An Alternative to a Bundled Retirement Plan

A solution where different entities provide different plan services to a plan has the double-barreled virtues of looking like a bundled plan, without actually being a bundled plan.

W. Scott Simon, 07/09/2012

W. Scott Simon is a principal at Prudent Investor Advisors, a registered investment advisory firm. He also provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. Simon is the recipient of the 2012 Tamar Frankel Fiduciary of the Year Award.

In my last two columns, I wrote about the case of *Tussey v. ABB, Inc*. which was decided on March 31 in Missouri by federal district court judge Nanette Laughrey. In May's column, I discussed the case in terms of the complex, inefficient, and unnecessarily expensive Rube Goldberg-like contraption that is revenue-sharing. In June's column, I discussed *Tussey* in terms of a bundled retirement plan and how that helps disguise where money is flowing from, where money is flowing to, and in what amounts. Without knowing such things, no plan sponsor can determine whether a plan's costs are reasonable in relation to the services for which they're expended within the meaning of section 404(a) of the Employee Retirement Income Security Act (ERISA).

Tussey demonstrates in spades how the revenue-sharing bundled retirement plan model helps keep otherwise presumably competent employees at plan sponsors who are in charge of running 401(k) plans from reaching their full intelligence quotient. The consequences of their ill-informed decision-making contribute directly to a less secure and comfortable retirement lifestyle for plan participants (and their beneficiaries).

Such employees--whether serving in fiduciary or non-fiduciary capacities in their retirement plan--should be ever mindful that they can have an impact for good or ill on real flesh-and-blood people. Because many of these employees are in lower and middle management--and therefore not privy to the special retirement goodies often available to upper management--it would seem that much of their own retirement wealth accrues primarily in their company's 401(k) plan. One would think that, if nothing else, the self interest of these employees would motivate them to influence a company's decision-makers to establish a retirement plan with reasonably low costs and well-diversified investment options that would more efficiently build their own wealth.

Each of the 401(k) plans present in the troika of cases of *Tibble v. Edison International*, *Braden v. Wal-Mart*, and *Tussey* holds more than $1 billion in assets; they are not mom-and-pop plans. These companies have the means to devote significant monetary resources and personnel to their 401(k) plans. Yet despite that, they cannot seem to comprehend the harmful consequences of revenue-sharing or even understand that their plans need not submit to the inflexibilities of a bundled offering. (So just what were those 28 persons--all named defendants--on the retirement plans committee at Wal-Mart in *Braden v. Wal-Mart* doing all day?)

Take a moment to think about it: Isn't it remarkable that giant providers of bundled retirement plans such as Fidelity ordinarily choose not to take onto their own shoulders the legal responsibility (and liability) for selecting, monitoring, and replacing their plans' investment options carried by their plan sponsor clients? In fact, they choose normally not to assume any legally meaningful fiduciary responsibility at all. Even in cases where sponsors have the option of off-loading their selecting/monitoring/replacing duties and decide not to exercise that option, presumably they would still wish to offer plan participants reasonably low-cost (and well-diversified) plan investment options. And yet, as shown in June's column, providers of bundled plans are indifferent to offering such investment options to participants because they have no incentive to do so. In fact, they are motivated to do just the opposite: offer investment options bloated with the added costs of revenue-sharing for the non-proprietary funds (and internal credits for their proprietary funds) on their record-keeping platform.

What's more, even giant providers of bundled plans won't be there to take care of plan sponsors if the sponsors get into legal trouble with plan participants, the DOL, or the IRS. These providers ordinarily are not sued, and even when they are, they rarely incur any serious liability. So any plan sponsor contemplating (or already) using such a giant can take little comfort from any perceived legal advantage offered by such "bigness."

The 'Unbundled Bundled' Solution

The alternative to the contraption of revenue-sharing that a bundled retirement plan provider such as Fidelity offers to its plan sponsor client ABB, Inc. in *Tussey* (or Hewitt offers to its client Edison in *Tibble,* or Merrill Lynch offers to its client Wal-Mart in *Braden)* is the so-called "unbundled bundled solution" (a term I first saw in a 2007 white paper, but which may have been coined even earlier). This solution, where different entities provide different plan services to a plan, has the double-barreled virtues of looking like a bundled plan, without actually being a bundled plan. I know that this solution works very well because our firm, Prudent Investor Advisors, seamlessly provides it to all our plan sponsor clients.

There are four entities involved in servicing a 401(k) plan: an investment advisor, a record-keeper, a custodial trustee, and a mutual fund company (or companies). In a bundled offering, the same entity (e.g., Merrill Lynch, Fidelity, or Vanguard) provides all plan services.

In an unbundled bundled solution, different entities provide different services. Our firm--which is a registered investment advisor that's an investment manager pursuant to ERISA section 3(38) and is therefore a fiduciary with discretionary authority over a plan's assets within the meaning of ERISA section 3(21)(A)(i)--recruits and assembles the other separate servicing entities with the approval of (and ongoing monitoring by) the plan sponsor. This approach offers the convenience of integrating an unbundled suite of services on a trading platform that, from a plan sponsor's viewpoint, looks for all intents and purposes like a bundled plan.

But the real advantage of such an approach is that it clearly separates out services such as record-keeping, participant communications, and reporting and disclosures from one another, and then ties each of them directly to the costs (including profit) for which they're expended. When, for example, a fund with no revenue-sharing in an unbundled bundled solution replaces a revenue-sharing laden fund in a bundled offering, something truly remarkable happens: The true cost of revenue-sharing (including a record-keeper's excessive-because-it's-hidden profit) is unlocked from the expense ratios of funds. As the costs of record-keeping and investment options are exposed to the sunlight of market competition, they're driven down. This solution is much better than a plan sponsor guessing (or not even knowing) about the true costs of record-keeping and other services offered in a bundled offering. It's also much better than having a court attempt to guess after the fact a plan sponsor's understanding of revenue-sharing.

The unbundled bundled solution also gives a plan sponsor the ability to swap out a part of the service provider team, should it become unsuitable, and swap in a new one. This avoids the problem of having to keep the rotten apple that spoils the whole barrelful since changing an entire servicing team can often be quite disruptive to companies.

The unbundled bundled solution described here is good for plan sponsors because it allows them to off-load significant fiduciary responsibility and liability onto the shoulders of a decision-making fiduciary with real discretionary authority (and therefore liability) for plan assets. It's also good for plan participants because that discretionary fiduciary will provide them with a prudent menu of reasonably low-cost and broadly and deeply diversified investment options. In addition, this solution provides for an ERISA section 3(38) investment manager to be in full fiduciary alignment with a plan sponsor that legally provides a more level playing field between them, thereby helping to ensure that a plan is run in the sole interest and for the exclusive benefit of plan participants (and their beneficiaries).

Case Shines Spotlight on Bundled Retirement Plans

Plan sponsors may find it more difficult to mitigate the risk of its fiduciaries and to offer plan participants institutionally priced investment options with a product-driven bundled plan solution, writes Scott Simon of Prudent Investor Advisors.
W. Scott Simon, 06/11/2012

W. Scott Simon is a principal at Prudent Investor Advisors, a registered investment advisory firm. He also provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. Simon is the recipient of the 2012 Tamar Frankel Fiduciary of the Year Award.

In this month's column, I'd like to drill down further into the *Tussey v. ABB* opinion issued by federal district court judge Nanette Laughrey at the end of March. A lot more marrow can be extracted from the bones of this case.

Please note that the following discussion pertaining to Fidelity applies only insofar as Fidelity is involved with the two 401(k) plans (PRISM Plans) sponsored by defendant ABB in *Tussey*. In fact, this discussion could also apply to any other large and reputable service provider to retirement plans.

Fidelity Is a Manufacturer of Investment Products
Mutual fund families such as Fidelity are--God bless 'em--unabashed capitalists. They seek to sell their investment products as cost-efficiently through as many distribution channels as they can in order to generate the largest profit possible. Edward C. (Ned) Johnson III, chairman of Fidelity Investments, is not a multibillionaire for nothing.

To help generate profits, Fidelity, for instance, manufactures investment products such as its proprietary mutual funds. Perhaps the most well known of these funds is the Fidelity Magellan Fund, which is on the menu of investment options available to participants in the PRISM Plans. (Fidelity, of course, manufactures other products, but *Tussey* appears to involve only mutual funds.) As a manufacturer of products, Fidelity is really no different than ABB, which manufactures power and automation equipment products.

The unforeseen development of the 401(k) plan industry beginning in 1981 presented Fidelity (and other such providers) with new and potentially huge opportunities to distribute their proprietary investment products in the retirement plan market.

A Bundled Retirement Plan Exists to Distribute Investment Products
The solution that Fidelity and other service providers to retirement plans eventually came up with to vastly expand sales of their proprietary investment products came to be known as a "bundled" retirement plan. In such a plan, different Fidelity units provide a suite of services to plan sponsors. In *Tussey*, for example, defendant Fidelity Management Trust Company (Fidelity Trust) is the record-keeper for the PRISM Plans, providing recordkeeping and other administrative

services, including providing the trading platform for the PRISM Plans. Fidelity Trust places proprietary mutual funds--after selection by ABB--on its recordkeeping platform; these funds are provided by another Fidelity unit, Fidelity Investments (not a defendant in *Tussey*), and made available to participants in the PRISM Plans as investment options. Fidelity Trust is also the trustee of the PRISM Plans, providing trustee and custodial services such as safe-keeping the billion dollar-plus assets of the plans.

Yet another Fidelity unit, defendant Fidelity Management & Research Company (Fidelity Research), serves as the investment advisor to Fidelity's proprietary mutual funds that are on the menu of investment options offered in the PRISM Plans. Some blogs on *Tussey* note that Fidelity Research is the investment advisor to ABB pursuant to section 3(21) of the Employee Retirement Income Security Act (ERISA) (to be more precise, an advisor rendering investment advice for a fee pursuant to ERISA section 3(21)(A)(ii)). However, neither Judge Laughrey's opinion nor the case record supports this assertion.

Fidelity Research is simply the investment advisor to the Fidelity mutual funds on the menu of investment options in the PRISM Plans. (Judge Laughrey did find that Fidelity Research "is a fiduciary to the Plan to the extent it manages Plan assets in FICASH as it exercises discretionary authority and control when it invests Plan assets in various overnight securities [i.e., pursuant to ERISA section 3(21)(A)(i)]." This finding, however, pertains to the issue of float income, which is beyond the scope of this month's column. In any event, this discretionary authority and control doesn't pertain to the extent of fiduciary involvement in the menu of investment options in *Tussey*.)

Plan sponsors such as ABB like bundled retirement plans because they are easy and convenient, offering a kind of one-stop shopping: "Hey, we'll just hire Fidelity to run the PRISM Plans." Fidelity (and other such providers) certainly likes bundled retirement plans. These plans are a particularly lucrative sales channel through which Fidelity effectively and efficiently distributes its proprietary investment products, such as mutual funds. Indeed, the primary reason why bundled plans exist is so plan service providers like Fidelity can distribute their proprietary investment products on their recordkeeping platform. When Fidelity receives money from its own funds and pays, for example, Fidelity Trust for its recordkeeping services, some refer to that as "internal" revenue-sharing, in contrast to revenue-sharing that's paid to Fidelity by third-party mutual fund companies whose own (i.e., non-Fidelity) investment products Fidelity places on its platform. In any event, the more these products pay in revenue-sharing to Fidelity, the better for Fidelity (and the worse for plan participants).

Even in those rare cases where Fidelity is the bundled record-keeper for a retirement plan and a plan sponsor has chosen not to select many Fidelity mutual funds, Fidelity can still extract sufficient (and sometimes even excessive) revenue-sharing payments from non-Fidelity funds. A bundled plan makes it more likely that any excessive revenue-sharing--whether paid by a Fidelity fund or a non-Fidelity fund--can be disguised in the sense that it won't be monitored by a plan sponsor, as Judge Laughrey found in *Tussey*.

When Fidelity (or any other such provider) bids to provide a bundled retirement plan, it offers its own proprietary mutual funds on the plan's platform plus a number of non-proprietary funds provided by other mutual fund companies. Each fund family has its own contract with Fidelity as to how much revenue-sharing each fund will pay to Fidelity. Fidelity's contract with ABB allowed that, if the amount of revenue-sharing in a particular period of time wasn't sufficient to fully cover Fidelity's required fees, Fidelity reserved the right to charge the plan sponsor for any shortfall.

Reciprocally, though, when the amount of revenue-sharing in a particular period of time more than fully covered Fidelity's required fees, Fidelity had no duty to rebate the excess to the plan sponsor. The ABB-Fidelity contract also allowed this. Many plan sponsors fail to keep track of any such excessive revenue-sharing, which is just what happened in *Tussey*. Indeed, the ABB human resources department had the responsibility to "sign off" on (i.e., consent to) invoiced, hard-dollar recordkeeping fees, but it had no such duty when recordkeeping fees were paid through revenue-sharing. In offering a bundled retirement plan, the investment product provider really doesn't care which investment options plan participants select from the plan's menu, because it will get what it needs to cover its required fees one way or the other (and sometimes a lot more than that).

The real money-makers in a bundled retirement plan are the default funds that a provider makes available to plan participants once a plan sponsor has selected them. (These are funds that participants get if they don't make investment elections.) In *Tussey*, the expensive retail versions of the Fidelity Freedom Funds were default options. As Judge Laughrey noted in her decision in *Tussey*: "Revenue sharing was paid to Fidelity Trust based on each of the retail funds that comprised the Freedom Funds. Fidelity charged an additional fee for deciding how to allocate additional funds coming into the Freedom Funds." So not only were participants in two 401(k) plans with more than a billion dollars of assets paying retail prices to invest in the Fidelity Freedom Funds (and non-Fidelity funds), Fidelity also charged them an asset allocation fee on top of that when they invested in the Freedom Funds.

A Directed Trustee Has No Discretionary Authority

ERISA section 403(a) provides, in part, that all assets (except insurance contracts) of an employee benefit plan (e.g., a 401(k) plan) must be held in trust by one or more trustees. ERISA section 403(a) further provides for two kinds of trustees: (1) directed and (2) discretionary.

When a plan document expressly provides that a trustee is subject to the directions of a named fiduciary who is not a trustee (or an investment manager) (pursuant to ERISA section 402(a)), that would be a "directed" trustee. Fidelity, as noted, is the directed trustee in *Tussey* holding in trust for safe-keeping the billion dollar-plus assets of the PRISM Plans. The Pension Review Committee of ABB, Inc. (PR Committee) is the named fiduciary of the PRISM Plans. The PR Committee gives directions to Fidelity Trust, but such directions must be prudent--that is, in accordance with the terms of the plan and not contrary to ERISA.

The other kind of trustee--not present in *Tussey*--is a "discretionary" trustee, which is named in a plan or trust document as "having exclusive authority and discretion over the management and control of plan assets" (i.e., a plan's menu of investment options). Although Fidelity Trust made available to the PR Committee a menu of investment options that we may assume was shaped largely (if not entirely) by Fidelity's overriding need to receive sufficient revenue-sharing payments, under ERISA (and under the Fidelity-drafted contracts with ABB) the PR Committee still retained the ultimate authority to select, monitor, and replace the investment options made available to participants in the PRISM Plans. Of course, as the named fiduciary of the PRISM Plans, the PR Committee had the option to delegate (in writing) its responsibilities and liabilities for selecting, monitoring, and replacing the investment options in the PRISM Plans to an ERISA section 3(38)-defined "investment manager." The PR Committee could have been relieved of such responsibilities and liabilities had it made such delegation (while retaining a continuing monitoring duty over the 3(38)).

As a directed trustee, Fidelity Trust has no discretionary authority to make decisions, only to follow prudent directions from a discretionary decision-maker. This central characteristic of many bundled retirement plans creates two problems for plan sponsors and plan participants (and their beneficiaries): (1) Fidelity doesn't ordinarily mitigate risk for plan fiduciaries, and (2) Fidelity is indifferent to making available to plan participants institutionally priced investment options.

While these two problems, as noted, significantly harm both plan fiduciaries and plan participants, reciprocally, they also significantly help Fidelity in maximizing the profits it generates in bundled retirement plans. Financial product providers can compound the first problem by sometimes implying (whether in oral and written communications in sales presentations to plan sponsors or in advertising costing millions of dollars) that they so mitigate risk for plan fiduciaries.

A Directed Trustee Doesn't Mitigate Risk for Plan Fiduciaries

Any unabashed capitalist seeks to minimize the risks that threaten its fundamental, underlying goal of generating maximum profits. One such risk for Fidelity in the retirement plan marketplace is if Fidelity were to provide fiduciaries of qualified retirement plans with legally meaningful risk mitigation. Fidelity doesn't ordinarily provide plan sponsors with such protection because to do so would pose an unacceptably large risk in realizing its full profit potential. There's absolutely nothing wrong with that business decision on the part of Fidelity in an ERISA legal sense.

But it can be wrong in a business sense when a financial product provider appears to imply otherwise: that it does provide legally meaningful risk mitigation. In such cases, such providers can sometimes create the impression in sales presentations made to plan sponsors that the providers will stand in fiduciary (or "co-fiduciary") solidarity with them to share in any liability when attorneys for plan participants come a-knockin'. This gives sponsors a warm fuzzy feeling that the provider "will be there to take care of us if we get into trouble." As a result, a sponsor's decision to retain a large and reputable plan service provider would appear to be a very easy one. (In a past version of this belief, it was often said: "No one was ever fired for doing business with IBM.")

That kind of feeling is a false one. In the first place, financial product providers are rarely sued because they make crystal clear in their contracts with plan sponsors that it is the sponsors--not the product providers--that are ultimately responsible and liable for the prudence of a plan's menu of investment options. Second, even when product providers are sued, they almost always escape any significant liability for the same reason because, after all, judges can read contracts, too. *Tussey* is a perfect illustration showing plan sponsors why product providers, in reality, "will not be there to take care of us."

An ERISA Investment Advisor Doesn't Mitigate Risk for Plan Fiduciaries
Fidelity Research is not, as noted, an ERISA section 3(21)(A)(ii) fiduciary (i.e., one rendering investment advice for a fee) in *Tussey*. But suppose it was. Even then, Fidelity Research couldn't claim that, as the investment advisor to ABB, it's providing legally meaningful risk mitigation to the ABB fiduciaries anymore than Fidelity Trust could claim that, as the directed trustee of the PRISM Plans, it's providing legally meaningful risk mitigation to the ABB fiduciaries. Even if both these Fidelity units in *Tussey* were ERISA fiduciaries (concerning the investment options in the PRISM Plans), neither would have any discretionary decision-making authority under the law of ERISA or under the terms of the Fidelity-ABB contracts. That lack of discretion renders them powerless to legally protect ABB fiduciaries.

The fiduciary responsibilities (and liabilities) of Fidelity Research--even if it were the investment advisor to ABB--are limited to providing only non-discretionary advice to ABB, such as the composition of the menu of investment options in the PRISM Plans. While Fidelity's giving of such advice might be helpful to ABB in a business sense, it's not binding on Fidelity in a legal sense. That's because a 3(21)(A)(ii) investment advisor is a non-discretionary "advice-giver" (i.e., one rendering investment advice for a fee) that can provide only legally nonbinding advice to a 3(21)(A)(i) discretionary "decision-maker" (i.e., one exercising any discretionary authority or control in the management of a plan or disposition of a plan's assets).

A Directed Trustee Is Indifferent to Providing Institutionally Priced Investment Options
As the directed trustee in *Tussey*, Fidelity Trust is indifferent to making available to plan participants institutionally priced investment options. On the contrary, because Fidelity is an unabashed capitalist seeking to maximize its profits (as in *Tussey*), ordinarily many (or even all) investment options made available by such service providers in their bundled plans are retail-priced that pay revenue-sharing.

Sometimes a directed trustee can wear a fiduciary hat and at other times a corporate hat. (This "two-hatted" doctrine is usually discussed in the context of a plan sponsor.) This allows a directed trustee to act as a fiduciary at times and at times as a non-fiduciary--often at the expense of plan sponsors and plan participants.

The essential problem facing many plan sponsors (and therefore plan participants) is that they have no idea which hat is being worn at what times. Judge Laughrey nails this critical issue beautifully in her opinion where she notes how, when Fidelity is discussing its recordkeeping fees, Fidelity isn't wearing its fiduciary hat but its corporate hat: "As a 'directed trustee,' Fidelity Trust wears the 'hat' of a fiduciary only when carrying out its delegated duties as the Plan trustee and recordkeeper...[But] Fidelity Trust did not act under the direction of the Trust Agreement when [it] communicated with [ABB officials] regarding a reduction in recordkeeping fees [which would be dependent] on the PRISM Plans' fund line-up. Thus, Fidelity Trust did not wear the fiduciary 'hat' in [those fee discussions]; [Fidelity] simply represented Fidelity Trust's own [corporate] interests in [the] discussions with [ABB officials]. *These interests were to increase Fidelity Trust's compensation for the recordkeeping and administrative services to the Plan*." (Emphasis added.)

Once it began negotiating its own recordkeeping fees in *Tussey*, Fidelity essentially morphed from an ERISA directed trustee for the PRISM Plans into a fiduciary for Fidelity's shareholders. Fidelity, of course, is legally permitted to profit from unbridled revenue-sharing when wearing its corporate hat, as it did in *Tussey*. Plan sponsors (and their advisors) must be particularly on guard in such situations, though, because many of them just assume that Fidelity is always wearing its fiduciary hat with their sole interests at heart.

This won't change with the new ERISA section 408(b)(2) regulations, either. As has always been the case under ERISA section 404(a)(1)(B), under section 408(b)(2) it is only a plan sponsor that has the duty to determine if the costs of the plan it sponsors are "reasonable." As of July 1, Fidelity (and other such providers) is under the obligation to disclose its fees and what services it provides in exchange for those fees. But Fidelity has no duty to determine if those fees are unreasonable, such as the excessive revenue-sharing that Judge Laughrey found in *Tussey*. On the contrary, Fidelity's only fiduciary duty (when negotiating its own recordkeeping fees with ABB, for example) is to its corporate shareholders to maximize profits, and the failure to carry out such a duty could be a breach of duty--vis-à-vis its own shareholders.

Summary

If the goals of a plan sponsor are to mitigate the risk of its fiduciaries and/or to offer plan participants institutionally priced investment options, *Tussey* shows that the sponsor may find it more difficult to achieve those goals with a product-driven bundled plan solution.

Particularly alert plan sponsors will readily see the value of effectively eliminating conflicts of interest by adopting a fiduciary-centric solution with an independent advisor in which fiduciary advisors (1) provide legally meaningful risk mitigation for plan fiduciaries and (2) provide plan participants with institutionally priced investment options.

Having real fiduciary skin in the game, such providers have an incentive to provide low-cost and broadly and deeply diversified investment options, the combined effect of which is to leave more money in the pockets of plan participants, thereby allowing them a better chance to achieve improved long-term compounding of wealth to generate enhanced retirement income. This fiduciary-centric solution will be described in next month's column.

Revenue Sharing on Trial

The answer to the complexity, inefficiency, and unnecessarily expensive practice of revenue-sharing so well exposed in Tussey v. ABB is to simply do away with revenue-sharing, writes W. Scott Simon of Prudent Investor Advisors.

W. Scott Simon, 05/03/2012

W. Scott Simon is a principal at Prudent Investor Advisors, a registered investment advisory firm. He also provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. Simon is the recipient of the 2012 Tamar Frankel Fiduciary of the Year Award.

I could just kiss Nanette Laughrey--chastely, of course, on the hand.

Laughrey is the federal judge for the Central Division of the Western District of Missouri who handed down her 81-page opinion in *Tussey, et al. v. ABB, Inc., et al.* on March 31. That opinion (rendered after a lengthy, four-week "bench" trial before a judge, not a jury) illustrates very clearly, among other things, the complex, inefficient, and unnecessarily expensive Rube Goldberg-like contraption that is revenue-sharing. This contraption in turn befuddles otherwise presumably intelligent employees at plan sponsors who are in charge of running 401(k) plans. The consequences of their ill-informed decision-making contribute directly to a less secure and comfortable retirement lifestyle for plan participants (and their beneficiaries).

About Revenue-Sharing

Every mutual fund bears an annual expense ratio, which is the "cost" that a mutual fund provider such as Fidelity charges an investor for the privilege of choosing to invest in any of that provider's proprietary funds.

In the context of a 401(k) plan, mutual funds are placed on a trading platform maintained by a record-keeper such as Fidelity Trust. That record-keeper as well as other service providers to a 401(k) plan must be paid for the services they provide, such as maintaining a system that participants can access to make changes to their contributions and investment options in a 401(k) plan.

"Revenue-sharing" is a way for these service providers to be paid for rendering such services. In *Tussey*, for example, Fidelity Trust negotiated revenue-sharing agreements with the different mutual fund companies that maintained funds on Fidelity Trust's platform. Those agreements allow the companies to "carve out" a certain portion (i.e., revenue-sharing) of a fund's annual expense ratio and pay it to Fidelity Trust in exchange for Fidelity Trust's services as the plan trustee and record-keeper.

The expense ratio of a mutual fund that pays revenue-sharing must be inflated to accommodate the extra fee paid to a service provider such as Fidelity Trust. The expense ratio of any fund is paid by a plan participant invested in that fund, so when they invest (unknowingly) in funds that pay revenue-sharing, that inflated fee going to pay a record-keeper and trustee will be paid (unknowingly) by plan participants. In *Tussey*, for example, plan participants unknowingly paid Fidelity Trust for record-keeping and trustee services whenever they invested in funds that paid revenue-sharing.

In many cases, then, it is plan participants that pay the administrative costs of a 401(k) plan (through an inflated expense ratio), not the plan sponsor. That's why some sponsors think that their 401(k) plans are "free" since plan participants also pay the part of an expense ratio related to investment costs. In such cases, the plan is free to the sponsor, but not to the participants.

The basic problem with revenue-sharing is that it is an inefficient and opaque way to compensate service providers. Its needless complexity leaves many plan sponsors unable to line up costs with the value of services so that they can prudently fulfill their fiduciary duty to determine the reasonableness of costs. In this way, revenue-sharing is like any other third-party payer system. In cases such as *Tussey*, revenue-sharing costs incurred by plan participants went unnoticed by the plan sponsor and therefore remained unknown, harming plan participants while generating an "unreasonable" profit for Fidelity. (The *Tussey* Court determined that Fidelity's profit was "unreasonable" to the extent that the revenue-sharing fees it received exceeded the value of the services provided by Fidelity.)

An even more fundamental problem with revenue-sharing is that it places plan sponsors in an untenable position. It essentially makes them hostage to a record-keeper that has already negotiated with various fund companies the amounts of revenue-sharing that will be paid by the mutual funds that the record-keeper "recommends" that a plan sponsor include on a plan's menu of investment options for investing by plan participants. As such, plan sponsors find themselves (usually unknowingly) playing second fiddle to the terms in contracts that have already been entered into by third parties: a record-keeper and the fund companies. The real underlying reason why revenue-sharing exists, of course, is so a plan's record-keeper can control as much as possible its own revenue stream regardless of any negative ERISA implications that may arise in cases such as in *Tussey*.

There's nothing illegal about revenue-sharing, even when it's not disclosed. When section 408(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) is implemented on July 1, plan sponsors will be able to see the amount of revenue-sharing for every fund on a plan's platform that pays it. But the number disclosed will be only a gross revenue-sharing number, not a number that's broken out and tied directly to the cost of each of the services being performed. So even then, plan sponsors will still have the duty to determine whether revenue-sharing payments are "reasonable" (pursuant to ERISA section 404(a)(1)(B)) in relation to the value of the services for which they're expended.

Plan Sponsors Don't Have to Engage in Revenue-Sharing

Revenue-sharing is seen by many plan sponsors and their advisors as something that's a permanent part of the retirement plan marketplace. In writing this month's column, I ran across an email that I wrote four years ago to my partners at Prudent Investor Advisors commenting on an article that I had just read. The article boasted that, after a fee study and analysis of a revenue-recapture program [involving revenue-sharing], a certain $1.6 billion retirement plan was able to realize a savings of $558,000. My comment: "That's significant? Nobody put 2+2 together to remind the plan's fiduciaries that it's a Fidelity bundled plan! No one bothered to tell the fiduciaries that YOU DON'T HAVE TO HAVE A PLAN THAT INCLUDES ANY REVENUE-SHARING IN THE FIRST PLACE! IT DOESN'T HAVE TO BE THAT WAY AT ALL! UNBELIEVABLE IGNORANCE!" (Emphasis in the original.)

The answer to the complexity, inefficiency, and unnecessarily expensive practice of revenue-sharing so well exposed in *Tussey* is to simply do away with revenue-sharing. As one prominent ERISA attorney noted in concluding his analysis of *Tussey*: "I would have [a] real question, going forward as a plan sponsor, as to whether it makes any sense at all to continue with revenue sharing. Better to just pay a fixed cost than to risk extensive liability for engaging in revenue sharing." Whoever said that attorneys cannot come to eminently sensible conclusions?

The Players in Tussey

Defendant ABB, Inc. ABB manufactures power and automation equipment. It sponsors a number of retirement plans to attract and retain employees that totaled $1.4 billion in assets in 2000. Two of these plans, the subject of the *Tussey* lawsuit, are the Personal Retirement Investment and Savings Management Plan and the Personal Retirement Investment and Savings Management Plan for Represented Employees (collectively, PRISM Plans), both 401(k) plans.

Plaintiff Ronald Tussey and others sued ABB, three ABB entities that were responsible in part for running the PRISM Plans, as well as an ABB employee on behalf of a class of present and former ABB employees who participated in the PRISM Plans for damages and injunctive relief. Tussey also sued Fidelity Management Trust Company (Fidelity Trust), the plans' record-keeper (which provided record-keeping services and other administrative services) and the "directed" trustee of the trust (which provided trustee and custodial services such as safe-keeping the assets of the plans), pursuant to direction by ABB. Tussey sued another Fidelity affiliate as well: Fidelity Management & Research Company (Fidelity Research), the investment advisor to the Fidelity mutual funds offered by the PRISM Plans.

The Background of the Tussey PRISM Plans

Fidelity Trust presented ABB with a recommended menu of investment options, which ABB accepted and then directed Fidelity Trust to make available to participants in the PRISM Plans on the Fidelity Trust trading platform. This kind of recommendation is non-discretionary advice. According to Fidelity (and other providers like it), the (legal) buck always stops with a plan sponsor. That is, a sponsor ultimately is solely legally responsible and liable for the selection, monitoring, and replacement of a 401(k) plan's investment options. That's why Fidelity (and other providers like it) is seldom even named as a defendant in lawsuits alleging excessive fees in a plan's investment options, or if it is named, it is not found liable.

In *Tussey*, participants directed Fidelity Trust to take their contributions and invest them as directed in designated mutual funds from the menu of investment options on the platform maintained by Fidelity Trust for the PRISM Plans. These options included Fidelity "proprietary" mutual funds provided by Fidelity Investments (yet a third Fidelity entity that, unlike Fidelity Trust and Fidelity Research, was not a defendant in *Tussey*) as well as "non-proprietary" (to Fidelity) funds provided by other fund companies.

Fidelity Trust became the record-keeper for the PRISM Plans beginning in 1995. At first, Fidelity Trust presented ABB with an invoice whose total was derived by multiplying a hard-dollar, per-participant fee by the number of plan participants. ABB paid for Fidelity Trust's record-keeping and trustee services in the 1990s. But eventually the costs for those services were paid by participants in the PRISM Plans who invested in funds that paid revenue-sharing.

Not all mutual funds on the platform maintained by Fidelity Trust for the PRISM Plans paid revenue-sharing. Any participant that invested in such funds paid no revenue-sharing. That means some participants paid more in revenue-sharing while others paid less, with some paying nothing. In addition, different funds paid different levels of revenue-sharing. So some participants in the PRISM Plans were subsidizing the costs of record-keeping and trustee services for other participants not invested in funds that paid revenue-sharing. That's not a level playing field, which leads to some participants getting free rides at the expense of others.

ABB Did Not Know How Much Revenue-Sharing Was Paid to Fidelity Trust

A significant problem for ABB in *Tussey* is that it had no idea how much revenue-sharing the fund companies were carving out of the funds' expense ratios and then paying to Fidelity Trust. Nor was any revenue-sharing being paid to Fidelity Trust explicitly reported in the fund's prospectus or disclosed as such to plan participants investing in any fund paying revenue-sharing.

Fidelity Trust received "external" revenue-sharing from both Fidelity and non-Fidelity funds, and internal revenue-sharing from Fidelity funds. This was all going on (with the exception of just one fund) without the knowledge of ABB. Defendant John W. Cutler Jr., the director of a PRISM Plans committee since 1999, didn't know that revenue-sharing was being paid to Fidelity Trust for each of the retail-priced mutual funds that constituted Fidelity's proprietary Freedom Funds. Nor did he know that Fidelity charged an additional fee on top of those revenue-sharing fees for its services in deciding how additional funds coming into the Freedom Funds would be allocated. Cutler remained unaware of this fee for nearly five years and became aware of it only when another plan sponsor told him about it.

ABB also had no knowledge of the "internal" revenue-sharing received by Fidelity Trust such as in the case of Fidelity's Magellan Fund: whenever participants in the PRISM Plans invested in the Fidelity Magellan Fund (one of the mutual funds on the Fidelity Trust platform), a set number of basis points was carved out and transferred internally from

Fidelity Research, which managed the Magellan Fund, to Fidelity Trust.

The Consequences of a 'Know-Nothing' ABB

ABB was a "Know-Nothing" concerning the amount of revenue-sharing fees that the participants in the PRISM Plans were paying to Fidelity, but Fidelity knew exactly the amount of those fees.

Fidelity Trust had no fiduciary duty to ABB, the PRISM Plans, or participants in the plans to utter a peep about the amount of revenue-sharing payments it received. When revenue-sharing was paid to compensate Fidelity Trust, its fee grew as the assets in the funds that provided revenue-sharing grew in value due to increased contributions and favorable markets--even though Fidelity Trust provided no additional services to the PRISM Plans.

On the flip side, when the assets in the funds that provided revenue-sharing declined, the amount of revenue-sharing paid to Fidelity for its services also declined. In times when the assets in the funds that paid revenue-sharing declined below a certain threshold, thereby threatening the amount of revenue-sharing required by Fidelity, Fidelity Trust would let out lots of peeps. At such times, Fidelity Trust demanded (as allowed by its contract with ABB) to be compensated by ABB with hard dollars to make up any shortfalls in its revenue-sharing payments.

So in *Tussey*, when markets went up in value, Fidelity received increased revenue-sharing payments, but when markets went down in value Fidelity received decreased revenue-sharing payments, but any shortfalls were made up by ABB in hard dollar payments to Fidelity. So heads, Fidelity wins; tails, ABB plan participants (and ABB) lose!

The Court's Findings and Assessment of Damages

The Court found that the ABB defendants breached certain fiduciary duties they owed to the PRISM Plans, including (1) failing to monitor the record-keeping costs earned by Fidelity Trust, (2) failing to negotiate rebates for the PRISM Plans from either Fidelity or other investment companies on the Fidelity Trust platform, (3) selecting more expensive share classes for funds on the Fidelity Trust platform when less expensive share classes were available, (4) improperly removing the Vanguard Wellington Fund (which paid 15 basis points in revenue-sharing) and replacing it with certain Fidelity Freedom Funds (which paid 35 basis points in revenue-sharing) and (5) paying Fidelity Trust an amount that exceeded market costs for services to the PRISM Plans in order to subsidize the corporate services provided to ABB by Fidelity Trust, such as ABB's payroll and record-keeping services for ABB's health and welfare plan and its defined benefit plan.

The Court also found that Fidelity Trust failed to distribute float income solely for the interest of the PRISM Plans and Fidelity Research transferred float income to the plans' investment options instead of to the plans themselves.

The Court determined that the PRISM Plans suffered total monetary damages of $36.9 million at the hands of the defendants: $13.4 million against ABB for its failure to monitor record-keeping costs and negotiate rebates, and $21.8 million for improper mapping of the Vanguard Wellington Fund to certain Fidelity Freedom Funds. The Court assessed monetary damages of $1.7 million against Fidelity for its breaches concerning float income.

The Court also provided injunctive (i.e., non-monetary) relief to the plan, including (1) requiring ABB to initiate a competitive bidding process (including a request for proposal) to select a new record-keeper within the 18-month period beginning on March 31, 2012 (with Fidelity being allowed to respond to the RFP), (2) requiring ABB to monitor the plans' record-keeping costs in accordance with ABB's duties of prudence (pursuant to ERISA section 404(a)(1)(B)) and loyalty (pursuant to ERISA section 404(a)(1)(A)), as well as its duty to follow all plan documents but only to the extent that they don't conflict with ERISA (pursuant to ERISA section 404(a)(1)(D)).

In my next column, I will analyze other issues raised by *Tussey*.

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to*

Understanding is the definitive work on modern prudent fiduciary investing.

Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner, and an Accredited Investment Fiduciary Analyst. Simon's certification as an AIFA qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals. For more information about Simon, please visitPrudent Investor Advisors, or you can e-mail him at wssimon@prudentllc.com

2 comments ★ 2

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George Cones • 11 months ago

Great information. Anyone who favors transparency should welcome this ruling. As long as plan participants (and plan sponsors) know what they paying, they can make a judgement as to the benefit of the service.

0 • Reply • Share ›

K415 • 11 months ago

A few nit-picky observations.

1. Revenue sharing is not always included in the funds' expense charges. My employer used an S&P 500 index fund in the lineup that published an expense charge that was slightly less than the 25bp of revenue sharing it paid. It was explained to me as being a sub-TA fee that doesn't show up in the published expense ratio.
2. Vanguard doesn't pay revenue sharing.
3. The main purpose of revenue sharing is to disquise service provider income. The new disclosure regulations will only make that worse, because it will be the only way to avoid giving a dollar amount on the total fees to participants. The participant will get a statement showing the dollar amount debited from his/her account and a statement that other fees reduced the NAV of the investments.

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Monday, December 10
4:00 p.m. ET | 3:00 p.m. CT

Using ETFs for Income
Aired on Tuesday, June 12

Archive

A Closer Look at the Fiduciary Governance Structure in Tussey v. ABB

How plan sponsors choose to delegate responsibilities can impact their degree of liability.
W. Scott Simon, 09/06/2012

W. Scott Simon is a principal at Prudent Investor Advisors, a registered investment advisory firm. He also provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. Simon is the recipient of the 2012 Tamar Frankel Fiduciary of the Year Award.

A reader of last month's column made some astute observations of my discussion about the fiduciary governance structure in Tussey v. ABB, Inc. This month's column will further that discussion hopefully. But first, here's a recap of the fiduciary governance structure in Tussey.

Tussey's Fiduciary Governance Structure

In Tussey, Federal district court judge Nanette Laughrey presided over a four-week bench trial in Missouri, and in late March issued an 81-page opinion. In the case, the plan sponsor (ABB, Inc.) of two defined contribution plans (PRISM Plans) appointed the pension review committee (PR Committee) as a 402(a) named fiduciary of the plans and delegated to it responsibility and liability for selecting, monitoring, and replacing the plan's investment options (i.e., doing the same things as a 3(38)). ABB also appointed the employee benefits committee (EB Committee) as the plan's 3(16) plan administrator and delegated to it the authority to oversee all employee benefits programs at ABB.

Judge Laughrey noted in her opinion: "Changes to the [PRISM Plans] investment line-up must be approved by the Employees Benefits Committee and ABB, Inc." I said in last month's column: "The word 'approved' here seems to imply that not only the EB Committee but also ABB, Inc. itself had veto power over any 'changes' made by the PR Committee in the plans' menu of investment options. If that's true, it would cancel out the discretionary authority delegated by ABB, Inc. to the PR Committee as a named fiduciary to select, monitor, and replace the investment options offered by the PRISM Plans. In turn, that would terminate whatever fiduciary protection the PR Committee had provided to the EB Committee and to ABB, Inc. concerning the investment options offered by the PRISM Plans. The effect of this would be for the EB Committee and ABB, Inc. to reassume fiduciary responsibility and liability instantly for the discretionary decision-making associated with the plans' investment options."

I then posed a "what-if?" question: What if changes made in the investment options by the PR Committee were not subject to veto by ABB and the EB Committee? Wouldn't that therefore mean that the delegation from ABB to the PR Committee to select, monitor, and replace the investment options would be valid? And wouldn't that, in turn, legally protect ABB and the EB Committee from liability for the PR Committee's decisions concerning the prudence of the investment options?

My answer to that what-if question was no. In my view, the better way to mitigate the risk of a plan sponsor's fiduciaries would be through the use of what I call a "fiduciary circuit-breaker." That is, rather than delegating selection/monitoring/replacing duties to the PR committee, give the PR committee the authority to hire an investment manager that would itself then select the menu of investment options. To me, that would seem to legally protect the delegating fiduciary such as a named fiduciary (an example of what I referred to as a fiduciary "higher-up") from potential liability for imprudent investment decisions made by the investment manager. It was this that I thought would serve as a "fiduciary circuit-breaker." If the PR committee had made the selections, though, the circuit-breaker would not be put in place and liability could lead all the way back up the chain of command to ABB's board of directors.

A Reader's Observations

Here, in part, are the observations made by the reader: "…I don't see any difference in liability protection between [ABB's board of directors (BOD)] appointing a 402(a) committee to select and monitor investments and the BOD's appointing a plan committee to pick a 3(38) manager. It seems that the liability protection for the plan sponsor--the circuit breaker--is not between the BOD and the plan committee, regardless what functions that plan committee performs, but arises from the selection of an external entity to serve as a 3(38) investment manager. If your liver has cancer, you have cancer. If your BOD committee is guilty, the sponsor is guilty."

My Reply

Here is my reply to the reader: I believe that we agree on everything I wrote in last month's column (including the value of a 3(38)) except for one (albeit significant) issue: whether plan fiduciaries gain an added legal benefit when a plan sponsor delegates to a plan committee the task of finding and vetting a 3(38) investment manager and, upon the committee successfully carrying out that task, the manager making the selecting/monitoring/replacing decisions.

You contend that this (purported) legal benefit doesn't exist because it's no different than when a plan sponsor delegates to a 402(a) named fiduciary the selecting/monitoring/replacing decisions. So in either event, you say that the responsibility and liability would still flow back up to the plan sponsor, thereby canceling any additional benefit.

I contend that the responsibility/liability is effectively cut off (i.e., the "fiduciary circuit-breaker" between the plan sponsor and the plan committee when the committee is appointed to find/vet a 3(38) only, thereby protecting the fiduciary "higher-ups."

These two different delegation scenarios can be diagrammed in the following way:

<u>Scenario 1: plan sponsor → 402(a) named fiduciary</u>

Here, the plan sponsor delegates to a named fiduciary responsibility for selecting/monitoring/replacing plan investment options. In making that delegation, the plan sponsor retains the responsibility/liability for selecting/monitoring/replacing investment options. Why? Because the plan sponsor would be responsible/liable for the failure of the named fiduciary to carry out what it had been delegated to do: prudently selecting/monitoring/replacing investment options.

Scenario 2: plan sponsor → plan committee → 3(38) investment manager
Here, the plan sponsor delegates to a plan committee responsibility to find and vet a prudent 3(38) investment manager. Once identified and vetted by the plan committee, the 3(38) would then become responsible/liable for selecting/monitoring/replacing investment options. In making that delegation, a fiduciary circuit-breaker kicks in to isolate the plan sponsor from the responsibility/liability for selecting/monitoring/replacing investment options. Why do I think that? Because the plan sponsor would only be responsible/liable for the failure of the committee to carry out what it had been delegated to do: prudently vetting and finding a 3(38).

In both scenarios, the responsibility and liability would indeed flow back up to the BOD but what would that actually be? In the first scenario, it seems to me, as noted, that the responsibility/liability would be for the failure of the named fiduciary to carry out what it had been delegated to do: prudently selecting/monitoring/replacing investment options. In the second scenario, it seems to me, as noted, that the responsibility/liability would be only for the failure of the plan committee to carry out what it had been delegated to do: prudently vetting and finding a 3(38).

In my mind, there's a significant difference between a fiduciary "higher-up" getting nailed legally for the failure of a delegatee to select, etc. prudent investment options and it getting nailed for the failure of a delegatee to find/vet a 3(38). In ERISA, liability follows accountability; you can be held liable for the duty which you have delegated. So when you say "If your BOD committee is guilty, the sponsor is guilty," I agree. But guilty of what? In scenario 1, the guilt on the part of fiduciary "higher-ups" is for the failure of the delegatee (a 402(a) named fiduciary) to select prudent investment options and in scenario 2, the guilt on the part of fiduciary "higher-ups" is for the failure of the delegatee (a plan committee) to find/vet a 3(38).

But I Could Be Wrong
It's always possible that I'm all wet in my thinking and that the reader is right. For example, I may have misinterpreted the fiduciary governance angle of this case from the get-go. When Judge Laughrey noted in her opinion that "Changes to the [PRISM Plans] investment line-up must be approved by the Employees Benefits Committee and ABB, Inc.," I assumed that fiduciary acts were involved (someone I once knew told me that sometimes when we assume, that makes an "a**" of "u" and "me"). But if, in fact, no fiduciary acts were involved--that is, the Employees Benefits Committee and ABB, Inc. simply wanted to distribute the workload but always wished to retain fiduciary control with no idea of delegating any fiduciary authority, well, then, this discussion largely would be moot. If the primary documents of the case were available, we might

be able to get a clear-cut answer as to what the plan fiduciaries meant by their need to "approve" changes in the plans' investment line-up.

I know of no cases dealing with this particular issue. In any event, perhaps the difference of view between the reader and me is not so great. He and I both agree on the significant protection provided by an investment manager pursuant to ERISA section 3(38). The only difference, then, seems to be in degree rather than in kind.

fi360.com (Blog post)

Court Finds a Neglected IPS can be Costly

Posted by Duane Thompson on April 19, 2012 in Legal

For most fiduciary practitioners who read this blog, the importance of maintaining and adhering to a sound investment policy statement is widely embraced as the guiding document from which other fiduciary responsibilities flow. At times, though, it is instructive to see how the courts reinforce the importance of this concept in a judicial review.

On March 31, in one of the few ERISA cases to reach trial on the reasonableness of investment management, recordkeeping, and administrative costs in a 401(k) plan, the U.S. District Court for the Western District of Missouri ruled that manufacturing company ABB Inc. breached its fiduciary duties by failing to monitor the fees it paid to Fidelity Management Trust Co. in addition to other fiduciary violations (Tussey v. ABB Inc., W.D. Mo., No. 2:06-CV-04305).

The case against ABB was one of 15 class action lawsuits filed by a St. Louis law firm and others in 2006 and 2007. Only two cases survived to reach trial, the others being dismissed or settled earlier in the process.

In Tussey, Judge Nanette K. Laughrey of the Missouri district court released an 81-page decision that at times included fairly scathing language, noting the court's "suspicions" that the relationship between plan sponsor and service provider "infected more than the specific instances" identified as fiduciary breaches. However, while awarding specific damages for losses and ill-gotten gains, the court stated it could not rely on suspicion alone in rejecting the plaintiffs' global damage theory. The facts of the case involved two 401(k) plans, one union and the other non-union, that in 2000 held more than $1.4 billion in plan assets. Fidelity not only provided recordkeeping and other administrative services to the plans, but through its investment affiliate, Fidelity Research, was determined by the court to be a plan fiduciary by managing plan assets through investment of initial cash contributions in various overnight securities. Over time, Fidelity also took over ABB's defined benefit plan, health benefits, and payroll services.

In 2000, without informing plan participants, the plans' investment committee took several steps that proved to be in conflict with its IPS and fatal to its legal defense. First, by switching from paying a hard-dollar, per-participant recordkeeping cost to a revenue-sharing offset from fund assets, and ignoring the actual change in recordkeeping costs over time, the court found that ABB caused the plans to pay excessive fees as well as failed to benchmark costs.

Based on expert witness testimony, the court found that the plans paid, on average, between $65 and $180 per participant during a six-year period when a reasonable fee would have been between $44 and $70. Part of the analysis was based on comparisons with the hard costs charged by the Texa$aver Plan to its participants. While not an ERISA plan, the court noted that the Texas plan also held over $1 billion in plan assets, and was therefore an appropriate yardstick for comparison.

Exacerbating ABB's due diligence problem were two other issues. First, in 2005 ABB hired Mercer, a pension consulting firm to review its administrative costs, but ignored Mercer's analysis that ABB was overpaying for recordkeeping services and that one of the plans was subsidizing other corporate services provided by Fidelity. Secondly, under the new payment arrangement, the court noted that as assets in the plan grew, so would Fidelity Trust's fees, although it did not provide any additional services to the plan. However, when the plan's assets declined, Fidelity Trust asked for hard dollars to make up the difference.

As a result, “ABB permitted Fidelity to take the revenue sharing to cover recordkeeping costs but this did not lower administrative costs,” the court said, noting that revenue sharing by itself was not imprudent.

Finally, the court pointed to the plain language of the IPS, which stated that, “at all times…rebates will be used to offset or reduce the cost of providing administrative services to plan participants” as further proof of ABB’s failure to comply with its fiduciary duty.

In another count of breach of fiduciary duty related to managing investments, the court found that ABB ignored its own process for de-selecting funds from its investment platform when it abruptly removed Vanguard’s Wellington Fund in 2000 for “deteriorating performance” and replaced it with Fidelity’s target-date Freedom Fund. The IPS required a review of a fund’s 3 to 5-year performance, and if there were five years of underperformance, the fund was supposed to be placed on a watch list and removed within six months. Wellington, in fact, had a “stellar” 70-year track record through 2000, and outperformed Morningstar’s benchmark by 400 basis points during the 3- to 5 year time period, the court said. And the Wellington Fund was never placed on a watch list prior to de-selection. In addition, when replacing Wellington with the Freedom Fund, ABB’s investment committee made only a cursory review of two other competing funds, which the court found suspicious.

Finally, the court found that ABB’s decision to use more costly shares of certain Fidelity funds with higher expense ratios ran contrary to the IPS objective of using a share class with the lowest expenses, violating ABB’s fiduciary duty of prudence.

In failing to monitor recordkeeping costs, the court found ABB liable for $13.4 million in lost fees to the plan, and $21.8 million lost by the plans in ‘mapping,’ or replacing, Wellington with the Freedom Fund.

Fidelity Trust was found in breach of its ERISA duties by retaining the ‘float,’ or interest on plan benefits by transferring the income to the investment options instead of directly to the plans, resulting in $1.7 million in lost float revenue.

The lengthy court opinion holds additional lessons in how a company failed to follow a prudent process in its investment decisions, in monitoring plan costs, and in the penalties involved in ignoring its own IPS. Although it did not find that ABB concealed its fiduciary breaches, the court seemed troubled by what it called a “conflicted relationship” with Fidelity.

Although the plaintiffs’ bar itself may have overreached, considering the larger proportion of cases dismissed by other courts, it seems likely that once DoL’s 408(b)(2) disclosure rule of service providers’ costs goes into effect this summer, plan sponsors who ignore the issues raised in Tussey will do so at their own peril.

- See more at: http://www.fi360.com/blog/post/court-finds-a-neglected-ips-can-be-costly#sthash.cJ0T2nvY.dpuf mercifully, I think for all concerned.

- - -

CROSS-EXAMINATION

By Mr. Ortelere:

Q. Refresh my recollection, Mr. Otto, I think you described earlier an article you wrote. Was it entitled "Peeling the Onion," peel the onion, something to that effect?

A. "Peeling the Onion on 401(k) Expenses."

Q. I gather in the context of this dispute what you mean is when you're dealing with a bundled provider, sort of peeling that onion to look at in isolation record keeping; is that correct?

A. Peeling the onion means looking at the individual expenses in the plan as opposed to just the overall expense ratio.

Q. And would that include record keeping as one example?

A. It would definitely include record keeping and administration.

Q. Now, during your direct examination, you cited from time to time ERISA; is that correct?

A. Yes.

Q. And it's cited in your report?

A. Yes.

Q. Now, I also heard you cite to the Department of Labor from time to time; is that correct?

A. Yes.
Q. And I even heard the IRS come up for good measure; is that right?
A. Yes.
Q. That's all I'm going to ask on that front, sir. Now, you do, and we discussed this in your deposition, you do understand that the Department of Labor's views will inform the interpretation given the statute; is that correct?
A. Ask the question again, I'm sorry.
Q. Well, you would admit, wouldn't you, sir, that what the Department of Labor -- the Department of Labor's views will inform the governing law in this area; is that correct?
A. I believe that that statement is correct, yes.
Q. Well, and we had this exchange in your deposition, do you remember?
A. We did.
Q. And by the way, did you read your deposition in preparation for the trial?
A. I did.
Q. So -- and we talked about that, didn't we?
A. Yes.
Q. And we talked about the commentary to the different regulations and proposed regulations from the Department of Labor. Do you remember that testimony, sir?
A. I remember the discussion.

Q. And I think I put before you some commentary from some proposed regs, and I think on more than one occasion you said you weren't about to disagree with the Department of Labor. Do you remember that testimony, sir?

A. No, I don't remember saying that, but, you know, if that's what I said, then certainly disagreeing with the Department of Labor is not something that I want to do in general.

Q. Let me know if there's a specific instance, I suppose, where you're going to disagree with the Department of Labor and I'll move things along.

Now, you understand the Department of Labor has begun to weigh in on many of these issues; isn't that correct, sir?

A. Yes.

Q. Do you follow the regulatory initiatives in this area?

A. Yes.

Q. December 13, 2007. By the way, Mr. Otto, again, I heard you to say I think that you'd been following the work of the Department of Labor in this area. Did I hear you correctly, sir?

A. I have been following it.

Q. So generally speaking, what is this document?

A. This is a, this is the proposed fee disclosure rule for Section 408(b)(2) from 2007.

MR. SCHLICHTER: Your Honor, at this point I don't see how a proposed DOL regulation has any relevance, I object.

MR. ORTELERE: Your Honor, we're going -- I'm going to be brief.

THE COURT: I don't care if it's brief or not. One of my concerns here is it's proposed. Are we going to look at a lot of proposed rules? I know we've had proposed legislation too.

MR. ORTELERE: What we're looking at is the comments where the DOL talks about the existing framework which I think the court would find useful in assessing the standards here. And that's covered specifically in their commentary.

Maybe I could lay a little foundation for the court, Your Honor. I'll put this to one side for one moment.

BY MR. ORTELERE:

Q. Let's take a look at your report, sir. Could we pull up Mr. Otto's report? Thank you. Why don't we hop to the third page. And if, Brian, if you could, first paragraph 4, could you highlight that?

Now, again, this is your report, right, sir?

A. Yes.

Q. And why don't you read to the judge, what did you say there in paragraph 4?

A. It says, (quoted as read) "In this expert report I've reviewed the information that was supplied by the defendants.

I based my work on the appropriate Global Fiduciary Standards of Care as set out by the Center For Fiduciary Studies."

Q. Why don't we hop to the footnote there at the bottom. And if you blow that up, that would be great. Why don't you read that, sir?

A. (Quoted as read.) "The Global Fiduciary Standards of Care are an ISO 9000 type set of practices addressing the ethical and procedural requirements of fiduciaries. In addition, I refer throughout my analysis to <u>Prudent Practices For Investment Stewards</u> written by Fiduciary 360."

Q. So there's a book that you cite there in the footnote, correct?

A. Correct.

Q. And you referred to it throughout your analysis; that's correct?

A. Yes.

Q. And your analysis is the report that you've given in this case; isn't that correct?

A. Yes.

Q. Do you recall our exchange on the book at your deposition, sir?

A. I do recall discussion about the book.

Q. Do you recall saying it provides great guidelines on fiduciary prudence? Do you remember that testimony?

A. I don't remember those exact words, but the -- it does.

Q. Okay. So we agree on that.
A. Yes.
Q. Great guidance. Now, you said further in response to a question I asked you that the book helps you to form the standards that you applied in this case; is that correct?
A. The book -- it is a fiduciary guideline. So I don't know if that answers your question, but it's a guideline for fiduciaries.
Q. And, Brian, would you pull up from the deposition pages 308 and 309? At the bottom there, question by Mr. Ortelere.
Sir, again, you recall having your deposition taken in this case?
A. I do.
Q. In fact, it was taken twice.
A. Yes.
Q. And as this document I think clearly reflects, I asked you some questions that day, correct?
A. You did.
Q. And you were under oath, correct?
A. Yes.
Q. And swore to tell the truth; is that correct?
A. Yes.
Q. Let me just read something to you, and then I'll ask some follow-up. At the bottom of page 308.
(Quoted as read.) "Question: But -- but this is

helpful to you in forming the standards that you describe in your opinion governing the fiduciary's conduct here in administering the ABB plan; is that correct?"

Mr. Doles objects and the answer is yes. Was that your testimony on that date, sir?

A. Yes.

Q. Let's, Brian, pull up the book. Without going -- you're familiar with the book, correct, sir?

A. I am.

Q. This is great guidance for fiduciaries, right?

A. Yes.

Q. Do you refer to this often in your work?

A. I do.

Q. And you're well familiar with its content; is that correct?

A. I've read through it a few times.

Q. Now, without going from -- well, it describes something called legal substantiation; is that correct?

A. That is in there, yes.

Q. Tell me, what does it mean by legal substantiation? This is the authority upon which your great book relies; is that correct?

A. Well, I believe for each of the practices it provides supporting legal documentation for practice.

Q. And that includes all sorts of DOL materials; isn't

that correct?
A. There's all kind of materials, yes.
Q. Including the Department of Labor?
A. Yes. But mainly, as I recall, mainly ERISA and the code, but it refers to other things.
Q. Well, it includes interpretive bulletins of the Department of Labor; is that correct?
A. It does.
Q. Well, why don't we talk about the book while we're here. And we'll circle back to the DOL in a moment. Now, this is the book, great guidance, in your words, for fiduciaries, correct?
A. That's what I had said, yes.
Q. And I think as we just read from your deposition, quite helpful in forming the standards that apply here; is that correct?
A. Yes.
Q. So these materials would be helpful to the court; is that correct?
A. I don't know that I can answer that question.
Q. But you did cite it in footnote 1 of your report, correct?
A. I cited it, yes.
Q. And you called it great guidance, correct? But you don't presume to know if the judge should look at it; is that

what you're telling me?

A. Well, it's not my job to presume that.

Q. Fair enough. It includes a set of standards, doesn't it?

A. It does.

Q. Standards for fiduciaries?

A. Yes.

Q. And standards for fiduciaries administering participant directed defined contribution plans; is that correct? Well, you cited it in your report for this case, sir, I didn't think that was a real leap.

A. Okay.

Q. Why don't we, we'll just run through some of the standards. Is that okay with you?

A. Sure.

Q. All right. Page 23.

A. What's it titled?

Q. S-2.1 and I know it's blurry. Over on the right there's a standard of criteria 2.1.3. Could you read that to the court, please?

A. (Quoted as read.) "In the case of a defined contribution retirement plan, the investment options must address the range of participant time horizons."

Q. So in other words, in tailoring the investments for a defined contribution plan, a prudent fiduciary will take into

account participant ages; is that correct?
A. Yes.
Q. Why don't we hop to page 27, Brian. Over on the right-hand side, the criteria, again -- and I think this is of a -- there's a similar sentiment set out here on 2.4.1 on the right, Brian, you've got it. Read that to the court.
A. (Quoted as read.) "2.4.1, assets are appropriately diversified to conform to the specified time horizon and risk-return profile."
Q. Now, in the context of a defined contribution plan, whose risk-return profile is considered there?
A. The participants'.
Q. And, again, that time horizon speaks to their ages or proximity to retirement, correct?
A. It would.
Q. Okay. And these are important considerations for fiduciaries who are structuring the investment lineup in a defined contribution pension plan like the PRISM Plan, right?
A. Profit sharing plan, yeah.
Q. I'm sorry. I asked about the PRISM Plan.
A. The PRISM Plan.
Q. I don't know where the profit sharing part came from.
A. The PRISM Plan.
Q. Why don't we hop right below it there, Brian, to 2.4.2. Why don't you read that for the Judge.

A. 2.4.2?
Q. Yes.
A. (Quoted as read.) "For participant directed plans, selected asset classes provide each participant the ability to diversify their portfolio appropriately, given their time horizon and risk-return profile."
Q. So if I'm following this, and correct me if I'm wrong, sir, the determination of the appropriate asset classes looks to the needs of the individual participants; is that correct?
A. I think if you're looking to the plan it looks to the needs of the participants as a group. You're looking at the demographics.
Q. It would vary; is that correct?
A. It would vary, yes.
Q. And, again, age being one factor that can vary among individual participants?
A. Age would vary between different participants.
Q. And a prudent fiduciary makes accommodation in offering a prudent investment lineup, recognizing differences in age, correct?
A. Yes.
Q. What about differences in investment sophistication, should a prudent fiduciary take that into account when determining an appropriate lineup?
A. I think that's an appropriate thing to address, yes.

Q. Why don't we just turn to page 28. Okay. There at the top, Brian, first paragraph beginning there is no formula, maybe you could just highlight the first sentence for me. Thank you.

Would you, looking again to the great guidance book, can you read to us the first sentence that's been highlighted there on the screen?

A. (Quoted as read.) "There is no formula the investment steward can follow to determine the best number of asset classes. The appropriate number is determined by facts and circumstances."

Q. Why don't we hop to the next page, Brian, 29. At the very bottom, there's a paragraph beginning with the steward. Again, looking to the book cited in footnote 1 of your report, sir, would you please read, it looks like three sentences to me. Could you read those sentences?

A. Just the last paragraph?

Q. I think that's the last paragraph beginning with the steward and ending with strategy.

A. (Quoted as read.) "The steward should investigate the qualities, characteristics, and merits of each investment manager and identify the role each plays in the implementation of the investment strategy. However, such an investigation and the related analysis cannot be conducted in a vacuum. It must be within the context of the needs of the investment strategy.

Once the needs have been defined and the general strategies developed, specific investment managers should be chosen within the context of this strategy."

Q. Page 34, please? Let me just pause, Mr. Otto. What is this page at the top there in bold entitled?

A. Implement.

Q. The bold face language directly beneath what you just read beginning with the investment, what does that say?

A. (Quoted as read.) "The investment strategy is implemented in compliance with the required level of prudence," that's the practice.

Q. So this page sets out prudent considerations for a fiduciary when making investment decisions; is that correct?

A. Yes.

Q. Can we hop down, Brian, to paragraph 7, expense ratios, fees? And then, yeah, you've got it.

Let's be clear. These are fields of due diligence that would suggest to me, due diligence in the conduct of a reasonable fiduciary making prudent investment decisions would consider this criteria; is that correct?

A. They could.

Q. Could or should?

A. They could.

Q. Well, this is your great guidance book. Are you saying suddenly that this criteria does not apply, sir?

A. I'm saying I might be more restrictive.
Q. Let's take a look at some of the particular categories and we'll just read them into the record. How is that?
A. Okay.
Q. Okay. Paragraph 7 there, expense ratios, fees, do you see why where I am?
A. I see where you are.
Q. There's been much discussion in this trial about expense ratios. Those are the figures reported in the prospectus, correct, which are applied to an investment to determine the net return; is that correct?
A. They're in the prospectus, yes.
Q. And did I do a halfway decent job of explaining the expense ratio?
A. Close.
Q. Something you want to add?
A. No.
Q. What's it say there? And, Brian, it's a little fuzzy on the right. Maybe you could blow that up a little more. Now we're in the -- there you go.
The suggested fields of due diligence. Could you read that for me?
A. (Quoted as read.) "Fees should not be in the bottom quartile (most expensive) of the peer group."
Q. So the book includes a benchmark for expense ratios; is

that correct? That's a yes or no question, sir.

A. It does.

Q. Okay. Let's go down to paragraph 9. Why don't you read for the court, what is paragraph 9, the language on the left?

A. Performance relative to a peer group.

Q. I take it this suggests guidance on how to monitor the performance of an investment; is that correct?

A. It does.

Q. Okay. Would you read just to the right there the next, I guess that's a sentence?

A. (Quoted as read.) "Each investment option's performance should be evaluated against the peer group's median manager return for one, three, and five-year cumulative periods."

Q. Can we look at page 40, please? All right. On the right-hand side, the second paragraph, it is important. Do you see where I am?

A. I do.

Q. Okay. Could you read that sentence, parenthetical included, beginning with it is important and ending with occasions? Do you see where I am, sir?

A. Yes. (Quoted as read.) "It is important for the steward to be familiar with the universe of available investment options (mutual funds, ETFs, and separate account managers to illustrate the more common vehicles), for no one implementation structure is right for all occasions."

Q. Sounds like you ended with an appropriate flourish, sir. It does say for no one implementation structure is right for all occasions, correct?

A. I believe that's what I read.

Q. By the way, it describes mutual funds as common vehicles in this context, correct? It does say that.

A. Yes.

Q. Okay. Now, let's pause for a minute and study over on the left-hand side under criteria. 3.3.3.

A. Okay.

Q. Are you with me?

A. I'm there.

Q. Can you please read that sentence there, 3.3.3?

A. (Quoted as read.) "Regulated investment options are selected over unregulated investment" -- excuse me -- "unregulated options when comparable risk and return characteristics are projected."

Q. So this criteria says, all things being equal, when making an investment choice, a prudent fiduciary picks the regulated investment option over the unregulated option. Isn't that what it says, sir?

A. That's what it says.

Q. Now, let's go to 3.3.4. Are you with me?

A. Uh-huh.

Q. Would you please read that into the record?

A. (Quoted as read.) "Investment options that are covered by readily available data sources are selected over similar alternatives for which limited coverage is available."

Q. Let's turn to page 43. Let me look at that for a minute. 3.3.4. So the book, the book in footnote 1 of your report, the great guidance suggests that investment options that afford participants the opportunity to gain information over their investments are preferable to those that don't offer that same amount of information. Isn't that what that says, sir?

A. It says that investment options that are, that have readily available data sources are, should be selected over ones that have limited coverage.

Q. Page 43, please. There at the bottom on the left -- sorry, sorry, Brian. Left-hand side at the bottom. Why don't you, that last paragraph, beginning with -- the next paragraph, Brian, there often. Maybe could slide that up a bit.

Why don't you read that, please.

A. (Quoted as read.) "There often will be times when an investment manager is beginning to exhibit shortfalls in the defined performance objectives, but, in the opinion of the steward, does not warrant termination. In such situations, the steward should establish in the IPS specific watch list procedures. The decision to retain or terminate a manager cannot be made by a formula. It is the steward's confidence in the investment manager's ability to perform in the future that ultimately determines the retention of the investment manager."

Q. Let me back up to the next to the last line, the decision to retain or terminate a manager cannot be made by a formula. That's what it says, right?

A. That's what it says.

Q. That suggests that discretion plays a part here in determining when to terminate an investment option; isn't that correct?

A. You can't make it by a formula. It's a management function, not a legislative function, yes.

Q. It's discretionary, right, discretion informs the judgment call; isn't that what it says?

A. Okay.

Q. And it also says that having a watch list is a prudent practice, correct?

A. It does mention watch list, yes. And to have procedures.

THE COURT: All right. That's a good place to stop for the evening. It's 5 o'clock. I am continuing to look at this issue of whether or not Fidelity can use the deposition from the other case to impeach the witness, so I just wanted to bring that to your attention that I am still considering that issue.

MR. BOYLE: We're going to have some authorities for you.

THE COURT: All right. Thank you. Court is in recess.

(Trial adjourned for the evening at 5 p.m.)

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CERTIFICATE

I certify that the foregoing VOLUME VI (PAGES 1211-1459) is a correct transcript from the record of proceedings in the above-entitled matter.

FEBRUARY 24, 2010

/s/____________________________
Kathleen M. Wirt, RDR, CRR
U.S. Court Reporter

JANUARY 13, 2010

- - -

THE COURT: I need the witness sworn in again.

- - -

ALBERT OTTO,

being first duly sworn by the courtroom deputy, testified further as follows:

MR. ORTELERE: Your Honor, before I resume the cross-examination of Mr. Otto, I think Mr. Boyle would like to address the court.

MR. BOYLE: Your Honor, the night shift generated some authorities on a couple of --

THE COURT: Far too many people.

MR. BOYLE: A couple of issues. One of them is with respect to deposition of David Lail, and the other is with respect to an issue we earlier discussed, admissibility of material relied upon by experts which would separately be inadmissible as a substantive matter.

And I think the course of action particularly with regard to the Lail issue is to go ahead and file these things ECF and let plaintiffs respond because there are a couple of I think interesting issues --

THE COURT: No doubt.

MR. BOYLE: -- the court is going to want to tend to. So I don't want to make a practice of kicking the can down the road, but I think that makes the most sense. I have courtesy copies here.

THE COURT: Obviously, if it's entered substantively, there's no timing issue. If it's not entered substantively, is there a timing issue? The witness will be gone.

MR. BOYLE: I'm happy to go through the additional examination I contemplated for impeachment purposes today. We had also intended to rely on the Lail deposition in our case in chief substantively. So we have two different purposes for the deposition, and we're happy to proceed as the court directs in that regard.

THE COURT: What I'm saying is that if you want to go into his deposition, the content of the deposition beyond what you have already gone into, then it would require me ruling on the issue concerning the impeachment; isn't that correct?

MR. BOYLE: If we wanted to go through what I had contemplated for Mr. Otto, that's correct.

THE COURT: And so how could we wait for the plaintiff to respond in writing?

MR. BOYLE: We could talk about that right now. The issue, I'm afraid I may have put the court off in a direction I didn't intend with regard to the use of the word impeachment. It's really an FRE 705 issue, cross-examination of the expert on the basis of materials the expert has reported to rely upon in forming their opinion. That's really the nature of the impeachment piece that I had contemplated. I could hand the brief out now and we could have a brief discussion a little bit later this morning.

THE COURT: That would be a good idea, and then everybody will have access to the briefing. Because otherwise I don't see any practical way that the plaintiff is going to respond in writing in time for me to rule on the issue in time for this witness to be examined.

MR. SCHLICHTER: Your Honor, we don't have a second shift, it's just the same shift day and night for us. But we do have something that we prepared in anticipation but would like to see, obviously, what it is they have. And I understand how the court is approaching it, and I don't have any issue with that.

THE COURT: At some point before we finish with this witness, I would like to resolve this evidentiary issue, this one. This one I need the night shift to look at.

MR. SCHLICHTER: And also, Your Honor, another cleanup item. We are furnishing the corrected numbers on that Al Otto's, Mr. Otto's exhibit yesterday from the one year that started out in his report with the part of the year '07, he made it the full year. There was a mistake on it, which I think we understand why it was made.

We've simply gone back on the report to the portion of the year of '07 that is in his report, so we're furnishing that document to the defendants this morning with the same information that's on the exhibit to his report, so that there's no question about it. And we have not extended it last quarter of the year, we've simply left it at the three quarters point in the year '07, as it is in his report.

THE COURT: Okay.

MR. ORTELERE: I think Mr. Boyle can comment on that, that being part of his examination.

MR. BOYLE: This does match what is in the original report.

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RESUMED CROSS-EXAMINATION

By Mr. Ortelere:

Q. Good morning, Mr. Otto, good to see you again.

A. Good morning.

Q. Okay. Sir, picking up where we left off, Brian, could you bring back up the book? Again, your words, sir, from your deposition, this book provides great guidance for fiduciaries, correct?

A. Yes.

Q. Just for ease of reference for today, can we call it the great book to avoid confusion? I don't want to have to say <u>Prudent Practices For Investment Stewards</u>. So do we have an agreement?

A. Your words.

Q. But there would be no misunderstanding, correct? You'll know what I'm referring to, correct?

A. You're referring to the Prudent Practices for Investment Stewards.

Q. Did you go back and read it last night?

A. I did not.

Q. Now, again, this was put together by an organization called Fiduciary 360, correct?

A. Yes.

Q. And I take it you believe they promulgate reliable materials, correct?

A. I do.

Q. Now, Brian -- my Brian, could you highlight the lower third, I'll call it? There you go. Okay.

So Fiduciary 360, what is Fiduciary 360, by the way?

A. It is an organization that provides designations for professionals in the investment world. They also have a software company. They provide analytical software for analyzing investments based on investment criteria.

Q. Maybe for clarification, the book includes standards, correct?

A. It does.

Q. Okay. Now, looking at your -- do you have your report

handy? I can get you a copy.
A. It's right here.
Q. Let's flip back to footnote 1.
A. Yes.
Q. Now, you say there, (quoted as read) "The Global Fiduciary Standards of Care are an ISO 9000 type set of practices." What's an ISO 9000 type set of practices?
A. It's an international standard. It's common mainly in, well, manufacturing, technology, industry. It's a way of standardizing processes so that companies, organizations can communicate globally.
Q. Bless you. And, again, you say, I refer to these standards throughout my analysis, correct?
A. Yes.
Q. Back to the cover of the book, lower third. Now, it says further technical review by American Institute of Certified Public Accountants. Do you see where I am?
A. I do.
Q. So I take it, and it appears on the cover, that that's, that additional technical review beyond what Fiduciary 360 provided, that's a reason, that additional review, that a fiduciary can have a certain comfort level when turning to these standards, correct?
A. I think that's helpful, yes.
Q. Now, it goes further. We touched on this briefly

yesterday, but I want to drill down a little bit more. Legal substantiations by Reish, Luftman, Reicher, and Cohen. Is that what the cover of the great book says?

A. Yes.

Q. Now, again, it's on the cover. That's another reason that a fiduciary can have some level of confidence in this work product, in the great book, correct?

A. Yes.

Q. Page 51, please, of the book. Highlight, if you would, Brian, the top paragraph. Would you just read, please, the first sentence from that page of the great book?

A. (Quoted as read.) "The practices identified in this handbook prescribe a timeless and flexible process for the successful management of investment decisions."

Q. So the process is flexible, the one set out in the book, right?

A. Yes.

Q. Could you highlight the second sentence, please, Brian? Could you just read that for the court, please?

A. (Quoted as read.) "Once familiar with the practices, the investment steward will understand that no new investment product or technique is good or bad, per se, nor will it be valuable simply because it worked for other fiduciaries."

Q. Could we please skip, Brian, to page 49. Above the word substantiation, please highlight the two paragraphs. The first one begins with in the case of and the second one with however.

Okay. Why don't you, Mr. Otto, read the first sentence, please.

A. Beginning with in the case?

Q. Yes, please, the one sentence.

A. (Quoted as read.) "In the case of defined contribution plans, it is customary to offer investment options that carry fees that often are used to offset the plan's record keeping and administrative costs."

Q. Okay. And I thought there was a comma there. Please read the next sentence in that paragraph.

A. (Quoted as read.) "For a plan with few assets, such an arrangement may be beneficial for the participants."

Q. That's talking about revenue sharing, right?

A. It appears to be, yes.

Q. I mean, is there -- there's no debate, right? That is talking about revenue sharing, right?

A. Yes.

Q. Okay. By the way, sir, let me get out the data. When you put together -- and refresh my recollection, in 2003, if I understood your testimony, you looked at some data points to create your limits of reasonableness. Is that correct? Or it's based on data that you collected in 2003; is that correct?

A. 2003, as well as my experience prior.

Q. Well, let's zero in on some of that data, if you don't mind. Now, again, you're very familiar with your deposition, correct?

A. I've read my deposition.

Q. Okay. So the vendor searches that inform that 2003 calculation, that's an expression that you use liberally in your deposition; is that correct?

A. Vendor search, yes.

Q. And from those conversations or searches came data which you embedded into your limits of reasonableness chart; is that correct?

A. Conversations and searches.

Q. We'll get to the conversations in a minute, if you don't mind. Let's stick with what you call vendor searches. There were vendor searches that informed your analysis in creating the limits of reasonableness chart; is that correct?

A. They affect my numbers, yes.

Q. Correct me if I'm wrong. There were four vendor searches in 2003 that you assimilated into your analysis that spawned, in turn, the limits of reasonableness chart; is that correct?

A. We talked about four, yes.

Q. Okay. Now, one was a law firm with 1200 to 1300 participants, correct?

A. Yes.

Q. One was a technology firm which I think you testified had about 1400 participants, correct?
A. That's what I recall.
Q. There was some other manufacturing enterprise that I think you said in your deposition had 1600 employees, correct?
A. Yes.
Q. Okay. And there was some other recycling venture, I think you called it, with 4,000 employees, correct?
A. Yes.
Q. And those, those sized plans informed your analysis which in turn spawned the limits of reasonableness chart; is that correct?
A. Yes.
Q. Among other things. I'm just drilling down on those four data points.
A. Part of it, yes.
Q. And there was experience, you call it post-2003 that was baked into your calculation, correct?
A. Well, experience is pre- and post-2003.
Q. Fair enough. But when we speak to experience, I just want to be clear: We're not talking about the vendor searches, are we?
A. Well, vendor searches are certainly part of my experience.
Q. Just for ease of reference in your testimony so we can

put on the shelf the four vendor searches, there's additional experience which are not vendor searches which inform your calculation; isn't that correct?

A. Yes.

Q. Okay. All right. Why don't you read the next paragraph, please.

A. (Quoted as read.) "However, as the assets grow, the investment steward should periodically determine whether it is more advantageous to pay for record keeping and administrative costs on an a la carte basis and switch to mutual funds that have a lower expense ratio in order to reduce the overall expenses of the investment program."

Q. To be clear, sir, and the point is made elsewhere in the document, but from the great book, mutual funds are an appropriate investment for 401 defined contribution plans; isn't that correct? It says it right there in that sentence, doesn't it?

A. I think what it's referring to, it's assuming that if one is using mutual funds, you want to use the lowest expense ratio mutual fund in the --

Q. But that wasn't my question, was it? I just asked you does it refer to mutual funds. Let me back up. It refers to mutual funds in that sentence, doesn't it?

A. Yes.

Q. Okay. So it's a fair assumption, a safe bet when considered next to the things we looked at yesterday that mutual funds are a perfectly acceptable investment alternative for defined contribution 401(k) plans; isn't that correct?

A. I think it's a function of facts and circumstances for the specific case. Mutual funds fit in certain cases and they may not fit in others.

Q. But they can fit, right? You just said that, depending upon the facts and circumstances, they can fit, right?

A. Depending upon the facts and circumstances, I think, yes, mutual funds can fit just like collective trusts or separately managed accounts.

Q. Although the book -- and do we need to go back again -- says all things being equal, you should go with the regulated investment. Doesn't it say that? Should we look at it again?

A. No, it said that --

Q. Let's back up, if you would, to page 13. Legal counsel's editorial statement. I'm sorry, sir, I'll give you a moment to catch up.

Now, I take it legal counsel as referred to in the larger font, that must be the, pardon me, Reish Luftman firm described on page 1, correct?

A. Reish Luftman.

Q. I'm sorry, is that how that's --

A. I believe that's how it's pronounced.

Q. I mean them no disrespect. Brian, third paragraph, would you just highlight the first line. So I apologize if I just asked this question, it's been a long night. This editorial statement is the statement from the firm described on the front page, right?

A. That's my understanding, yes.

Q. Now, they say there, tell me if I read this wrong, (quoted as read) "The scope of this handbook does not address financial actuarial and/or record keeping issues." Did I read that correctly?

A. That's what I read, as well.

Q. But once again, the book does describe a standard for benchmarking expense ratios, right?

A. It does describe, it does discuss monitoring fees on an ongoing basis, yes.

Q. Well, just to be absolutely clear, could we go back to page 34, Brian? Paragraph 7 in the chart? There's a standard set forth there in paragraph 7, correct, Mr. Otto?

A. Yes.

Q. Okay. And that standard relates to expense ratios and fees, correct?

A. It's actually -- you're using the term standard. It says threshold defined by fi360. I don't take that to mean necessarily standard, it's a minimum threshold.

Q. All right. I'll make the question simpler. There in paragraph 7 it says expense ratios/fees, correct?

A. Yes.
Q. By the way, do you see criteria up in the left there, top left, 3.1.1, do you see where I am?
A. I do.
Q. Okay. It says, correct me if I'm wrong, a due diligence procedure for selecting investment options exists. It's what it says, right?
A. Yes.
Q. Okay. Then the document goes out and suggests steps to discharge that due diligence standard, correct?
A. Yes.
Q. Okay. Now, let's go back to paragraph 7. We're still there. Would you read for me, what does it say about the fee standard set out there in paragraph 7? Read those words to me, please.
A. Under the column threshold defined by fi360, is that what you're asking?
Q. Yes, it's on the screen on the right.
A. (Quoted as read.) "Fees should not be in the bottom quartile, most expensive of the peer group."
Q. Now, in your report, you didn't analyze the --
THE COURT: For my clarification, fi360, what does it mean?
MR. ORTELERE: You can ask the witness. I think he's referring to the authors of the book, but --

BY MR. ORTELERE:
Q. What do you mean by fi360?
A. Fi360 is Fiduciary 360. It's an acronym that they use as their logo.
Q. And they're the -- again, they're on the cover, right, that's the author.
A. Yes.
Q. Now, sir, in your report, did you analyze the expense ratios in the lineup investments in the PRISM Plan under the standard set forth in the great book?
A. I analyzed the investment expense -- or the expense ratios based on my understanding of what is prudent.
Q. So the answer to my question is you didn't apply the standard in the great book, right?
A. Well, actually --
Q. You did some other analysis.
A. That's not true. The standard in the book is below the standard -- I mean, it's a threshold. It's a minimum threshold.
Q. Can you just point me in your report where you discuss the quartile ranking of the PRISM Plan investments relative to that standard in the book? It's a very simple question, Mr. Otto.
A. I did not discuss that in my report. The expense ratios that I was looking at, I mean, referring, if you look at

the, ABB's investment policy, it sets out the standard for ABB. So that's what I was using when I looked at the expense ratios.

Q. Can we try one last time my question? But you didn't apply the standard from the book in your report, right?

A. Well, you know, I'm not trying to be difficult. In the book it says to follow the IPS. And so in analyzing investments, that honestly is what I did.

Q. Okay. Fine. You applied the IPS. I hear you. But did you apply the standard in paragraph 7? That's all I'm asking.

A. The IPS was more rigorous than the standard in paragraph 7, so I wouldn't apply it, no. I think I've answered your question. I did not apply it. I applied the standard in the IPS.

Q. Thank you. By the way, I think you talked about yesterday, correct me if I'm wrong, you either sat at the table, I think you might have said hundreds of times where rebates -- well, let's stop.

To your way of thinking, what's a rebate in this context?

A. Did I use the term rebate?

Q. I think what you said was there had been transactions that you've been involved in where the record keeper ultimately returns to plan or participants money. I think you said hundreds of times, sir. Shall I get the transcript?

A. No, we don't need to get the transcript. I don't think there's a plan I've worked on in the last decade where revenue sharing has not been used to offset fees of some sort.

Q. And they're used here to offset fees, correct, in the ABB plan?

A. They completely offset the fees.

Q. But I'm going one step further. Is it your testimony -- and we can clear this up quickly -- that you've been involved in transactions where some of that money paid to the record keeper in the form of revenue sharing is then returned either to the plan or participants? We don't have to go further if the answer is no, but I thought I heard you to say that you've been involved in that sort of transaction.

A. Yes, I have.

Q. Oh, okay. Now, is that sort of transaction specifically mentioned anywhere in the great book?

A. I don't believe it is, no.

Q. I think you testified yesterday, sir, that you've been in transactions where Fidelity was at the table, correct?

A. Yes.

Q. And if I understood you, typically the value proposition from your perspective is that you're assisting the plan sponsor in those negotiations, that's what you do --

A. Yes.

Q. -- at times. Can you tell me, sir, when you're in

Fidelity, Fidelity's attorneys asked, Mr. Boyle, about whether Fidelity provided information on revenue sharing in this program, and I don't remember the name of it. Do you recall that?

A. The Plan Sponsor Web.

Q. The Plan Sponsor Web. So we're clear, is it the case that from what you understand and what Fidelity's attorneys elicited from you that ABB was provided information on a special website for plan sponsors showing what the revenue sharing is?

A. I know that currently if you are a client of Fidelity, you can generally go online and get this information. I don't know exactly when that became available.

Q. All right. Have you seen anything in any documents or records or anywhere, in any minutes to tell you that ABB in fact did that?

A. I have not.

Q. Now, you were asked extensive questions yesterday and today about the fiduciary book, <u>Prudent Practices for Investment Stewards</u>. And I'm not going to go through all of that. But I do want to ask you a couple of things about it.

First of all, is this a document that is designed to protect, to create guidelines for fiduciaries and people such as yourself who advise fiduciaries about protecting plan participants?

A. Yes. This particular book is designed for, more for the plan sponsor. There's another book that they have that's more for the advisor. And then they have another book for the investment manager. And there are guidelines for all three services.

Q. Have you seen any evidence, Mr. Otto, in any e-mails or records or minutes of meetings of the PRC or the EBC, any of these committees, anywhere showing that they ever used this book?

A. No.

Q. In the book on page 19, I believe this is, it's section S-1.3, and I'll just use the -- I'll just use the -- okay. Take a look at that. I believe it's the third full paragraph. Would you read that, please?

A. Sure. (Quoted as read.) "The investment steward should always be asking, who benefits most from an investment decision? If the answer is any party other than the participant or the beneficiary, then the steward is likely to be committing a fiduciary breach."

Q. So when you have a bundling of bundles, as I put it, where you have corporate plans with the same service provider here at Fidelity as the DC plan, does this issue of the potential conflict arise?

A. The potential conflict does arise. You need to always be asking these questions.

Q. Also Section S-1.4, I believe, which is page, these pages are not numbered.
A. I have it.
Q. Okay. Under the criteria over to the right of that page, the fourth -- well, there are a number of things there. But the fourth, 1.4.4 in particular, what does that say?
A. (Quoted as read.) "Consideration is given to putting vendor contracts back out to bid every three years."
Q. How long was it that this, to this date, to the present that there's been no bid on record keeping services by Fidelity?
A. Well, I think the last bid was, as I understand it, 1995.
Q. Section S-4.5 was shown to you and I'd like to go back to that, Mr. Otto?
A. 4.4?
Q. 4.5. That's page 49, I believe. Rebekah, if we could highlight the top half, the whole half. I think a portion of that was read to you, as I understand what was read, was shown to you. I believe what you were asked about was the last two paragraphs. Do you see those?
A. Uh-huh.
Q. And the second sentence in the first said for a plan with few assets, such an arrangement may be beneficial for the participants, that is, using investment options that carry fees

to offset record keeping costs. All right. For a plan with few assets.

So it's clear, Mr. Otto, first of all, is the fiduciary handbook written for only fiduciaries and people such as yourself who work with a particular sized plan?

A. No, it would apply to all sized plans.

Q. Okay. So would it be fair to say that most fiduciaries in doing their work are working for the 90 percent or whatever the number was which are less than a hundred employees?

A. Yes.

Q. All right. Now, the second sentence, then, the next paragraph of what was read to you discusses what happens as assets grow. And the statement is that the investment steward, which would be the fiduciary, should periodically determine whether it is more advantageous to pay for record keeping and administrative costs on an a la carte basis and switch to mutual funds that have a lower expense ratio.

If you do that, if you follow the investment steward recommendations or guidelines, is there any way that you can periodically determine whether it's more advantageous to pay on an a la carte basis which means, I take it, fixed fee?

A. Yes.

Q. Is there any way you can do that without doing the math?

A. No, you need to -- for the specific situation, you need to do the math, and it's preferential to do a vendor search or an RFP periodically.

Q. All right. The first two paragraphs on that page were not shown to you. Would you read what those two paragraphs say?

A. (Quoted as read.) "The investment steward has a duty to account for all dollars spent on investment management services, whether those dollars are paid directly from the account or in the form of soft dollars and other fee sharing arrangements. In addition, the investment steward has the responsibility to identify those parties that have been compensated from the fees, and to apply a reasonableness test to the amount of the compensation received by any party."

"In the case of an all-inclusive fee, sometimes referred to as a bundled or wrap fee, investment product, the steward should investigate how much the various service vendors associated with each component of all, of the all-inclusive fee are compensated to ensure that no one vendor is receiving unreasonable compensation and to compare the costs of the same services on an a la carte basis."

Q. What does that mean?

A. It means you need to look at the components of cost.

Q. And is this situation involving an all-inclusive fee with a bundled product the situation that we have here in the ABB PRISM Plans?

A. Yes.

Q. I want to keep that there, but go back for -- I want to go back for a moment to one other question. I'd like to ask, Mr. Otto, about revenue sharing returns, refunds, whatever term you want to use. Are you familiar with Laura Starks' testimony here, the expert for these parties and her role in the Texas pension plan?

A. I'm familiar with her, yes.

Q. And are you aware that the Texa$aver plan that she is, has a relationship with, itself obtains refunds from revenue sharing for its 401(k) plans?

A. Yes, I am.

Q. So going back to the document, the investment steward book which describes the duty that the steward has to investigate the various vendors and to break apart these components and compare the costs of the same services as that point, is that what you've tried to do in looking and drilling down at these costs to develop your opinions?

A. Yes.

Q. In looking at all of the documents and looking at the depositions, did ABB -- you've been grilled about your work. Did ABB do anything along the lines of what you did to determine what these record keeping costs are, or what the market for record keeping services, in fact, is?

A. I didn't see any effort to identify the fees being paid for record keeping or any other services or benchmark that it had done at any time during the time frame of information.

MR. SCHLICHTER: Thank you, Mr. Otto.

THE COURT: Recross by Fidelity?

MR. BOYLE: Your Honor, I think we may have reached the moment of truth on the Lail deposition. And perhaps we ought to -- just for efficiency purposes, we might have a discussion about that now.

THE COURT: Did you give me a brief on its use for impeachment purposes or just for admissibility?

MR. BOYLE: The first part of the brief is on admissibility. The second part, the Rule 703/705 is directed to the cross-examination value.

And the core of the argument is that just as some experts rely on otherwise inadmissible reports, this expert has relied on conversations, and Rule 705 has been interpreted to allow the expert to be cross-examined on the nature of that reliance material. In this case it just so happens that one of the conversational partners was deposed in a litigation in which the same limit of reasonableness curve, the very same limit of reasonableness curve was the basis for the expert's opinion, the same plaintiffs' lawyers were involved in the case.

THE COURT: Well, it wouldn't matter, would it?

MR. BOYLE: It really wouldn't matter, although I