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How much are you really paying your your 401(k) / 403(b) provider?

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Impact of Fees

- November 2006 GAO Report:
 - Over \$2 trillion invested in 401(k) plans
 - Doesn't include 403(b) plan assets, which likely push total to total to over \$3 trillion
- 401(k) / 403(b) Plans have created a very big big industry
 - Lots of players
 - Lots of fees



Impact of Fees

- Illustration

- 401(k) / 403(b) account holds \$20,000
- Assume no further contributions

- Over 20 years, average annual rate of return is 7% (before fees)
 - Scenario 1 – 0.5% average annual fee
 - Scenario 2 – 1.5% average annual fee



Impact of Fees

- Fee Illustration, cont.
- Scenario 1 -- \$20,000 account grows to \$70,500 in 20 years
 - 6.5% net average annual return
- Scenario 2 -- \$20,000 account grows to \$58,400 in 20 years
 - 5.5% net average annual return



Types of Fees

- Three broad categories of fees
 - Investment-related fees (reflected in the “expense “expense ratio”)
 - Fees for selecting the portfolio of mutual fund securities
 - “12b-1 fees”
 - Marketing and distribution of the mutual fund
 - Shareholder services (e.g., distributing the prospectus)
 - Front-end loads and back-end loads



Types of Fees

- Three broad categories of fees
 - Recordkeeping fees
 - Set-up and maintenance of the 401(k) plan
 - Enrolling plan participants
 - Processing participant investment elections
 - Preparing and mailing account statements
 - Check-cutting fees
 - Plan loan fees
 - Legal and professional fees
 - Trustee fees



Types of Fees

- Three broad categories of fees
 - Insurance and other fees
 - Insurance wrapper fees
 - Lost investment earnings in GICs
 - Surrender charges



Fee Arrangements

- Hard Dollar Fees
 - Flat rate per participant per month, typically paid by a plan to the 401(k) / 403(b) service provider
 - Also could be flat charges for certain transactions (loans, (loans, check writing, QDROs, etc.)
 - Total dollars paid to the provider do not move with changes in assets.



Fee Arrangements

- Revenue Sharing Arrangements
 - Mutual funds, common or collective trusts, and insurance insurance GICs share fees with the 401(k) / 403(b) service service providers
 - 12b-1 fees
 - Sub-transfer agency fees
 - Other fees for services provided
 - Fund passes the revenue sharing cost through to the plan plan in the form of higher expense ratios
 - Total dollars paid to the provider increase as assets increase



401(k) Fee Litigation

- In September 2007, several major companies were sued in class action lawsuits in Federal court
 - Plaintiff classes allege breaches of fiduciary duties relating to 401(k) fees
 - Cases raise same types of issues for 403(b) plans



401(k) Fee Litigation

- Lockheed Martin
- International Paper
- Bechtel
- Exelon Corporation
- Caterpillar
- General Dynamics
- United Technologies
- Boeing
- Kraft Foods
- Deere
- CIGNA
- National Financial
- Principal Life Insurance Insurance
- Nationwide Life Insurance
- ING Life Insurance
- Northrup Grumman (dismissed)



401(k) Fee Litigation

- Cases allege ERISA breach of fiduciary duty
- ERISA plan fiduciaries have a duty:
 - to use plan assets to pay benefits and “reasonable” plan plan expenses
 - to act in a prudent manner
 - includes the prudent selection of plan investment options and and 401(k) / 403(b) service providers
 - to not lie or mislead participants (duty of loyalty)



401(k) Fee Litigation

- ERISA plan fiduciaries can limit their fiduciary exposure arising from participant investment decisions under ERISA Section 404(c)
 - Requires full disclosure of plan fees
 - Lack of disclosure also relates to duty of loyalty
loyalty claim



401(k) Fee Litigation

- Church plans generally not subject to ERISA
ERISA
 - May be subject to state trust law
 - Similar fiduciary requirements
- Focus of GAO, U.S. Department of Labor and courts in the ERISA world will have an impact on church plans
 - May change the way fees are structured and communicated



401(k) Fee Litigation – Alleged Claims

- Fiduciaries failed to account for fees paid to 401(k) / 403(b) service providers through revenue sharing
 - When combined with hard dollar fees, the total fee total fee paid is excessive
 - Violates ERISA exclusive benefit and prudence fiduciary rules



401(k) Fee Litigation – Alleged Claims

- Fiduciaries failed to disclose to participants participants the revenue sharing fees paid to to 401(k) / 403(b) service providers
 - Violates ERISA duty of loyalty
 - Also eliminates the ERISA Section 404(c) defense defense because fees not fully disclosed



401(k) Fee Litigation – Alleged Claims

- Fiduciaries violated their duty of prudence by by purchasing retail shares rather than institutional shares of the same investments investments
 - Retail shares are available to any investor, large large or small
 - Some funds offer institutional shares to large investors (such as plans)
 - Same investment; lower fees



401(k) Fee Litigation – Alleged Claims

- Other claims
 - Style drift
 - Active funds mirroring index funds
 - Fund investments do not reflect the fund's asset category category
 - Failure to monitor investment performance
 - Performance did not hit benchmarks
 - Fiduciaries used the wrong benchmarks



Fiduciary Best Practices

- Identify and train fiduciaries
 - Who is responsible for selecting investment options for your plans?
 - Committee vs. individual
 - Consider a broad range of expertise
 - What are their fiduciary duties and responsibilities?
 - Committee charter to document scope of responsibility
 - Institutionalize periodic monitoring (at least quarterly)



Fiduciary Best Practices

- Identify and train fiduciaries, cont.
 - Is an outside expert needed?
 - In-house expertise may be available for some investment investment classes, but not others
 - Outside expert should be independent, paid with a flat fee fee



Fiduciary Best Practices

- Investment policy statement
 - Provides guidelines for the fiduciaries
 - Identifies desired asset classes, investment parameters
 - Should confirm that fees are considered in choosing investments investments
 - Establishes performance benchmarks and horizons for meeting the benchmarks
 - Avoid “watch lists”
 - Once established, must be followed
 - Should build in some flexibility



Fiduciary Best Practices

- Review total fees being paid and fee arrangements
 - Work with your 401(k) / 403(b) provider to identify identify any revenue sharing arrangements
 - Segregate investment fees from recordkeeping recordkeeping fees
 - Assess each against an appropriate benchmark



Fiduciary Best Practices

- Review total fees being paid and fee arrangements, cont.
 - Consider replacing revenue sharing arrangements with hard dollar fees
 - As plan assets grow, hard dollar fees will be cheaper for the the plan.
 - Consider replacing any retail shares with lower-fee lower-fee institutional shares



Fiduciary Best Practices

- Review and update plan communications
 - Moving towards a standard of full disclosure of fees paid by the plan
- Update any plan handbooks and other communications that discuss investment options



Fiduciary Best Practices

- Document fiduciary deliberations regarding selection of investment options
 - Fiduciary duty is about process, not necessarily necessarily results



Questions?

