERISA fiduciary liability) may be negated by a failure to identify and disclose all plan fees and expenses to participants.

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In addition, arrangements with service providers may be considered prohibited transactions under Section 406 if the exemption provided in Section 408(b)(2) is not satisfied, subjecting the plan fiduciaries and the service providers to tax penalties. To satisfy the requirements of this exemption, an arrangement between a plan and a service provider will not be a prohibited transaction if: 1) the contract or arrangement is "reasonable," 2) the services provided are necessary for operating the plan, and 3) the service provider's compensation is "reasonable" for such services. Currently, the standard for evaluating what fees are reasonable is unclear, making it difficult for plan sponsors to determine whether a service provider arrangement will constitute a prohibited transaction.

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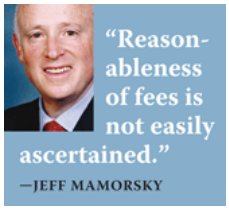
This has led to a flurry of "hidden fee" litigation, reflecting plan participants' dissatisfaction with inadequate fee-disclosure requirements and the need for protection from excessive fees. Plan participants have filed multiple lawsuits against plan sponsors, claiming that the decision to pay excessive investment and administrative fees was imprudent and a breach of the fiduciary duty of care.



As a result, employer plan sponsors have hired investment consultants to advise them on the reasonableness and identification of plan investment and administrative fees and expenses. In fact, there is a tendency to rely on such independent advice from outside experts.

However, in the first "excessive and unreasonable fees" decision to go to trial, a U.S. District Court in California held that while securing independent advice from an investment consultant is "some evidence" of a thorough investigation, it is not a complete defense to a charge of imprudence. At the least, said the court, plan fiduciaries must "make certain that reliance on the expert's advice is reasonably justified." According to the ruling, this is accomplished with evidence demonstrating the thoroughness and scope of the consultant's review. In effect, an employer plan sponsor cannot "hide behind" a consultant but must be able to produce evidence of a robust and thorough investigation through procedural and substantive prudent process standards, a forensic fee audit, and benchmarking [*Tibble v. Edison Int'l*, C.D. Cal., No. CV 07-5359 SVW (AGRx), 7/8/10].

In a comprehensive 82-page decision, which is must reading for employers concerned about hidden fee liability, the district court found that the fiduciaries of Southern California Edison's (SCE) 401(k) plan breached their duty of prudence under ERISA when they selected more costly retail class mutual funds for the plan instead of attempting to secure institutional class mutual funds.

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The fiduciaries found liable were not only the employer plan sponsor but also members of the plan investment and benefits committees, the vice president of human resources, and the manager of the sponsor's Human Resources Service Center.

In concluding that the fiduciaries breached their duty of prudence, the court emphasized that there was no evidence that the fiduciaries investigated the difference between the retail-class funds and the institutional-class funds. Had the fiduciaries weighed the relative merits of the two fund types, said the court, "they would have realized that the institutional share classes offered the exact same investment at a lower cost to the Plan participants."

Plaintiffs representing the plan participants in this class-action suit argued that, when deciding to invest in the retail share classes rather than the cheaper institutional share classes, the defendant fiduciaries were improperly motivated by a desire to capture more revenue sharing for Southern California Edison (SCE), even though doing so increased the fees charged to plan participants. Plaintiffs argued that defendants put the interests of SCE in offsetting the plan's record-keeping costs through revenue sharing above the interests of the plan participants in paying lower fees. To support that claim, plaintiffs relied primarily on a series of e-mails, generally between members of SCE's investments staff and human resources department.

To determine whether the decision to invest in retail share classes constituted a breach of the duty of prudence, the court examined whether the fiduciaries engaged in a thorough investigation of the merits of the investment at the time the funds were added to the plan. The finding was that "there is ***no evidence*** that defendants even considered or evaluated the different share classes when the funds were added to the Plan."

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