401(k) Fees and Fiduciary Responsibility

What Plan Sponsors Need to Know

EXECUTIVE SUMMARY

In recent years, market events have made many 401(k) participants more sensitive to the corrosive effect that excessive plan fees can have on long-term asset accumulation. Plan sponsors, meanwhile, are being reminded by regulators they have a fiduciary duty to avoid excessive plan costs, and must approve and monitor fee payments, most of which are deducted directly from participant accounts or investment vehicles in which they are invested.

While sponsors have a fiduciary duty to ensure plan costs are reasonable, that does not mean fees must be the sole focus in sacrifice to all other factors. In this respect, fees should not be evaluated in isolation, but rather in light of the overall benefits provided to the plan and plan participants.

To ensure that fees are reasonable and to guard against potential conflicts of interest or other abuses, plan fiduciaries should establish a clear, prudent and well-documented process for managing their financial relationships with investment managers, plan administrators, trustees, and other plan vendors.

INTRODUCTION

The capital market volatility seen in 2008 and 2009 has led millions of 401(k) participants to reexamine their investment strategies. While market values have recovered significantly since the fall of 2008, many participants are paying closer attention to the drag that fees and other costs can impose on account performance.

For 401(k) plan sponsors, this scrutiny poses a double-edged challenge. On the one hand, the impact on investment performance caused by excessive fees has a direct effect on the financial security of their employees. More directly, though, payment of excessive fees by a plan could expose directors, officers, and other fiduciaries of the plan to potential legal liability. Under ERISA, plan fiduciaries are responsible for knowing the full extent of all expenses borne by their plans. Failure to understand the nature and scope of fees paid to investment managers and other plan providers could be viewed as a breach of fiduciary duty if such failure results in avoidable losses to plan participants.¹

If fiduciaries had good reasons to pay close attention to fees before the market crisis, they have even stronger ones now. Federal regulators have issued new rules that require more detailed disclosure of plan expenses. The plaintiff’s bar, meanwhile, has also discovered the fee issue. Lawsuits have been filed against a number of large 401(k) plan sponsors, alleging they failed to exercise due diligence in entering into fee

¹ “Among other duties, fiduciaries have a responsibility to ensure that the services provided to their plan are necessary and that the cost of those services is reasonable.” Department of Labor, Employee Benefits Security Administration, “Understanding Retirement Plan Fees And Expenses,” May 2004.
arrangements with plan providers, and did not adequately disclose those payments to plan participants.

THE CURRENT FEE ENVIRONMENT
Plan fiduciaries have an obligation to understand and approve fees paid from participant accounts. However, obtaining this information hasn’t always been easy. Regulation of 401(k) plans is shared by the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL). Oversight of investment managers and other service providers is divided among a host of federal and state agencies.

This situation has created pressure for reform at the federal level. The DOL has finalized regulations that will require additional 401(k) fee disclosures by plan providers as well as plan sponsors.

PLAN SPONSOR–TO–REGULATORS DISCLOSURE
One set of rule revisions has already gone into effect. Effective for plan years beginning in and after 2009, plan sponsors must provide additional fee information on Schedule C of the Form 5500 they file annually with the DOL. Required disclosures now include:

- total payments to all plan providers who received at least $5,000 during the plan year, taking into account all compensation, including indirect third-party payments;
- the sources of all indirect payments of $1,000 or more received by certain providers (including plan administrators and asset managers) for certain types of services;
- the names of any providers who have failed to provide the plan sponsor with the information needed to complete the Schedule C.

The reporting rules are complex and include streamlined disclosures for payments to “bundled” providers—those that sell a number of different services, provided either directly or by third parties, for a single price. Sponsors should consult their legal counsel to understand how the regulations apply to them.

The DOL regulations clearly reflect a view that prudent fiduciaries should know about and approve fees paid from participant accounts—including third-party payments.

SERVICE PROVIDER–TO–PLAN SPONSOR DISCLOSURE
The DOL will also require additional service provider disclosures that would go some way toward ensuring plan sponsors have the information needed to meet their fiduciary obligations. New regulations tighten the rules under ERISA Section 408(b)(2), which allows sponsors to pay outside vendors for plan services as long as the contracts for those services are “reasonable.”

The new rules clarify the definition of “reasonable” to require a number of new disclosures by certain plan service providers, including administrators, investment managers, custodians, recordkeepers, brokers, and investment advisors, as well as attorneys, accountants, actuaries, and other professionals who receive third-party payments from those providers. These requirements include:

- written disclosure, prior to entering into any contract, of all services to be provided and all fees to be charged;
- disclosure of all direct and indirect compensation received by the provider and/or its affiliates, including 12b-1 fees, sub-transfer agency fees, fund shareholder service fees, sales commissions, and soft-dollar payments;
- description of the manner in which compensation will be received.

BEST PRACTICE CONSIDERATIONS—REVIEW AND COMPARE
- Compare your current fees (i.e., management, recordkeeping, etc.) with the appropriate benchmarks—understand what you are paying.
- Review the management fees for each investment vehicle in the plan and compare with similar vehicles in the same asset class. Ensure the fees are within the normal range for that asset class. If they are not, consider documenting the reasons for choosing that option, such as consistent outperformance over an extended time period.
- Ensure any third-party payments used to cover plan administrative costs are consistent with plan documents and that only ERISA-qualified expenses are reimbursed.

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The final rules will become effective April 1, 2012, and will apply to existing service arrangements as well as service agreements entered into on or after that date. As with the Form 5500 requirements, the proposed rules are complex and include special provisions for bundled services. Plan providers as well as plan sponsors should seek guidance from legal counsel to determine how they might be impacted.

**PLAN SPONSOR-TO-PARTICIPANT DISCLOSURE**

The DOL has also finalized rules that will require additional fee disclosures to plan participants. Under the final regulations, plan sponsors will be required to provide participants in self-directed plans with both plan-related and investment-related information. The new disclosure requirements apply to all participant-directed plans, not just plans intending to comply with ERISA Section 404(c), which provides sponsors with a fiduciary safe harbor for the investment performance of participant-directed plans as long as disclosure requirements and certain other conditions are met.

The final regulations are applicable for plan years beginning on or after November 1, 2011, and outline the steps a plan sponsor must take to ensure that participants are provided sufficient information regarding the plan, including fees and expenses, to make informed investment decisions. The centerpiece of the regulations requires that disclosures relating to the plan’s investment options (including fees and expense information) be made in a comparative format.

Although some plan sponsors have expressed concern about the additional reporting costs that might be imposed by the DOL’s reforms, it appears the bulk of the compliance burden ultimately will fall on plan providers. Sponsors who have not already done so should contact their providers to verify the extent to which such providers will provide assistance with the required disclosures.

**THE RISK OF LITIGATION**

In addition to calls for tighter regulation of fee arrangements, some large 401(k) plan sponsors have had to contend with a rash of ERISA class action lawsuits.

The suits contend that the fiduciaries of a number of large plans breached their ERISA duties either by failing to evaluate potential fees in their negotiations with providers or by not fully disclosing those fees to plan participants.

The suits also allege that in some cases third-party payments were used to conceal the size of fees paid—so that the fiduciaries themselves did not know their true extent. Defendants have challenged these claims on a variety of grounds, including:

- The DOL has acknowledged that ERISA does not require separate disclosure of each component of all 401(k) plan fees, except for plans seeking to take advantage of the safe harbor provisions of ERISA Section 404(c).
- The premise that third-party administrative payments are not legitimate has been contradicted by the DOL in several advisory opinions.
- None of the claims allege the total fees paid to any service provider were more than what is customarily charged in the marketplace.

Claims of breach of fiduciary duty are inherently issues of fact, making the outcomes difficult to predict. Even if the suits are dismissed or the sponsors prevail at trial, defending against them represents a considerable expense and nuisance.
THIRD-PARTY ADMINISTRATIVE PAYMENTS

Fund companies or other investment managers may allocate a certain percentage of their expense ratios to pay for services provided by other firms. Examples of these payments include the 12b-1 distribution fees paid by some funds as compensation to sales intermediaries, and the sub-transfer agent fees sometimes paid to 401(k) plan administrators in lieu of the services a transfer agent would otherwise provide for retail fund shareholders. Fund companies may also pay 12b-1 fees to intermediaries or brokerage firms for providing advice to plan sponsors or participants.

Third-party payments are a common feature of many 401(k) service arrangements and have been recognized as appropriate by the DOL in several advisory opinions. By law, 12b-1 fees must be disclosed in the mutual fund prospectus. However, there are several fiduciary aspects of these arrangements that plan sponsors need to understand:

- **Disclosure.** Fiduciaries are required to know about payments made to third parties out of the net returns on the investment vehicles offered in their plans. Since even moderate costs can, over time, have a sizable impact on asset accumulation by participants, plan sponsors must understand the amounts paid and to whom they are paid.
- **Reasonableness.** Fiduciaries must ensure that fees received by third parties are reasonable for the services rendered, especially as these fees increase in line with the growth of the plan’s assets.
- **Potential conflicts of interest.** Fiduciaries are charged with understanding who is ultimately receiving third-party payments from the assets in the plan, and ensuring those payments do not compromise decisions made on behalf of participants.

PUTTING FEES IN CONTEXT

Sponsors have a fiduciary duty to ensure plan costs are reasonable. However, this duty is often misunderstood. Reasonableness does not mean fees must be reduced to the lowest possible level. Fees do not need to be—and should not be—considered in isolation. They are just one side of the value relationship. If a provider can demonstrate that its services have the potential to improve investment performance, or provide other tangible benefits to participants, paying higher-than-average fees for those services could be considered reasonable.

BEST PRACTICE CONSIDERATIONS—DISCLOSURE AND DOCUMENTATION

- Ask providers to disclose annually, in writing, all plan-related fees that have been levied, including indirect administrative payments from investment managers. When requesting such disclosure, use a template such as the DOL’s 401(k) Plan Fee Disclosure Tool, which provides a structured way to compare fees and costs.
- Fully document all fee disclosures and review that documentation at least once a year. Monitor changes in provider arrangements that could reduce costs. Fund managers, for example, may introduce lower-cost institutional shares that the plan can access.
- Ask providers to disclose the mutual fund share classes or other fee structures being used in the plan. Examine a variety of pricing scenarios to see what effect they have on the plan’s total all-in fee.
- Be sure service agreements and fee sheets specify all fees the plan or participants may be required to pay, including termination charges, fixed fees for certain reports, or withdrawal adjustments on certain investments, such as guaranteed investment contracts.
- Inform participants about plan costs, including whether third-party administrative payments are used to pay some of those costs. Many plan providers have adopted templates for this purpose.


BEST PRACTICE CONSIDERATIONS—TAKE ACTION

- If fees seem misaligned, consider seeking competitive bids from a variety of different types of providers—such as mutual fund companies, insurance companies, and third-party administrators.
- Ask providers to suggest changes (such as consolidating payrolls, reducing paperwork, or adding certain automatic features) that could lower costs to the plan or its participants.
- Sponsors who wish to qualify for the limited fiduciary liability for defined contribution plans provided under ERISA Section 404(c) should confirm that any transaction fees or costs charged in connection with the investment options in their plans are adequately disclosed to participants.
- If plan size justifies the expense, consider hiring an “independent fiduciary” to obtain necessary information and make administrative recommendations. This may substantially lower fees and/or increase services to the plan.

COST FACTORS INFLUENCING FEES

Every plan has certain services that must be provided regardless of size, such as recordkeeping, accounting, compliance testing, and vendor management. As a rule, the more participants and assets over which these fixed costs can be spread, the lower the level of fees per dollar of assets. There are also variable costs, such as some types of participant communication, that typically will increase proportionally with the number of participants. In general, however, as the plan grows, fees should decline as a percentage of the total assets.

Given that asset management fees represent, on average, 74% of total plan costs, it’s not surprising the single most important driver of total cost is the type of investment vehicle being used.

Plans with higher average account balances, which generate more revenue per participant, will tend to have lower fees as a percentage of total assets. Other factors—some of which plan sponsors may have the ability to influence—may also have an impact on fees:

- **Number and size of accounts.** More participants generally means more accounts over which costs can be spread. However, if increased participation generates a large number of small accounts, this may increase costs and fees in the short run. But in the long run, participant and employer contributions and capital appreciation should produce higher balances, allowing providers to reduce fees or increase services.
- **Automatic features.** Auto-enrollment may generate more accounts with smaller average balances. However, other features, such as automatic contribution increases, tend to increase plan assets. Over time, this should lead to lower fees and/or increased services.
- **Employer matching contributions.** Higher matching rates should lead to increased participation and larger balances. Both factors should drive fees lower.
- **Asset allocation.** Equity vehicles tend to charge higher management fees. So, the greater the percentage of assets allocated to equities, the higher the costs as a percentage of assets.
- **Plan design.** The number of plans offered by a single sponsor, as well as differences in plan type—for example, whether multiple matching or vesting schedules are used—may affect fees. Consolidating payrolls, simplifying plan design and using a common format for transmitting plan data all may have a positive impact on costs.
- **Participant communications.** Sponsor requests to customize communication materials or on-site educational meetings for different participant groups may drive fees higher. Sponsors need to determine whether the benefits to participants justify the cost.
- **Mergers and acquisitions.** Some providers may charge additional one-time fees when sponsors restructure or merge existing plans. Others may view mergers as opportunities to gain assets and participants and may forgo the extra fees.

COST REDUCTION STRATEGIES

Given the generally inverse correlation between plan size and plan cost, sponsors of larger plans may have opportunities either to reduce fees as a percentage of assets or to obtain additional services from plan providers.
Plans with significant assets, for example, may be able to reduce investment management fees by transferring assets to lower-cost vehicles such as institutional funds or collective trusts. Typically, the larger the plan, the greater access the sponsor will have to lower-cost vehicles, thus improving net returns to participants. On the other hand, sponsors need to understand that shifting assets to lower-cost vehicles may reduce the third-party payments from fund managers used to cover plan administrative costs. This could lead to higher fixed dollar fees and/or a decrease in plan services.

To evaluate these potential trade-offs, sponsors should ask current or prospective plan providers for alternative pricing scenarios, to identify the one that aligns most closely with plan goals.

CONCLUSION

The 401(k) fee environment is changing, including increased federal regulation focused on fee disclosure. Plan sponsors also face an increasing risk of litigation arising from their handling of fee-related arrangements. These developments make it essential for sponsors to review their relationships with plan service providers to ensure they are meeting their fiduciary obligations.

At the same time, however, sponsors need to balance their duty to avoid excessive or abusive fees with their goal of providing plan participants with the investment tools they need to achieve their retirement objectives. Fees should not be considered in isolation, and sponsors are not required to select the lowest-cost providers in all cases. Rather, the fees required should be balanced against the quantity and quality of the services provided.

To manage their fiduciary responsibilities effectively, plan sponsors should develop clear plan objectives, carefully compare the services offered in the marketplace, and determine whether the fees charged are justified by the benefits to plan participants.

INDUSTRY FEE AVERAGES

How much should sponsors expect their 401(k) plans to pay in fees? The answer depends on a variety of factors. However, a survey conducted by Deloitte Consulting for the Investment Company Institute provides some benchmarks:

- The median "all-in" fee (covering all investment, administrative, and participant service costs) for the plans surveyed was 0.72% of assets—or approximately $350 per participant, based on a $48,522 median of average plan account balances. The mean, or average, fee was 0.93%.
- Larger plans pay lower fees. Plans with more than $500 million in assets reported paying a median 0.41%—versus 1.27% for plans with $1 million–$10 million in assets and 1.89% for plans under $1 million.
- There is also a negative correlation between the number of plan participants and fees. Plans with less than 100 participants paid a median 1.77%, while plans with more than 10,000 participants reported median fees of just 0.49%.
- Larger average account balances are also associated with lower fees. This effect becomes more pronounced once plan assets exceed $10 million.

The survey also found a wide range of fees within each asset segment. Even micro plans may be able to negotiate fees that are well below the reported median or average.

Plan sponsors appear to be benefiting from two related cost trends. On the one hand, the average expense ratio for mutual funds has been falling. On the other, expense ratios for funds used in 401(k) plans are lower than the industry average (Chart 2, right).

Call 1-800-638-7780 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other important information that you should read and consider carefully before investing.

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