Benefits ASAP

A Littler Mendelson **Time Sensitive** Newsletter

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SEC TURNS UP THE HEAT ON 401(k) FIDUCIARIES

By Darren Nadel and Steven Friedman

This is not an easy time to be a 401(k) plan fiduciary. With frightening regularity, attacks have been launched by government agencies and plan participants, some successfully, at fiduciaries. And never has the group of potential plan fiduciaries been so large. In fact, quite recently courts have defined plan fiduciaries to encompass an array of corporate employees who range from those who are responsible for the administration of the 401(k) plan to the highest levels of the corporation.

A common myth about 401(k) plan administration is that as long as 401(k) fiduciaries give plan participants a slate of investments to choose from, the fiduciaries can't be held liable for the investment choices made by the participants. This myth was derived from a safe harbor provision in ERISA that shields fiduciaries if the underlying plan investments are found to be prudent. The safe harbor, however, does nothing to protect a fiduciary who is imprudent in (i) either initially selecting a plan investment or (ii) continuing to offer an option which is no longer prudent.

Much of the current focus on fiduciary liability related to 401(k) investments stems from the Enron scandal in which a spotlight was focused on whether company stock was a prudent plan investment option. Out of the Enron litigation came the theory that plan fiduciaries could include not only those dealing directly with plan administration but also the corporate committees formally responsible for plan administration and executive officers and members of the Board of Directors who have a duty to appoint and monitor the plan committee.

Fiduciary liability issues remained in the spotlight with the unfolding of the mutual fund scandals and a faltering stock market which raised concerns about the propriety of selecting or continuing to hold certain mutual funds as plan investments. This was followed by the discovery of late trading and market timing practices which caused plan fiduciaries to take steps to restrict these practices.

Now the SEC has created what may be the biggest challenge for plan fiduciaries in announcing that it has commenced an investigation into mutual fund investments in 401(k) plans.

Specifically, the SEC is focusing on the payments made by mutual funds to be included in 401(k) plans. The SEC analogizes this to purchasing shelf space at the supermarket to make sure a product is prominently displayed. It is quite feasible that this inquiry will focus, in part, not only on the improprieties involved in the sale of funds to the plans but on plan fiduciaries as well. The scenario goes like this. The benefits administrator hires an outside third party administrator to operate the 401(k) plan. Having hired a reputable organization that offers widely recognized funds, the administrator sleeps well at night, thinking all is well. What the administrator may not know (or knows but does not adequately analyze as a plan fiduciary) is that some mutual funds pay money to be recommended for inclusion in 401(k) plans. The payment of those fees out of the mutual funds may or may not get disclosed to the plan participants. In fact, administrators often only distribute the annual or semi-annual report for the mutual funds in the 401(k) plan to participants at the time the participants first choose to participate in the 401(k) plan. Many mutual funds don't send the participants their annual and semi-annual reports automatically because they send them to the 401(k) plan administrator (the actual investor in the fund) instead. While there is no *per se* rule requiring administrators to forward the reports to participants, fiduciaries have a duty to make adequate disclosures about each of the mutual fund choices in the 401(k) plan.

Potential Liability for Plan Fiduciaries

The combination of lack of disclosure, increased investment costs and diminished returns is a perfect recipe for a breach of fiduciary duty claim. What's more, ordinary investors may be able to buy the same funds in their private investment accounts and pay lower fees to the same fund, since some funds charge higher fees to 401(k) plans than to other investors. The administrator's obligation here is to investigate what fees are paid out, and make sure they are fully and accurately disclosed to the participants. Arguably, even if there is disclosure, fiduciary duty issues could arise with respect to such issues as (i) whether the deal procured by the fiduciaries was the best deal possible, (ii) whether there were any conflicts of interest inherent in the pricing structure.

The other major conflict caused by including funds that "pay to play" is the potential for selecting funds on the basis of their payment to the third party administrator, investment manager or broker. If the fund performs poorly compared to other funds that don't "pay to play," the conflict could be imputed all the way to the plan fiduciaries for not having properly investigated the fund choices, or for not making appropriate decisions in selecting the third party administrator, investment manager or broker.

Potential legal theories that plaintiffs could assert against plan fiduciaries in the wake of the SEC investigation include the failure to fully disclose all fees charged to a participant's account, charging participants excessive fees (compared to other investors in similar funds) and fiduciary conflicts of interest.

ERISA generally provides two types of remedies for these claims. The participants can sue the fiduciaries for equitable relief such as restitution, meaning putting everyone back in the same position they would have been had the breach not occurred. The second remedy allows participants to sue for damages on behalf of the plan to recover any losses to the plan resulting from the breach.

So what should benefits adminstrators be doing? They should dig into the details of the viability of the funds in the 401(k) plan, investigate fully how the funds were chosen and what fees the plan participants pay. Information should then be disseminated to participants so that they can understand what fees are being charged. If the selection or retention of a fund is found to be imprudent on account of the fee structure or if there has been inadequate disclosure to plan participants to make sound investment decisions, an employer could potentially find itself on the wrong end of a suit by the participants for breach of fiduciary duty or by the plan for recovery of any plan losses.

For further assistance, please consult one of our attorneys in the Employee Benefits Practice Group.