



Class-ifying Mutual Funds

The duty to understand mutual fund costs

IT IS COMMON for a mutual fund to offer several classes of shares, with the same investments but with different fees and expenses. These share classes, with their range of costs, are intended to provide choices for investors with differing needs—and, in our case, for plans of different sizes and cost structures.

The issue for plan sponsors and committee members is to make sure that they are selecting, and continuing to use, the appropriate—or prudent—share class. Why? Because the wrong share class can cost more money and, as a result, reduce your employees' retirement benefits—and, ultimately, lower their standard of living in retirement.

Two decisions—the *Wal-Mart* appeal and the *Edison International* trial—have focused on the fiduciary responsibility to prudently select appropriate share classes. The Court of Appeals in *Braden v. Wal-Mart* explained:

The message from these lawsuits is that fiduciaries need to understand the concept of share classes.

“The complaint alleges that the Plan comprises a very large pool of assets, that the 401(k) marketplace is highly competitive, and that retirement plans of such size consequently have the ability to obtain institutional class shares of mutual funds. Despite this ability, according to the allegations of the complaint, each of the ten funds included in the Plan offers only retail class shares, which charge significantly higher fees than institutional shares for the same return on investment. The complaint also alleges that seven of the Plan’s ten funds charge 12b-1 fees from which participants derive no benefit.”

In other words, the plaintiffs claimed that the *Wal-Mart* fiduciaries—with billion of dollars in their plan—should have bought “wholesale” rather than retail. As an aside, it is ironic that *Wal-Mart*, known for its low costs, was using retail mutual fund shares, which, almost by definition, are more expensive than their institutional brethren.

After reviewing the legal issues, the appeals court reversed the trial court’s decision to dismiss the case and sent the lawsuit

back to the trial court on those issues.

More recently, a federal court in California decided, after a full trial on the facts, that the Edison International fiduciaries—also with billions in 401(k) assets at their disposal—had violated their fiduciary duties by failing to ask for institutional shares and, instead, offering the 401(k) participants more expensive retail shares. In reaching that decision, the court noted that:

“At trial, Defendants could not offer any credible reason why the Plan fiduciaries chose the retail share classes of the William Blair, PIMCO and MFS Total Return funds....a prudent fiduciary commonly would review all available share classes and the relative costs for each when selecting a mutual fund for a 401(k) Plan. Here, however, there is no evidence that Defendants even considered or evaluated the different share classes.”

In effect, the court found that fiduciaries have a legal duty to understand the cost structures of the mutual funds available to their plans and to evaluate the different share classes of those funds.

The message from these lawsuits is that fiduciaries need to understand the concept of share classes and the cost structure of their 401(k) mutual funds—as well as the alternative investments. The fiduciaries also must consider the size and purchasing power of their plan and select the share classes (or alternative investments) that a fiduciary who is knowledgeable about such matters would select under the circumstances. In other words, the “prevailing circumstances”—such as the size of the plan—are a part of a prudent decisionmaking process. The failure to understand the concepts and to know about the alternatives could be a costly fiduciary breach.

Fred Reish is Managing Director and Partner of the Los Angeles-based law firm of Reish & Reicher. A nationally recognized expert in employee benefits law, he has written four books and many articles on ERISA, IRS and DoL audits, and pension plan disputes. Fred has been awarded the *Institutional Investor* Lifetime Achievement Award and the *PLANSPONSOR* Lifetime Achievement Award. He is also one of the 15 individuals named by *PLANSPONSOR* magazine as “Legends of the Retirement Industry.”