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# HOW MUCH IS ENOUGH? GIVING FIDUCIARIES AND PARTICIPANTS ADEQUATE INFORMATION ABOUT PLAN EXPENSES

DEBRA A. DAVIS\*

## I. INTRODUCTION

Understanding the fees charged to a plan is a critical component of a fiduciary's responsibilities and important information for participants to have. In order to help participants save for retirement, fiduciaries of 401(k) plans need to make sure that the plan is not paying more than reasonable fees for the services provided. In order to accomplish this duty, fiduciaries must understand the fees paid by the plan.

It is not always easy for fiduciaries to understand the plan's fees. The complexity of the manner in which fees are paid by retirement plans can make it challenging for this information to be communicated to fiduciaries in a meaningful way. Both direct and indirect payments by the plan can be complicated. For example, direct payments may be determined based on a formula where the payment is a percentage that is calculated daily based on the plan's assets. Indirect compensation can be even more difficult to understand. Investment companies frequently make payments to a plan's service providers that vary based on the amount of plan assets in each of the investment options and that typically reduce the investment's earnings (known as "revenue sharing"). Different investment options pay different amounts of revenue sharing. As a result, it may be difficult for fiduciaries to understand the amount of indirect compensation being paid as a result of the plan's investments.

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Participants also need information about the plan's expenses. In most 401(k) plans, participants are primarily responsible for funding and investing their accounts' assets in order to obtain adequate retirement income. As a result, they need adequate information to decide whether to participate in the plan and if they participate, information about the expenses associated with the investment options offered by the plan.

There is little doubt that fees can have a significant impact on the amount of money participants will have at retirement.<sup>1</sup> The U.S. Department of Labor (the "Department") provides the following example in its publication on fees in 401(k) plans:

Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of \$25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to \$227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only \$163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.<sup>2</sup>

Thus, it is critical that the law provide fiduciaries and participants with the information they need to make decisions about their plans. This article addresses the types of information needed by fiduciaries of and participants in employer-sponsored 401(k) plans in order for plans to operate efficiently and effectively. Part I of this article highlights the issues involving fee disclosure in 401(k) plans. Part II discusses the unique structure of 401(k) plans. Part III addresses the roles of fiduciaries and their responsibilities in these types of plans. Part IV analyzes the information needed by fiduciaries to fulfill these responsibilities and provides suggestions for improving the disclosures that are made to them. Part V discusses the roles of participants in 401(k) plans and Part VI evaluates the information needed by participants to make decisions regarding the plan and suggests ways in which this could be accomplished.

## II. STRUCTURE OF 401(K) PLANS

Plans that allow employees to elect to defer a portion of their pay into the plan on a pre-tax basis are known as 401(k) plans.

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1. See Colleen E. Medill, *Challenging the Four "Truths" of Personal Social Security Accounts: Evidence from the World of 401(k) Plans*, 81 N.C. L. REV. 901, 907-08, 937-46 (2003) (discussing the effect of fees on employees' account balances at retirement).

2. U.S. Dep't of Labor Publication, *A Look At 401(k) Plan Fees*, available at [http://www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html) (last visited June 29, 2008).

They are a type of defined contribution plan and can be sponsored by employers or employee organizations.<sup>3</sup> Defined contribution, and in particular 401(k) plans, have become increasingly popular.<sup>4</sup> The number of participants in defined contribution plans has significantly increased. The U.S. Government Accountability Office (GAO) reported that the number of active participants covered by defined contribution plans increased from thirty-three million in 1985 to fifty-five million in 2005.<sup>5</sup> The GAO also reported that ninety-five percent of all defined contributions had a 401(k) component in 2005.<sup>6</sup>

#### A. *Responsibility for Funding Participants' Accounts*

In defined contribution plans, a participant's benefit is primarily based on the contributions that are made to his account and any earnings on those contributions.<sup>7</sup> In 401(k) plans, a person who participates in the plan (known as a participant) is entitled to the amount of money in his account.<sup>8</sup> The value of a participant's account is based on the deferrals made by the participant, any employer contributions, other income such as forfeitures that are allocated to the account and the investment earnings.<sup>9</sup> The value of the account is reduced by expenses.<sup>10</sup>

Employers have the ability to make contributions to 401(k)

3. 29 U.S.C. § 1002(2) (2000). This article focuses on plans sponsored by employers.

4. See, e.g., John H. Langbein, Susan J. Stabile & Bruce A. Wolk, *PENSION AND EMPLOYEE BENEFIT LAW* 58-62 (4th ed. 2006) (defining and discussing various defined contribution plans); Susan J. Stabile, *Is it Time to Admit the Failure of an Employer-Based Pension System?*, 11 LEWIS & CLARK L. REV. 305 (2007) (scrutinizing the employer-based 401(k) system); Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 74-75 (2002) exploring the "behavioral tendencies that affect participant behavior in defined contribution plans"; Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 613 (2000) (discussing the movement toward defined contribution plan usage); Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L.J. 1, 4 (2000) (examining the shift from the defined benefit plan toward the 401(k) plan).

5. GAO, *Private Pensions: Increased Reliance on 401(k) Plans Calls for Better Information on Fees*, Testimony before the House of Representatives, Committee on Education and Labor 5 (Mar. 5, 2007).

6. *Id.* at 7.

7. See generally, Stabile, *supra* note 4 (scrutinizing the employer-based 401(k) system); Debra A. Davis, *Do-It-Yourself Retirement: Encouraging Employees to Direct the Investment of Their Retirement Savings*, 8 U. PA. J. LAB. & EMP. L. 353 (2006) (discussing the function of a defined contribution plan); Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451 (2004) (analyzing the defined contribution trend).

8. 29 U.S.C. § 1002(23)(B) (2000).

9. 29 U.S.C. § 1002(34) (2000).

10. *Id.*

plans, but are under no obligation to do so. Where a defined contribution plan contains a 401(k) feature, plan sponsors are not required to make any other contributions to the plan.<sup>11</sup> Although 401(k) deferrals are withheld from participants' pay checks, they are considered employer contributions.

### *B. Selecting the Investments for a Participant's Account*

Retirement plan assets are typically invested in a number of investments. Under ERISA, fiduciaries are responsible for prudently selecting and monitoring their plan's investments.<sup>12</sup> They are also responsible for allocating participants' accounts among those investments.<sup>13</sup> As discussed in greater detail below, the responsibility for allocating participants' accounts can be shifted to participants who select the investments for their accounts.<sup>14</sup> Fiduciaries can also receive protection for participants who do not make investment decisions if the fiduciaries invest their accounts in a qualified default investment alternative and make the required disclosures.<sup>15</sup>

In most 401(k) plans, participants are responsible for deciding how their accounts will be allocated among the plan's investments.<sup>16</sup> Abstracts of Form 5500 for the 2005 plan year, which are the most recent available, reflect that approximately eighty-nine percent of all 401(k) plans allowed participants to direct some or all of the investment of their accounts among the investments offered by the plan, which cover around ninety-six percent of all active 401(k) plan participants.<sup>17</sup>

## III. FIDUCIARY RESPONSIBILITY

Fiduciaries who manage retirement plans must prudently oversee the plans' investments and the use of those investments. Guidance issued by the Department and court cases explain the methodology fiduciaries must use in order to fulfill those obligations.

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11. 26 C.F.R. § 1.401-1(b)(2) (1976); 26 U.S.C. § 401(k)(2) (2000).

12. *See generally*, 29 U.S.C. § 1104(a) (2000) (providing for the "[p]rudent man standard of care").

13. 29 U.S.C. § 1104(a) (2000); 29 C.F.R. § 2550.404a-1 (1979).

14. 29 U.S.C. § 1104(c)(1) (2000).

15. 29 U.S.C. § 1104(c)(5) (2000).

16. *See, Zelinsky, supra* note 7, at 484.

17. Private Pension Plan Bulletin Abstract of 2005, Form 5500 Annual Reports, U.S. Dep't of Labor (Washington, D.C., Feb. 2008). The bulletin indicated that 387,116 out of 436,207 401(k) plans allowed participants to direct some or all of their accounts and approximately 62,732,000 out of 65,652,000 participants were able to direct some or all of their accounts.

### A. General Duties

Fiduciaries must comply with ERISA, which imposes strict requirements upon them. Fiduciaries are required to act solely in the interest of participants.<sup>18</sup> ERISA provides that “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries. . . .”<sup>19</sup> They are required to discharge their duties for the exclusive purpose of providing benefits to participants and paying only reasonable expenses.<sup>20</sup>

Fiduciaries are held to the standard of a knowledgeable prudent person, known as the prudent person rule. When determining whether fiduciaries acted prudently, they will be evaluated based on whether they acted “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. . . .”<sup>21</sup> Thus, fiduciaries are compared to prudent persons who are familiar with the issue being addressed by the fiduciaries and how they would act in similar circumstances.

Courts have held that fiduciaries’ compliance with ERISA’s requirements is evaluated based on whether they used a prudent process, which requires both procedural and substantive prudence. Procedural prudence involves obtaining the relevant information needed to make a decision. Substantive prudence requires fiduciaries to use that information to make a reasoned decision. The court in *Riley v. Murdock* explained:

Courts have articulated two way[s] in which to measure a fiduciary’s use of prudence in carrying out their duties. The first is whether the fiduciary employed the appropriate methods to diligently investigate the transaction and the second is whether the decision ultimately made was reasonable based on the information resulting from the investigation.<sup>22</sup>

Courts have stated that a prudent process requires fiduciaries to conduct an investigation to obtain the relevant facts when making decisions about the plan.<sup>23</sup> The court in *Roth v. Sawyer-Cleator Lumber Co.* explained that “a fiduciary is obligated to

18. 29 U.S.C. § 1104(a)(1) (2000). The term “participants” is used in this document to refer to both participants and beneficiaries.

19. *Id.*

20. 29 U.S.C. § 1104(a)(1)(A) (2000).

21. 29 U.S.C. § 1104(a)(1)(B) (2000).

22. *Riley v. Murdock*, 890 F. Supp. 444, 458 (E.D.N.C. 1995) (citation omitted).

23. See, e.g., *United States v. Mason Tenders Dist. Council of Greater N.Y.*, 909 F. Supp. 882, 886 (S.D.N.Y. 1995) (citations omitted).

investigate all decisions that will affect the pension plan. . . ."<sup>24</sup> Similarly, the court in *Fink v. National Savings and Trust Co.* stated, "A fiduciary's independent investigation of the merits of a particular investment is at the heart of the prudent person standard."<sup>25</sup>

The failure to conduct an investigation may be viewed as a breach of a fiduciary's duties. In *United States v. Mason Tenders Dist. Council of Greater New York*, the court stated, "The failure to make any independent investigation and evaluation of a potential plan investment is a breach of fiduciary obligations."<sup>26</sup>

Fiduciaries must then use the information they obtained to make a reasoned decision. As the court in *Lanka v. O'Higgins* explained, the prudent process requirement is an:

[O]bjective standard, requiring the fiduciary (1) to employ proper methods to investigate, evaluate and structure the investment; (2) to act in a manner as would others who have a capacity and familiarity with such matters; and (3) to exercise independent judgment when making investment decisions.<sup>27</sup>

Fiduciary responsibility is focused on the process used, rather than the outcome obtained. The court in *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.* explained, "In determining compliance with ERISA's prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions."<sup>28</sup>

Thus, fiduciaries' compliance with ERISA's requirements will be evaluated based on whether the process they used to make decisions involved procedural and substantive prudence. Fiduciaries must investigate an issue and request the types of information that a prudent person who is knowledgeable about the issue would deem important. Fiduciaries must use the information obtained to make a reasoned decision based on the information that their investigation revealed.

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24. *Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915, 918 (8th Cir. 1994).

25. *Fink v. Nat'l Savings & Trust Co.*, 772 F.2d 951, 957 (D.C. Cir. 1985).

26. *Mason Tenders*, 909 F.Supp. at 887.

27. *Lanka v. O'Higgins*, 810 F. Supp. 379, 387 (N.D.N.Y. 1992) (citations omitted).

28. *Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (5th Cir. 1999.) See also, *Donovan v. Walton*, 609 F. Supp. 1221, 1238 (S.D. Fla. 1985) (citations and footnote omitted) (analyzing the meaning of the prudence standard through case law).

### B. Plan Investment Duties

ERISA's requirements apply to fiduciaries' obligations with respect to the selection and monitoring of the plan's investments.<sup>29</sup> In performing these duties, fiduciaries are held to the standard of a knowledgeable prudent person.<sup>30</sup> In the context of the plan's investments, fiduciaries are evaluated based on how a prudent person who is knowledgeable about retirement plan investing would act. The Department has issued regulations regarding the manner in which fiduciaries should comply with the prudent person rule in the context of plan investments. The regulation explains:

With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of section 404(a)(1)(B) . . . are satisfied if the fiduciary (i) *has given appropriate consideration to those facts and circumstances* that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know *are relevant to the particular investment or the investment course of action involved, including the role the investment or the investment course of action plays in that portion of the plan's investment portfolio* with respect to which the fiduciary has investment duties; and (ii) *[h]as acted accordingly*.<sup>31</sup>

Thus, fiduciaries must determine which facts and circumstances are relevant to making prudent investment decisions, must gather the needed information, evaluate it, and reach a reasoned and informed decision. In evaluating whether a fiduciary has satisfied ERISA's requirements, courts look at whether the fiduciary engaged in a prudent process when making decisions. As discussed above, engaging in a prudent process involves both substantive and procedural prudence. That is, fiduciaries should determine what information is material and relevant to their task, examine and understand that information, and then make an informed and reasoned decision based on that information.<sup>32</sup>

#### 1. Investment Decisions Necessitate Knowledge of Investment Concepts

In making their investment decisions, the Department and courts have held that fiduciaries should consider generally

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29. 29 C.F.R. § 2550.404a-1 (1979).

30. 29 U.S.C. § 1104(a)(1) (2000).

31. 29 C.F.R. § 2550.404a-1(a)(1) (1979) (emphasis added).

32. See, e.g., 29 C.F.R. 2550.404a-1(b) (1979) (providing for investment duties of the fiduciary).



accepted investment theories. "Generally accepted investment theories" refers to the fundamental and broadly acknowledged principles underlying modern concepts of investing. These include concepts such as modern portfolio theory and should be used by fiduciaries when selecting the categories of investment to offer in the plan.

Modern portfolio theory provides that a portfolio should be made up of a variety of investment categories that perform differently from one another. For example, equities, bonds and cash are examples of three distinct asset classes. The concept is that risk and reward can be balanced through the selection of different types of investments.

The Department's regulation to ERISA section 404(a) describes the manner in which a fiduciary will satisfy his investment duties. Although the regulation does not use the term "modern portfolio theory," the methodology it describes is consistent with modern portfolio theory. The regulation indicates that the fiduciary will satisfy his duties under ERISA if he "[h]as given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved . . . and [h]as acted accordingly."<sup>33</sup> The regulation explains that a fiduciary may be considered to have given "appropriate consideration" to relevant facts and circumstances if he determines that "the particular investment . . . is reasonably designed, as part of the portfolio . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action. . . ."<sup>34</sup> The fiduciary should also consider "[t]he composition of the portfolio with regard to diversification; . . . [t]he liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and . . . [t]he projected return of the portfolio relative to the funding objectives of the plan."<sup>35</sup>

In *Laborers National*, the court explained that the language used in the regulation supports the use of modern portfolio theory. The court stated, "In general, the regulations provide that the fiduciary shall be required to act as a prudent investment manager under the modern portfolio theory rather than under the common law of trusts standard. . . ."<sup>36</sup> The court stated, "Since 1979, [fiduciaries] have been held to the standard of prudence of the modern portfolio theory by the Secretary's regulations."<sup>37</sup>

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33. 29 C.F.R. § 2550.404(a)-1 (1979).

34. *Id.*

35. *Id.*

36. *Laborers Nat'l Pension Fund*, 173 F.3d at 317.

37. *Id.* at 322.

Similarly, the court in *Chao v. Moore* interpreted the regulation in the same manner. The court stated, “In interpreting the duty of prudence, the Secretary [of Labor] has prescribed regulations that incorporate modern portfolio theory.”<sup>38</sup>

Guidance issued by the Department indicates that fiduciaries should use generally accepted investment theories, such as modern portfolio theory. The Department indicated in guidance that “[s]everal commentators requested classification of the requirement that asset allocation models and interactive investment materials must be based on ‘generally accepted investment theories’ . . . .”<sup>39</sup> The Department stated that it “included this requirement to assure that, for purposes of the safe harbors, any models or materials presented to participants or beneficiaries will be consistent with widely accepted principles of modern portfolio theory. . . .”<sup>40</sup> The use of modern portfolio theory to support the prudence of a fiduciary’s action is also demonstrated by additional guidance issued by the Department in the form of an interpretive bulletin, advisory opinion and proposed exemptions.<sup>41</sup>

Thus, fiduciaries need to include in their plans investments that are consistent with the concepts of modern portfolio theory. As a result, the plan must offer investments with sufficient diversity that they behave differently depending on market conditions. As discussed below, fiduciaries need to consider a variety of factors, including fees, when selecting these investments.

## 2. *ERISA Requires the Prudent Selection of Investments*

After selecting the investment categories, fiduciaries need to populate those categories using a prudent process.<sup>42</sup> That is, fiduciaries must use substantive prudence to conduct an investigation to gather the information that a person knowledgeable about investments would consider important under similar circumstances. For example, fiduciaries may want to obtain information about the investments’ historical performance over various time periods as well as benchmarking information for their peer groups.

Fiduciaries must also consider the investments’ associated expenses. The GAO reported that “Various fees are associated with 401(k) plans, but investment and record-keeping fees account

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38. *Chao v. Moore*, No. Civ.A. AW-99-1283, 2001 WL 743204, at \*4 (D. Md. June 15, 2001).

39. 29 C.F.R. § 2509.96-1 (1996).

40. *Id.*

41. *Id.*; U.S. Dep’t of Labor Advisory Opinion 2001-09A; U.S. Dep’t of Labor Application for IPTE D-10897; U.S. Dep’t of Labor Application for IPTE D-10720; U.S. Dep’t of Labor Application for IPTE D-10319.

42. 29 C.F.R. § 2550.404(a)-1 (1979).

for most 401(k) plan fees.”<sup>43</sup> Fiduciaries may be able to decrease the plan’s costs by selecting a different share class for the mutual funds in the plan.<sup>44</sup> However, fees should not be evaluated to the exclusion of other factors. For example, an investment may have relatively high expenses, but have a very high historical rate of return that fiduciaries may determine outweighs the high cost of the investment. The Department reminds readers in its publication on 401(k) plan fees, “Keep in mind that the law requires the fees charged to a 401(k) plan be “reasonable” rather than setting a specific level of fees that are permissible. Therefore, the reasonableness of fees must be determined in each case.”<sup>45</sup>

Consequently, fiduciaries need to understand the fees associated with the investment options available to their plans in order to prudently select the plan’s investments. As discussed below, the assessment of these fees are frequently based on formulas and can be difficult to understand.

### 3. ERISA Requires the Monitoring of Investments

In addition to using a prudent process to select the plan’s investments, fiduciaries must also regularly monitor the selected investments in order to determine whether they continue to be appropriate for the plan. As one court explained, “ERISA fiduciaries must monitor investments with reasonable diligence and dispose of investments which are improper to keep.”<sup>46</sup> Another court explained that “[o]nce an investment has been made, a fiduciary has an ongoing duty to monitor investments with reasonable diligence and remove plan assets from an investment that is improper.”<sup>47</sup>

Similarly, the Department has applied the on-going duty to monitor to the appointment and retention of service providers. Although the guidance focused on participant investment education, the general principles apply to all service providers, including providers of investment options. The Department explained:

[A]ny designation of a service provider to a plan. . . is an exercise of discretionary authority or control with respect to management of the plan; therefore, persons making the designation must act prudently

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43. GAO, *supra* note 5, at 11.

44. Fred Reish, *How You Are Paying What You Don’t Know: A Primer on Indirect Mutual Fund Payments*, REISH LUFTMAN REICHER & COHEN BULLETIN (February 2008), available at [http://www.reish.com/publications/article\\_detail.cfm?ARTICLEID=741](http://www.reish.com/publications/article_detail.cfm?ARTICLEID=741).

45. U.S. Dep’t of Labor Publication, *A Look At 401(k) Plan Fees*, available at [http://www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html).

46. Whitfield v. Cohen, 682 F.Supp. 188, 196 (S.D.N.Y. 1988).

47. Harley v. Minn. Mining & Mfg. Co., 42 F.Supp.2d 898, 906 (D.Minn. 1999).

and solely in the interest of the plan participants and beneficiaries, both in making the designation(s) and in continuing such designation(s).<sup>48</sup>

Thus, fiduciaries must investigate and evaluate the investments on an ongoing basis and then decide, based on the information obtained, whether to retain or replace those investment choices. The fees associated with the investments should be included as part of this process.

### *C. Fiduciary Responsibilities Related to Plan Expenses*

When determining what expenses can be charged to the plan, fiduciaries must consider the provisions of the plan document, the type of expense involved, and whether the expense would cause the plan to engage in a prohibited transaction.

#### *1. Payment of Proper Expenses*

Under ERISA, only reasonable expenses can be paid. ERISA requires fiduciaries to discharge their duties for the exclusive purpose of providing benefits to participants and paying only reasonable expenses.<sup>49</sup>

Plans may only pay for certain types of expenses. The expenses must be attributable to fiduciary, rather than employer, activities. Fiduciary expenses include those related to the administration of the plan or the implementation of decisions made by the employer with respect to the plan.<sup>50</sup> Expenses related to the employer's actions are known as "settlor" expenses and may not be paid by the plan. Settlor expenses include costs related to the establishment, design and termination of the plan as well as items that exclusively benefit the employer, such as services performed for reporting in their financial statements or FASB Statements.<sup>51</sup> (Special rules apply with respect to settlor expenses for multi-employer plans.)

Additionally, expenses can only be paid if the plan document permits them to be paid by the plan or is silent. ERISA provides that fiduciaries must follow the terms of the plan unless they conflict with ERISA.<sup>52</sup> Proper expenses may be paid using plan assets as long as the plan document does not prohibit it.<sup>53</sup> That is, if the plan document authorizes the payment of expenses from plan assets or is silent, reasonable expenses can be paid by the

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48. 29 C.F.R. § 2509.96-1(e) (1996).

49. 29 U.S.C § 1104(a)(1)(A).

50. U.S. Dep't of Labor Advisory Opinions 97-03A and 2001-01A.

51. U.S. Dep't of Labor Advisory Opinion 2001-01A and related hypothetical examples published by the Department on January 18, 2001.

52. 29 U.S.C § 1104(a)(1)(C).

53. U.S. Dep't of Labor Advisory Opinion 2001-01A.

plan. However, plan assets may not be used if the plan states that the employer is responsible for expenses. That said, most plan documents provide that plan expenses may be paid either by the employer or from plan assets. For plans that do not permit the payment of expenses from plan assets, the plan sponsor may amend the plan document to allow such payments for future expenses.

## 2. Avoidance of Prohibited Transactions

ERISA prohibits a fiduciary from allowing a person<sup>54</sup> to provide services to a plan unless an exemption applies.<sup>55</sup> The exemption under ERISA section 408(b)(2) is commonly used, which exempts a contract or arrangement for the provision of services if: (i) the services are necessary for the establishment or operation of the plan; (ii) they are provided under a reasonable contract or arrangement; and (iii) no more than reasonable compensation is paid for the services.<sup>56</sup> Similar provisions are contained in the Internal Revenue Code (“Code”).<sup>57</sup> Although provisions regarding prohibited transactions are contained in both ERISA and the Code, the Department has the sole authority to issue guidance with respect to most types of prohibited transactions under both ERISA and the Code.<sup>58</sup>

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54. 29 U.S.C. § 1002(9) defines the term “person” as “an individual, partnership, joint venture, corporation, mutual company, joint-stock company, trust, estate, unincorporated organization, association, or employee organization.”

55. 29 U.S.C. § 1106(a)(1)(C).

56. 29 U.S.C. § 1108(b)(2).

57. Code section 4975(c)(1)(C) prohibits a person from providing services to a plan unless an exemption applies. Code section 4975(d)(2) contains an exemption with the same conditions as ERISA section 408(b)(2). Treasury Regulation § 54.4975-6 interprets Code section 4975(d)(2) and contains provisions similar to Department Regulation § 2550.408b-2. 26 U.S.C. § 4975(c)(2), (d)(2); 29 C.F.R. § 54.4975-6 (1977).

58. The Treasury Department initially had authority to issue exemptions from the Code’s prohibited transaction rules. 26 U.S.C. § 4975(c)(2). However, the Reorganization Plan No. 4 of 1978 shifted most of the Treasury Department’s responsibilities with respect to prohibited transactions to the Department. It gives the Department the authority for prohibited transactions, except with respect to excise taxes, certain IRA rules, loans to leveraged ESOPs, certain definitions, enforcement purposes and transactions that are exempted by ERISA section 404(c). Jimmy Carter, *Reorganization Plan No. 4 of 1978*, Section 102 (Aug. 1978), available at <http://benefitsattorney.com/modules.php?name=Authorities&pa=showpage&pip=7>. The Internal Revenue Service reiterates this delegation in Announcement 79-6 and directs requests for guidance to the Department. Although the Department has the authority to issue regulations and grant exemptions, the IRS has sole responsibility for assessing excise taxes on prohibited transactions.

The Department has issued a regulation that interprets ERISA's requirements.<sup>59</sup> It indicates that a service is necessary for the establishment or operation of a plan if it is appropriate and helpful to the plan in carrying out the purposes for which the plan is established or maintained. Additionally, the service must be furnished under a contract or arrangement that is reasonable. The contract or arrangement must permit the plan to terminate the contract or arrangement without penalty and on reasonably short notice under the circumstances. Finally, it indicates that no more than reasonable compensation may be paid for the service.

The law contains significant consequences for the plan's primary fiduciaries as well as service providers who engage in prohibited transactions. The Code imposes excises taxes on persons who engage in prohibited transactions that involve qualified plans. The Code imposes two layers of excises taxes: (1) an excise tax of fifteen percent for each year involved; and (2) an excise tax of one-hundred percent if the transaction is not corrected.<sup>60</sup>

Additionally, ERISA permits the Department to assess civil penalties against persons who engage in prohibited transactions. ERISA states that in the event of "any knowing participation in [a

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59. 29 C.F.R. § 2550.408b-2 (1977).

60. 26 U.S.C. § 4975(a), (b). Code section 4975(a) imposes an initial tax of 15% of the amount involved on persons who participate in prohibited transactions. The fifteen percent excise tax is calculated based on the "amount involved." Code section 4975(f)(4) defines the "amount involved" as the greater of: (1) the amount of money and the fair market value of the other property given; or (2) the amount of money and the fair market value of the other property received. If a service provider satisfied the exemption under Code section 4975(d)(2) or (10), other than with respect to the amount involved, the "amount involved" is the excess compensation. The fifteen percent excise tax is assessed on any disqualified person who participates in a prohibited transaction. Code section 4975(e)(2) includes fiduciaries and service providers to the plan in the definition of a "disqualified person." The tax under Code section 4975(a) applies to every year in the taxable period beginning on the date the prohibited transaction occurs and ending on the earlier of the date: (i) the IRS mails a notice of deficiency for the tax, (ii) the tax is assessed; or (iii) the prohibited transaction is corrected.

Code section 4975(b) provides that the IRS may impose an additional tax of 100% of the amount involved if the prohibited transaction is not corrected within the taxable period. For purposes of the 100% tax, the amount involved is based on the highest fair market value during the taxable period. Code § 4975(f)(4). The 100% tax under Code section 4975(b) only applies for one year. Internal Revenue Manual, Section 4.71.5.9.1 [Last Revised: 03-01-2005].

Code section 4975(f)(5) defines "correction" of a prohibited transaction as "undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would be if the disqualified person were acting under the highest fiduciary standards." The IRS has indicated that the correction method for the overpayment of excessive compensation only requires that the excess contribution be reimbursed to the plan.

fiduciary] breach or violation by any other person, the Secretary shall assess a civil penalty against such fiduciary or other person in an amount equal to 20 percent of the applicable recovery amount.”<sup>61</sup> The U.S. Supreme Court in *Harris Trust and Savings Bank v. Salomon Brothers, Inc.* indicated that the phrase “other person” in ERISA section 502(l) includes non-fiduciary service providers.<sup>62</sup> That is, a service provider may be either a fiduciary or a non-fiduciary with respect to a plan. Under ERISA, the term “fiduciary” includes both a plan’s primary fiduciaries who are responsible for the operation of the plan as well as persons whose actions make them “functional fiduciaries.” Functional fiduciaries are only responsible for the plan to the extent their actions make them fiduciaries. ERISA defines this type of fiduciary as:

[A] person . . . to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.<sup>63</sup>

Any penalty assessed under this provision of ERISA is based on the amount of any settlement with the Department or ordered by a court.<sup>64</sup> The penalty under ERISA is offset to the extent the person has excise taxes imposed under Code section 4975.<sup>65</sup> The Department can file a lawsuit to collect the penalty if necessary.<sup>66</sup>

ERISA also allows participants, beneficiaries, fiduciaries and the Department to sue both fiduciaries and non-fiduciaries, including service providers, who participate in a prohibited transaction.<sup>67</sup> ERISA provides that fiduciaries may be sued for breaches of any of their responsibilities under ERISA and will be personally liable for any losses to the plan resulting from their breach and any other appropriate equitable or remedial relief.<sup>68</sup> A non-fiduciary service provider may only be sued under ERISA “(A) to enjoin any act or practice which violates any provision of this title or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this title or the terms of the plan. . . .”<sup>69</sup> These

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61. 29 U.S.C. § 1132(l)(2).

62. 530 U.S. 238 (2000).

63. 29 U.S.C. § 1002(21)(A).

64. 29 U.S.C. § 1132(l)(2).

65. 29 U.S.C. § 1132(l)(4).

66. 29 U.S.C. § 1132(a)(6).

67. 29 U.S.C. § 1132(a).

68. 29 U.S.C. § 1109(a), 1132(a)(2).

69. 29 U.S.C. § 1132 (a)(3), (5).

provisions do not address who can be sued. However, the U.S. Supreme Court in *Harris Trust and Savings Bank v. Salomon Brothers, Inc.* clarified that the language contained in these provisions applies to non-fiduciary service providers.<sup>70</sup> Consequently, a non-fiduciary service provider may be sued by participants, beneficiaries, fiduciaries, and the Department under ERISA if the service provider knowingly participates in a prohibited transaction.

While the Court clearly stated that service providers may be sued for engaging in a prohibited transaction, the persons bringing the lawsuit may only prevent an act or practice that violates ERISA or obtain “equitable relief” for the plan. The Supreme Court in *Great-West Life & Annuity Ins. Co. v. Knudson* held that the term “equitable relief” means something other than monetary damages.<sup>71</sup> The court explained that monetary relief is not equitable relief.

Thus, the law contains numerous provisions to discourage fiduciaries from allowing their plans to engage in prohibited transactions. Service providers are dissuaded from participating in prohibited transactions as a result of these rules as well.

### 3. *Common Types of Fees in 401(k) Plans*

Fees for 401(k) plans can generally be described as plan administration fees, investment charges, transactional fees (or individual service fees).<sup>72</sup> As the Department explains in its publication on fees in 401(k) plans, plan administration fees are for the “day-to-day operation of a 401(k) plan [which] involves expenses for basic administrative services—such as plan record keeping, accounting, legal and trustee services—that are necessary for administering the plan as a whole.”<sup>73</sup> Examples of the types of services for which these fees are paid include “telephone voice response systems, access to a customer service representative, educational seminars, retirement planning software, investment advice, electronic access to plan information, daily valuation and on-line transactions.”<sup>74</sup>

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70. 530 U.S. at 241. *See also*, *Keach v. U.S. Trust Co.*, 254 F.Supp.2d 1055, 1057 (C.D. Ill. 2003) (citing *Harris Trust v. Salomon Smith Barney, Inc.*, 530 U.S. 238 (2000)).

71. 534 U.S. 204 (2002).

72. U.S. Dep’t of Labor Publication, *A Look At 401(k) Plan Fees*, available at [http://www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html).

73. *Id.*

74. *Id.*



Investment fees are assessed based on the investments held by the plan. The Department explains that the expenses for managing the plan's investments are "[b]y far the largest component of 401(k) plan fees."<sup>75</sup> These fees are typically paid as an indirect charge. That is, they reduce the earnings for the investment rather than being deducted directly from the participants' accounts. The Department states "[f]or this reason, these fees, which are not specifically identified on statements of investments, may not be immediately apparent."<sup>76</sup>

The plan's service providers often receive a portion of the investment fees, which is referred to as indirect compensation because it is paid to the service provider by a person other than the plan or plan sponsor. The service provider may not calculate the exact amount that is attributable to each plan they provide services to. The reason is that this information is not readily available. Participants' investments are typically aggregated for indirect compensation purposes both within a plan and among numerous plans. For example, a mutual fund would pay revenue sharing based on the total amount of shares held at the service provider, which would be based on the holdings of all of the participants in all of the plans which use the service provider. The amount received per participant is usually very small, but in the aggregate can amount to a significant amount of money. However, the calculations that would be required to determine the portion of the indirect compensation per plan and then per participant would arguably be labor-intensive. Additionally, some service providers find that there is considerable expense involved in merely calculating the amount of indirect compensation they are entitled to and making sure that they receive it. As a result, most service providers who receive indirect compensation give fiduciaries information about it as a formula rather than as a dollar amount.

Investment fees can also be difficult for fiduciaries to understand and compare among service providers. Different service providers use varying methods to categorize and calculate their fees and a service provider may charge multiple fees for its services. Formulas are frequently used based on participants' accounts balances at certain times during the year. Additionally, the terminology used to describe the types of fees charges is not always consistent among providers. Furthermore, different providers perform different services for plans. Some providers bundle many of the services that plans need and present them to fiduciaries as a package, while others bundle only a few of these services and some are completely independent (that is, unbundled).

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75. *Id.*

76. *Id.*

Transactional fees are fees which are based on specific choices made by participants. The Department calls them "individual service fees" and explains that they are "charged separately to the accounts of individuals who choose to take advantage of a particular plan feature. For example, individual service fees may be charged to a participant for taking a loan from the plan or for executing participant investment directions."<sup>77</sup>

Given the complexity involved with the fee structure of 401(k) plans, it is understandable that inexperienced fiduciaries may not readily comprehend the fees being paid by their plans. However, under ERISA they are obligated to do so in order to understand whether no more than reasonable compensation is being paid for the services received by the plan and to prudently select and monitor their plan's investments.

#### IV. FEE INFORMATION NEEDED BY FIDUCIARIES

In order to evaluate their plan's service providers and investments, fiduciaries need to engage in a prudent process. First, fiduciaries need to engage in procedural prudence to obtain the necessary information about the fees being assessed and what is being received for those fees. They then need to engage in substantive prudence to make a decision based on that information.

##### *A. Information Needed for a Prudent Process*

Under ERISA, fiduciaries are responsible for making decisions about their plan's service providers and investments. As a result, they need to identify all of the services needed by the plan and potential service providers who can perform those services.

The types of information needed by fiduciaries in order to engage in a prudent process is not clearly specified by ERISA. However, fiduciaries need to be able to obtain sufficient information about the fees charged by the plan's service providers and their competitors in order to evaluate the fees paid by the plan, or for a new plan, the fees charged by the service providers that they are considering for the plan.

In order to determine whether the fees paid by the plan are reasonable, fiduciaries need to understand the compensation paid to their service providers as a result of the services being provided to the plan. Thus, fiduciaries of 401(k) plans need to be able to identify all amounts that reduce the value of participants' accounts directly or indirectly. That is, fiduciaries need to know what amounts are being paid directly from the plan as well as those that reduce the plan's earnings. Additionally, they need to

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77. *Id.*

understand whether their service providers are entitled to and/or are receiving any payments from third parties. Fiduciaries need this information to evaluate the total compensation received or eligible to be received by their service providers for the services provided. For example, fiduciaries may determine that the compensation paid by a third party to their service provider, which is calculated as a percentage of assets, is no longer appropriate after the plan's assets have significantly increased in size. The fiduciaries may decide to use a share class that pays that service provider less revenue sharing after determining that the total compensation received by the service provider is no longer reasonable.

Furthermore, fiduciaries need to be able to compare the fees charged by the plan's service providers to its competitors. They need to be able to evaluate their plan's fees based on market rates for comparable services. This can be difficult for fiduciaries because service providers may charge a variety of fees which may be calculated using formulas and the manner in which fees are structured can vary significantly.

### *B. Current Disclosure Requirements*

Current disclosure requirements vary based on whether a plan is categorized as a large or small plan. Small plans are generally plans that cover less than one-hundred participants. Abstracts of Form 5500s for the 2005 plan year, which are the most recent available, reflect that approximately eighty-six percent of all 401(k) plans are small plans, which cover around fourteen percent of all 401(k) participants.<sup>78</sup>

A large plan is a plan that covers one hundred or more participants.<sup>79</sup> Abstracts of Form 5500s for the 2005 plan year reflect that approximately fourteen percent of all 401(k) plans are large plans, which cover around eighty-six percent of all 401(k) participants.<sup>80</sup>

#### *1. Disclosures to Small Plans*

ERISA does not explicitly require service providers to make disclosures to fiduciaries of small plans regarding the compensation they receive in relation to the services they provide

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78. *Private Pension Plan Bulletin Abstract of 2005 Form 5500 Annual Reports*, U.S. Dep't of Labor (Washington, D.C. Feb. 2008), available at <http://www.dol.gov/ebsa/PDF/2005pensionplanbulletin.PDF>.

79. The eighty to one-hundred-twenty participant rule applies for this purpose. That is, if the number of participants in the plan is between eighty and one-hundred-twenty, and a Form 5500 was filed for the prior plan year, the plan sponsor may elect to use the same category (that is, "large plan" or "small plan") that was used for the prior year's Form 5500 filing.

80. See *Private Pension Plan Bulletin*, *supra* note 78.

to the plans. Fiduciaries are required to pay only reasonable expenses, however, ERISA does not contain a provision that specifically mandates that service providers disclose their compensation.<sup>81</sup> Service providers are prohibited from charging more than reasonable compensation for the services provided to plans under the prohibited transaction rules. However, under the current guidance, service providers to small plans are not obligated to disclose the amount of compensation that they receive. That said, the Department has proposed revisions to the regulation to ERISA section 408(b)(2) that would condition the exemption on additional disclosures being made to plans of all sizes.

## *2. Disclosures to Large Plans*

ERISA also does not mandate that service providers currently disclose their compensation to fiduciaries of large plans. However, the Department, Internal Revenue Service and Pension Benefit Guaranty Corporation have issued revisions to the Form 5500 Annual Return/Report for 2009 plan year (the “2009 Form 5500”), which would report service providers on Schedule C who receive compensation of at least five-thousand dollars during the plan year.<sup>82</sup> As discussed below, service providers are not currently required to make the disclosures necessary to complete the 2009 Form 5500. However, service providers may be reported on the 2009 Form 5500 if they do not disclose the information needed to complete the 2009 Form 5500. The Department’s proposed revisions to the regulation under ERISA section 408(b)(2) would also condition the exemption on the provision of information needed for reporting and disclosure purposes, including the 2009 Form 5500.

Schedule C to the 2009 Form 5500 generally requires a sponsor of a large plan to report information regarding the direct and indirect payments received by service providers. Service providers are reported on Schedule C if they: (1) provided services to or had transactions with the plan during the plan year; and (2) received at least five-thousand dollars in reportable compensation in connection with the services provided to the plan or their position with the plan. Exceptions apply for certain employees of the plan, plan sponsor, and service providers, and persons whose only compensation consists of insurance fees and commissions which are reported on Schedule A.

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81. ERISA section 404(a) requires fiduciaries to discharge their duties for the exclusive purpose of providing benefits and paying reasonable expenses of the plan. 29 U.S.C. § 1104(a).

82. For convenience, I refer to these agencies collectively in this article by reference to the Department.

The 2009 Form 5500 uses a broad definition of compensation that is reportable on Schedule C. Reportable compensation includes:

money and any other thing of value (for example, gifts, awards, trips) received by a person, directly or indirectly, from the plan (including fees charged as a percentage of assets and deducted from investment returns) in connection with services rendered to the plan, or the person's position with the plan.<sup>83</sup>

Compensation is reported differently, depending on whether it is direct, eligible indirect or other indirect compensation. Direct compensation is defined as “[p]ayments made directly by the plan for services rendered to the plan or because of a person's position with the plan are reportable as direct compensation.”<sup>84</sup> The 2009 Form 5500 includes as examples: “direct payments by the plan out of a plan account, charges to plan forfeiture accounts and fee recapture accounts, charges to a plan's trust account before allocations are made to individual participant accounts, and direct charges to plan participant individual accounts.”<sup>85</sup>

Indirect compensation is generally defined as amounts received by a service provider from persons other than the plan or the plan sponsor.<sup>86</sup> In order to be “eligible” indirect compensation, the indirect compensation must satisfy both (i) the definition of eligible indirect compensation and (ii) a written disclosure requirement. Eligible indirect compensation is defined as:

[F]ees 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[,] finders' fees[,] “soft dollar” revenue, float revenue, 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).<sup>87</sup>

The following written disclosures must be made to fiduciaries for compensation to be considered eligible indirect compensation:

- (a) the existence of the indirect compensation;
- (b) the services provided for the indirect compensation or the purpose for payment of the indirect compensation;
- (c) the amount (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation; and

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83. 72 Fed. Reg. 64824-25.

84. Schedule C, line 2(a)(e).

85. 72 Fed. Reg. 64825.

86. 72 Fed. Reg. 64825.

87. 72 Fed. Reg. 64826.

(d) the identity of the party or parties paying and receiving the compensation.<sup>88</sup>

Other indirect compensation is any indirect compensation that does not satisfy the definition of eligible indirect compensation. Information similar to the disclosures that are made to fiduciaries for eligible indirect compensation will be reported on Schedule C to the 2009 Form 5500.

Schedule C includes a section for plan sponsors to report service providers who fail to report information necessary to complete Schedule C. However, the fiduciaries indicate that plan sponsors “should contact the fiduciary or service provider to request the necessary information and tell them you will list them on the Schedule C . . . if they do not provide the necessary information.”<sup>89</sup>

The Department has proposed revisions to the regulation to ERISA section 408(b)(2) that would require service providers to disclose the information needed for the Form 5500 in order for service providers to rely on the exemption. As a result, fiduciaries will be able to obtain this information if the final version of the regulation continues to include this requirement.

### *C. Additional Disclosures Proposed by the Department*

The Department recently issued a proposed regulation under ERISA section 408(b)(2) that would generally require certain types of service providers to disclose the types of services that they will provide to plans, their compensation for those services and potential conflicts of interest.<sup>90</sup> These written disclosures would be required before a service provider entered into, extended or renewed an arrangement with a plan.

The additional conditions in the proposed regulation would apply to a person who is:

(A) A service provider who provides or may provide any services to the plan pursuant to the contract or arrangement as a fiduciary either within the meaning of section 3(21) of [ERISA] or under the Investment Advisers Act of 1940;

(B) A service provider who provides or may provide any one or more of the following services to the plan pursuant to the contract or arrangement: banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other investment brokerage, or third party administration. . .[or]

(C) A service provider who receives or may receive indirect compensation or fees. . .in connection with providing any one or

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88. 72 Fed. Reg. 64826.

89. 72 Fed. Reg. 64827.

90. 72 Fed. Reg. 64740 (Nov. 16, 2007).

more of the following services to the plan pursuant to the contract or arrangement: accounting, actuarial, appraisal, auditing, legal, or valuation. . . .<sup>91</sup>

These service providers would need to disclose all services to be provided to the plan under the contract and for each service, the compensation to be received by the service provider. Compensation is defined broadly for this purpose and includes:

[M]oney or any other thing of monetary value (for example, gifts, awards, and trips) received, or to be received, directly from the plan or plan sponsor or indirectly (i.e., from any source other than the plan, the plan sponsor, or the service provider) by the service provider or its affiliate in connection with the services to be provided pursuant to the contract or arrangement or because of the service provider's or affiliate's position with the plan.<sup>92</sup>

Service providers would also need to describe their manner of receipt of the compensation. That is, whether the service provider will bill the plan, deduct fees directly from plan accounts, reflect a charge against plan investments, or receive indirect payments from a third party. The service provider would also need to describe how any prepaid amounts will be calculated and refunded when a contract terminates.

The proposed regulation would not require the disclosures to be made using any particular format. Compensation could be expressed in terms of a monetary amount, formula, percentage of the plan's assets, or per capita charge for each participant or beneficiary of the plan.<sup>93</sup> However, the manner in which compensation would be expressed would need to include sufficient information to enable the responsible plan fiduciary to evaluate the reasonableness of the compensation. According to the preamble, the disclosures could be made in separate documents and incorporated by reference, such as in a prospectus or Form ADV. The preamble indicates, however, that if documents are incorporated by reference, the service provider must indicate where in the referenced document the information may be found.

The proposed regulation does not specify a minimum time period for providing the disclosures as long as they would be provided before the contract is entered into, extended or renewed. However, the Department comments in the preamble that the

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91. *Id.*

92. 72 Fed. Reg. 71004.

93. The preamble states that these options are available only "if a service provider cannot disclose compensation or fees in terms of a specific monetary amount. . . ." 72 Fed. Reg. 70990. However, this limitation was not included in the proposed regulation.

responsible plan fiduciary should make sure he obtains the information “sufficiently in advance of entering into the contract . . . to allow the fiduciary to prudently consider the information.”<sup>94</sup>

The proposed regulation includes special provisions with respect to a bundle of services that are priced as a package. The bundle of services can be provided: (i) entirely by one service provider; or (ii) by a service provider and an affiliate or subcontractor or other party. For a bundle of services, all services and the total direct and indirect compensation to be received by the service provider as well as any affiliate, subcontractor or any other party in connection with the bundle of services would need to be disclosed in writing. A bundled service provider would generally not have to disclose the allocation of the compensation among its affiliates, subcontractors, or other parties. However, an exception would apply for direct separate charges against a plan’s investment that are reflected in the net value of the investment and separate charges that are set on a transaction basis, such as finder’s fees, brokerage commissions, or soft dollars.

A service provider would also need to disclose in writing whether he or an affiliate would be able to affect his own compensation in connection with the provision of services without the prior approval of an independent plan fiduciary. The Department provides “incentive, performance-based, float, or other contingent compensation” as examples.

The proposed regulation would require the written disclosure of whether the service provider or an affiliate has any policies or procedures that address or prevent actual or potential conflicts of interest or an adverse effect on the provision of services. The preamble explains, “[f]or example, a fiduciary service provider may have procedures for offsetting fees received from third parties (through revenue sharing or other indirect payment arrangements) against the amount that it otherwise would charge a plan client.”<sup>95</sup>

The proposed regulation would require a service provider to disclose “all information related to the contract and any compensation received thereunder” if it is requested by the responsible plan fiduciary or plan administrator in order to comply with ERISA’s reporting and disclosure requirements. This would arise most frequently in the context of reporting information on Schedule C to the Form 5500 for large plans.

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94. *Id.*

95. *Id.*



Additional disclosure items would apply, including whether the service provider is a fiduciary, whether the service provider has any interest in transactions involving the plan, whether a service provider or an affiliate has any material relationships with another service provider and the disclosure of material changes.

#### *D. Suggested Improvements*

The proposed regulation and, for large plans, the 2009 Form 5500 would provide much of the information needed by fiduciaries in order to engage in a prudent process with respect to their plans' service providers. However, there are the following limitations inherent in the proposed regulation which should be remedied.

The information to be provided to fiduciaries, assuming the final version of the proposed regulation contains substantially similar provisions, does not have to be provided in a manner that a reasonable person could understand. That is, service providers have the ability to make disclosures in a way that the average fiduciary would not be able to fully comprehend. Even if the disclosures were made in plain English, the common use of formulas and the varying methods for calculating fees will make it difficult, if not impossible, for many fiduciaries to understand and compare the fees being charged by various service providers.

As a result, a uniform method of disclosure should be required in order to minimize this problem. While a uniform disclosure requirement is unlikely to completely alleviate this issue given the inherent complexity in the manner in which fees are charged in the industry, it would provide considerable assistance to fiduciaries (and the service providers they hire to help them understand the fees paid by the plan).<sup>96</sup>

#### V. ROLES OF PARTICIPANTS IN 401(K) PLANS

As a result of the protections afforded by ERISA, many fiduciaries shift responsibility for allocating the plan's investments to participants. Abstracts of Form 5500s for the 2005 plan year indicate that approximately eighty-nine percent of all 401(k) plans allowed participants to direct some or all of the investment of their accounts among the investments offered by the plan, which cover around ninety-six percent of all active 401(k) plan participants.<sup>97</sup>

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96. The American Society of Pension Professionals and Actuaries (ASPPA) has posted a sample fee disclosure form on its web site, which I was involved in drafting. Although other approaches could certainly be adopted, the disclosure form drafted by ASPPA demonstrates that this type of form is possible. The form is available at [http://www.asppa.org/pdf\\_files/Participant\\_Disclosure.Form.FIN.pdf](http://www.asppa.org/pdf_files/Participant_Disclosure.Form.FIN.pdf).

97. Private Pension Plan Bulletin Abstract of 2005, Form 5500 Annual Reports, U.S. Dep't of Labor (Washington, D.C.: Feb. 2008) available at <http://www.dol.gov/ebsa/PDF/2005pensionplanbulletin.PDF>. The bulletin

ERISA provides protection for fiduciaries for participant investing where plans comply with ERISA section 404(c). ERISA's protection can be provided either for participants who affirmatively direct the investment of their accounts or for participants who do not direct the investment of their accounts who are invested in a "qualified default investment alternative."<sup>98</sup>

Plans do not need to comply with ERISA section 404(c) to allow participants to direct the investment of their accounts. However, fiduciaries would arguably remain responsible for participants' investments choices if the plan does not comply with ERISA section 404(c).<sup>99</sup>

#### A. *Protection Afforded by ERISA Section 404(c)*

For participants who select the investments for their accounts, the Department has issued a regulation which imposes additional requirements in order for fiduciaries to receive protection under ERISA section 404(c)(1).<sup>100</sup> The regulation conditions relief on a plan offering a broad range of investments and making certain disclosures to participants.

The regulation includes over twenty conditions, including providing participants with: (i) certain types of documentation, information and disclosures; (ii) the ability to give investment instructions with sufficient frequency given the market volatility of the investments; and (iii) the ability to choose from a range of investments that is broad enough to provide participants with the reasonable opportunity to materially affect the potential returns in their accounts and to diversify their accounts so as to minimize the risk of large losses.<sup>101</sup> The regulation's conditions include the disclosure to participants of:

a description of the investment alternatives available under the plan and, with respect to each designated investment alternative, a general description of the investment objectives and risk and return

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indicated that 387,116 out of 436,207 401(k) plans allowed participants to direct some or all of their accounts and approximately 62,732,000 out of 65,652,000 participants were able to direct some or all of their accounts.

98. 29 U.S.C § 1104(c).

99. Some practitioners have argued that ERISA section 404(c) is merely a safe harbor and fiduciaries would not necessary be responsible for participants' investment decisions if the plan did not comply with ERISA section 404(c). That said, the Department has taken the position that ERISA section 404(c) is the only means by which a fiduciary can shift this responsibility to participants. 57 FR 46906, 46907 (Oct. 13, 1992).

100. 29 C.F.R. § 2550.404c-1 (1992).

101. *Id.*

characteristics of each such alternative, including information relating to the type and diversification of assets comprising the portfolio of the designated investment alternative. . . .<sup>102</sup>

Participants must also be given information about the fees associated with each investment. The regulation requires that the disclosure of "a description of any transaction fees and expenses which affect the participant's or beneficiary's account balance in connection with purchases or sales of interests in investment alternatives (e.g., commissions, sales loads, deferred sales charges, redemption or exchange fees)" and, upon request:

a description of the annual operating expenses of each designated investment alternative (e. g., investment management fees, administrative fees, transaction costs) which reduce the rate of return to participants and beneficiaries, and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative. . . .<sup>103</sup> Participants are also entitled, upon request, to a copy of each investment's prospectus that is received by the plan, which contains information about the fees associated with the investment.<sup>104</sup>

ERISA section 404(c)(1) does not relieve fiduciaries of the responsibility for prudently selecting and monitoring the investments offered by the plan. The preamble to the final regulation to ERISA section 404(c)(1) states:

The Department emphasizes, however, that the act of designating investment alternatives. . . in an ERISA section 404(c) plan is a fiduciary function to which the limitation on liability provided by section 404(c) is not applicable. All of the fiduciary provisions of ERISA remain applicable to both the initial designation of investment alternatives and investment managers and the ongoing determination that such alternatives and managers remain suitable and prudent investment alternatives for the plan. Therefore, the particular plan fiduciaries responsible for performing these functions must do so in accordance with ERISA.<sup>105</sup>

The regulation indicates that relief under this provision of ERISA only applies where a participant actually directs his investments. The preamble to the final 404(c)(1) regulation explains "until a participant or beneficiary exercises control with respect to assets contributed on his behalf, plan fiduciaries are subject to all of the fiduciary duties and obligations set forth in. . . ERISA with respect to such assets."<sup>106</sup>

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102. *Id.*

103. *Id.*

104. *Id.*

105. 57 Fed. Reg. 46906, 46907 (Oct. 13, 1992).

106. *Id.*

### *B. Special Rules for Default Investments*

ERISA provides that participants who do not direct the investment of their accounts will be treated as if they had, if the fiduciaries invest their account in a “qualified default investment alternative,” also known as a “QDIA.”<sup>107</sup> The Department issued a final regulation interpreting these provisions.<sup>108</sup> Fiduciaries will not be liable for any losses related to a qualified default investment alternative if they prudently select and monitor the default and otherwise comply with the Department’s regulation.

Department Regulation § 2550.404c-5 provides the following conditions that must be satisfied in order for a fiduciary to obtain “safe harbor” relief under section 404(c)(5), if the assets are invested in a “Qualified Default Investment Alternatives” or “QDIA.” Additionally, participants must have been given the opportunity to provide investment direction but have not done so. A notice must be given to participants before their first investment in the QDIA and annually thereafter. Certain materials provided to the plan for the QDIA must be furnished to participants. (The regulation cross references portions of the 404(c)(1) regulation regarding the types of information that needs to be provided to participants).

Participants must have the opportunity to direct investments out of the QDIA to another investment no less frequently than once within any three month period. Transfer restrictions, fees and expenses cannot be imposed upon a participant who opts out of investing in the QDIA or who decides to direct his or her own investments within the first ninety days after the participant’s first deferral is withheld or other first investment in a QDIA. The plan must offer a “broad range of investment alternatives” as defined in the 404(c)(1) regulation.

The regulation provides that following types of investments can be QDIAs: (1) a target-date fund or model, such as a lifecycle fund, that is selected for a participant based on the participant’s age, target retirement date or life expectancy; (2) a balanced fund or model, such as a lifestyle fund, which provides for a target level of risk based on the participants in the plan as a whole; (3) an investment management service, such as a managed account, that is based on the participant’s age, target retirement date or life expectancy. The regulation also provides that a money market account can be used as a QDIA, but only for the first 120 days of participation. In order to maintain the protection afforded under 404(c)(5), amounts invested in the stable value fund must be rolled over into one of the other three default options after the 120-day period. In addition, the regulation provides what the preamble

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107. 29 U.S.C § 1104(c)(5).

108. 29 C.F.R. § 2550.404c-5 (2007).

describes as a “grandfather’-like” provision for amounts defaulted into stable value funds before the effective date of the regulation (that is, before December 24, 2007). To receive this protection, the preamble to the final regulation indicates that fiduciaries must comply with the regulation for the grandfathered amounts as well. Deferrals or other contributions made on or after December 24, 2007 must be placed in a QDIA in order to receive protection under ERISA section 404(c)(5).

The QDIA regulation requires participants to be given notices that are written in plain language. The regulation provides that the notice must include: (1) a description of the circumstances under which a participant’s account will be invested in a QDIA; (2) an explanation of the right of participants to direct the investment of their accounts; (3) a description of the QDIA, including its investment objectives, any risk and return characteristics, and fees and expenses; (4) a description of the right of the participants to select other investments available under the plan, including a description of any applicable restrictions, fees or expenses related to a transfer; and (5) an explanation of where the participants can obtain investment information about other investments available under the plan. For automatically enrolled plans, the notice must also contain an explanation of the circumstances under which deferrals will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to opt out or elect a different percentage.

### *C. Proposed Participant Disclosure Regulations*

The Department has recently issued proposed regulations requiring fee disclosures to be made to participants in participant-directed individual account plans.<sup>109</sup> The proposed regulations would require investment information, including fee and expense information to be provided to participants once the regulations are finalized.

Fiduciaries would be obligated to make the disclosures described in the proposed regulation in order to satisfy their fiduciary obligations. Fiduciaries would continue to be responsible for prudently selecting and monitoring the plan’s investments as well.

Under the proposed regulation, fiduciaries would be required to provide participants with information that includes a description of the fees and expenses charged to participants for administrative services, designated investment alternatives, and as a result of actions taken by the participant.<sup>110</sup> Fiduciaries would also need to provide participants with the actual dollar amount

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109. Prop. Reg. § 2550.404a-5, 73 Fed. Reg. 43013 (Jul. 23, 2008).

110. *Id.*

charged to a participant's account on a quarterly basis for administrative expenses. Disclosures about the plan's designated investment alternatives would also be required.

## VI. INFORMATION NEEDED BY PARTICIPANTS

Participants need sufficient information about the fees charged to the plan to make informed decisions. Although they are not obligated to use a prudent process, to the extent participants are making decisions about the plan, it would be in their best interest to do so.<sup>111</sup> ERISA does not currently explicitly require the disclosure of fees to participants, except for plans that comply with ERISA section 404(c)(1). The Department, however, has proposed regulations that would require disclosures. The 9th Annual Transamerica Retirement Survey indicated that only twenty-six percent of participants surveyed were aware that any fees were charged to their account.<sup>112</sup> Only twenty-one percent of the participants that were aware of the fees were "very familiar" with the fees charged.<sup>113</sup>

However, the information needed by participants differs from that of fiduciaries. Additionally, a study by Julie Agnew and Lisa R. Szykman of the Center for Retirement Research at Boston College has shown that participants are subject to information overload.<sup>114</sup> Agnew and Szykman have found that "[r]esearch in the decision-making literature suggests that rather than processing more information when decisions become more complex, consumers tend to reduce the amount of effort they expend in order to make their decision or choice."<sup>115</sup>

Additionally, many participants do not have significant experience with investments and therefore may be less likely to be able to understand complex investment information. The 9th Annual Transamerica Retirement Survey indicated that seventy one percent of participants surveyed agreed with the statement that they did not know as much as they should about retirement investing.<sup>116</sup> Another example is the research conducted by the Pension Research Council of the University of Pennsylvania Wharton School, which indicates that many participants in 401(k)

111. ERISA section 404(c) provides that participants who direct the investment of their accounts are not fiduciaries. 29 U.S.C. § 1105(c).

112. *9th Annual Transamerica Retirement Survey*, (Feb. 28, 2008), available at <http://www.transamerica center.org>.

113. *Id.*

114. Julie Agnew & Lisa R. Szykman, *Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice and Investor Experience* 3 (Ctr. for Ret. Research, Working Paper No. 2004-15, 2004), available at [http://www.bc.edu/centers/crr/papers/wp\\_2004-15.pdf](http://www.bc.edu/centers/crr/papers/wp_2004-15.pdf).

115. *Id.*

116. *9th Annual Transamerica Retirement Survey*, *supra* note 112.

plans are not properly investing their accounts. The research uses a stop light color approach to characterize the conformance of 401(k) participant's portfolios to the paper's rules of portfolio construction.<sup>117</sup> The paper estimates that:

[N]early 43% [of participants] construct "green" portfolios with balanced exposure to diversified equities, while another 26% construct "yellow" portfolios with possibly too-aggressive or too-conservative equity holdings. Another three in ten participants make egregious errors and have "red" portfolios—either holding zero in equities or over concentrating their account in employer stock.<sup>118</sup>

#### A. Information Needed by Participants

Employees who are eligible to participate in 401(k) plans are typically responsible for deciding whether to participate in the plan, how much to contribute and how to invest their accounts. In order to evaluate whether to participate in the plan and how much to contribute, employees need to understand the direct cost of participation so they can compare the benefits of participating in the plan with saving outside of the plan. These types of fees would only include amounts that reduce the value of their accounts, either directly or by reducing their investment returns.

Participants also need to understand the investment expenses for the options available in the plan. In order to compare the investment choices and decide which investments are appropriate for their accounts, participants need to be able to understand how much they are paying or would pay for each investment offered by the plan. Participants will need other types of information about the investments, such as historical rates of return, in order to make assessments about the plan's options.

#### B. Recommended Disclosures to Participants

Participants should be given the minimum amount of information necessary to enable them to make decisions about their involvement in the plan and investment decisions. That is, participants, regardless of whether they are in a plan that intends to comply with ERISA section 404(c), need to be given information about any fees that reduce the value of their accounts, either directly or by reducing their investment returns. For investments, participants need basic information about the investment's risk and return objectives, historical rates of return and investment fees so they can compare them to other options offered by the plan.

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117. Gary R. Mottola and Stephen P. Utkus, *Red, Yellow, and Green: A Taxonomy of 401(k) Portfolio Choices*, PRC WP2007-14, Pension Research Council Working Paper (June 2007), available at <http://www.reish.com/publications/pdf/redyellowgreen.pdf>.

118. *Id.*

The proposed regulation issued by the Department is designed to accomplish these objectives.

However, it is important that the information given to participants is written in plain English and uniform, to the extent possible. Additionally, any additional information that the fiduciaries or the Department believes should be given to participants should only be provided upon request.

## VII. CONCLUSION

With the increased popularity of 401(k) plans, more participants are relying on them in order to help them objectives of obtaining adequate retirement savings. Sufficient information needs to be given to the persons responsible for making decisions about their plans, that is, fiduciaries and participants. However, the roles of fiduciaries and participants differ. As a result, the information given to them should be reflective of their varying responsibilities, but responsive to their respective needs.



