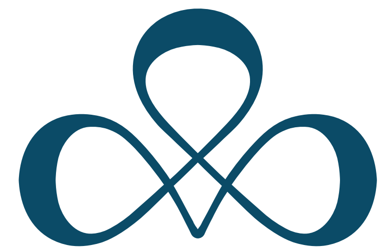

Wong vs. Fidelity – A sign of the times

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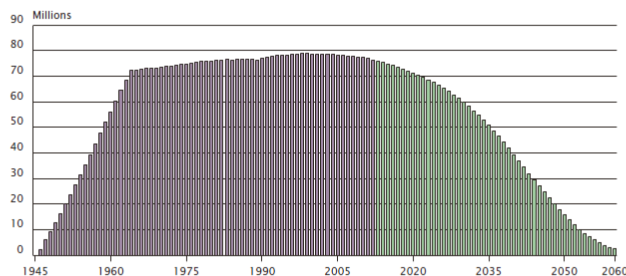
On February 21, 2019, a class action complaint[1] was filed by Andre Wong, et al (Plaintiffs), representing the T-Mobile USA, Inc. 401(k) Retirement Plan ("Plan") against Fidelity Management & Research and a number of its affiliates ("Fidelity" or "Defendant") for self-dealing and a breach of fiduciary responsibility. This could produce unintended consequences of limiting investment choices to participants in the future.

BACKGROUND

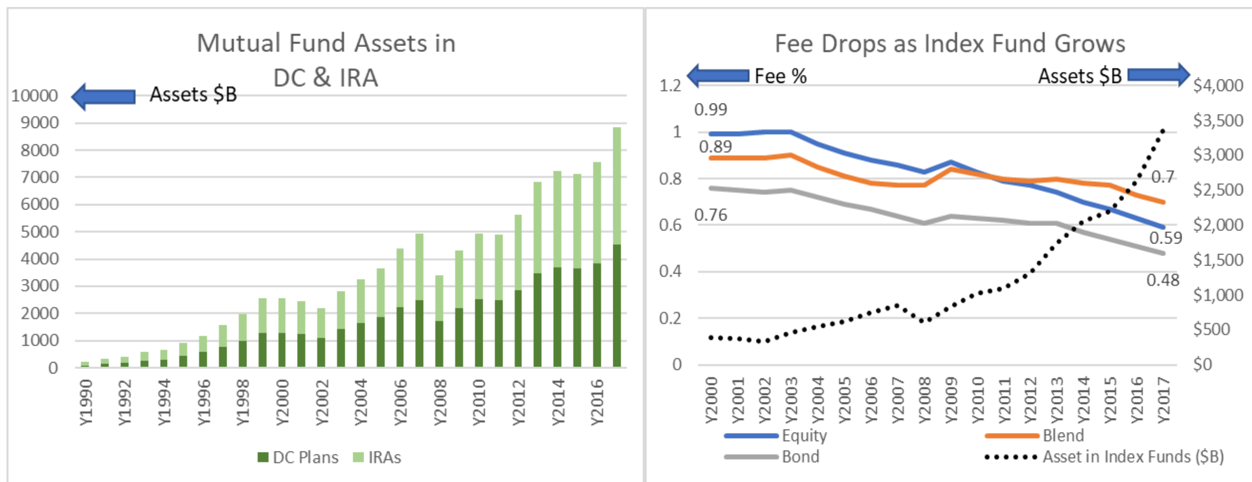
1. *Demographics and the Industry*

Post-WWII, the significant uptick in birth rate from 1946 through 1964 gave rise to the cohort known as the Baby Boomers which was over 72 million strong. The sheer size of the Baby Boomer generation naturally compelled the unprecedented expansion and growth of the financial and investment services industry into what it is today. The chart below from the U.S. Census Bureau[2] shows the projected lifecycle of this cohort. In 2011, the leading edge of the Baby Boomers began their 18-year march towards the golden years of their lives. As the number of Baby Boomers shrinks, so does the demand for, and the composition of, services and investments needed. Along the way, this generation has disintermediated and flattened the price (through scale and force) of every industry, and this is especially so with the advent of computerization, information technology and digitization. The same pressure has not been spared on the investment and financial services industry. Since May 1, 1975, (May Day), when brokerage commissions were deregulated from a monopolistic, fixed rate schedule to a negotiated scheme, Wall Street began the age of fee compression. However, the share size of the Baby Boomers created a demand that generated significantly greater revenue (even during a super competitive, scale driven, fee compressed environment) and fueled substantial growth of the number of asset managers, bankers, brokers, intermediaries, advisers and service providers.



[1] https://www.classaction.org/media/wong-v-fmr-llc-et-al.pdf
[2] https://www.census.gov/prod/2014pubs/p25-1141.pdf

According to the Investment Company Institute (ICI) annual Fact Book[3], the size of the mutual fund industry grew as Baby Boomers saved and invested for their retirement in defined contribution (DC) plans as well as in individual retirement accounts (IRAs) of all kinds.



At the same time, we witnessed the definitive reduction in fees (especially so since the Global Financial Crisis) charged by asset managers at a time of explosive growth in low cost, passive or index tracking funds.

For a long time, mutual fund sponsors have recognized that DC Plans and IRAs are significant and growing sources of long-term investment assets. As such, many have offered recordkeeping and custodial services to attract plan sponsors and investors to record keep and custody their assets. Over time, and with increasing fiduciary scrutiny, the conflict of using an ERISA retirement plan as a vehicle to distribute their proprietary investments became more challenging, compelling many asset manager-owned recordkeeping platforms to open their distribution conveyor belts to non-proprietary (or third-party) mutual funds, for a fee. This ushered in the era of open architecture or a mutual fund supermarket. In order for these recordkeepers to justify distributing competitors' mutual funds on their conveyer belt, they are compensated by 12b-1 fees, administration fees, service fees, sub-transfer agent fees and/or similar fees ("Revenue Sharing Payments" or "RSPs") by such third-party mutual funds. However, the fee compression pressure turned out to be so great and, under the watchful eye of fiduciaries, the revenues began to dry up and recordkeepers are now seeking new sources of revenue or compensation to replace lost income while maintaining the façade of a non-conflicted recordkeeper with an open architecture conveyor belt.

[3] ICI 2017 and 2018 Fact Book, https://www.ici.org/research/stats/factbook

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2. *The Class Action Suit – Allegations*

- Open Architecture - In 1989, as a part of its Workplace Investing business unit, Fidelity offered its open architecture mutual fund universe through its "FundsNetwork[4]" ("Mutual Funds") which allows participants to invest in Mutual Funds from other (non-Fidelity) fund companies. Fidelity's Workplace Investing business unit provides third-party Mutual Funds with access to over 24,000 retirement plans with over $1.6 trillion in assets.

- Infrastructure Payments - Beginning around 2017, Mutual Funds pay undisclosed, relationship-level fees to Fidelity under the guise of "infrastructure" payments ("Infrastructure Payments") if RSPs fall below a certain threshold for services. Fidelity has historically provided same services to its retirement plan customers as a necessary part of its business in return for fees directly paid by plans or participants. These fees are not generally affected by the receipt of Infrastructure Payments and Plan or participant level fees are not affected by the amount of the Infrastructure Payments received.

- Pay-to-Play – Fidelity makes it clear that, if Mutual Funds refuse to make the Infrastructure Payments, they will be restricted in their relationship with Fidelity and Fidelity will (a) not permit a Mutual Fund to add new funds to the FundsNetwork, (b) eliminate its existing Mutual Funds from the FundsNetwork through a hold and redeem approach, and (c) impose additional fees on Fidelity's clients that invest in the Mutual Funds.

- Open Architecture - Although Fidelity describes itself as providing an open architecture platform, Fidelity also effectively controls the menu of available Mutual Funds offered in its FundsNetwork and retains the discretion to change its fund menus and to not offer certain investment options based upon contract pricing and other considerations.

- Non-Disclosure – Infrastructure Payments are calculated based on the assets the Mutual Funds maintain under administration by Fidelity. These Infrastructure Payments are indirect compensation that Fidelity is required to disclose under ERISA § 408(b)(2)[5], and yet, Fidelity does not disclose the amount to the Plan and other plans and forbids Mutual Funds from disclosing the amount of these Infrastructure Payments.

- Fiduciary Status due to discretionary control – The lawsuit claims that Fidelity is a fiduciary under ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(a) by virtue of its discretion and exercise of discretion in negotiating/establishing its own compensation by and through its setting of the amount and receipt of the Infrastructure Payments. This has the effect of increasing the expense ratios and/or other expenses of the Mutual Funds.

[4] https://www.fidelity.com/mutual-funds/overview
[5] 29 C.F.R. § 2550.408b-2

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- Prohibited Transaction - As a result of its acceptance of Infrastructure Payments, Fidelity effectively operates a system in which it is motivated (a) to increase the amount of such payments in addition to RSPs paid to Fidelity, and/or (b) to conceal the true nature of Infrastructure Payments and requiring the participants who invest in Mutual Funds to unwittingly incur and pay undisclosed fees for the services. The receipt of Infrastructure Payments places Fidelity in a conflicted position in which the interests of the Plan are second to the interests of Fidelity earning greater profits through the receipt of such payments. This self-dealing on Fidelity's part is in violation of ERISA Section 406.

- Additional Compensation – Although Fidelity has claimed, in certain communications, that it credits payments from Mutual Funds to reduce the amount of payments made by the Plan, Fidelity has not and does not provide any specific credit to the Plans to account for the Infrastructure Payments. Moreover, Fidelity has never credited the Plans with the amount of Infrastructure Payments it receives on a dollar-for-dollar basis.

CLAIMS

1. As a party-in-interest, Fidelity violated Prohibited Transaction Rules.
2. Fidelity failed to discharge its duties with respect to the Plans solely in the interest of the Plan participants and beneficiaries and (a) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the Plans with (b) the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
3. To the extent that Fidelity is not deemed a fiduciary or co-fiduciary under ERISA, Fidelity is liable to the Plaintiffs for all recoverable damages and relief as a non-fiduciary and party-in-interest that knowingly participated in prohibited transactions and breaches of fiduciary duty in violation of ERISA, as well as knowing breaches of trust.

CONCLUSION

In its thirst to maintain and grow assets under administration in an increasingly competitive and dwindling fee environment, a recordkeeper must find a balance between the services it offers and the overall (direct and indirect) revenue generated in support of such services. A service provider's business and strategic decisions in expanding its reach and maximizing its revenue for the benefit of its shareholders are natural and reasonable. On the other hand, a service provider to a benefit plan subject to ERISA is deemed a party-in-interest[6] and thus subject to prohibited transaction rules[7] to prevent harm derived from self-dealing and conflict-of-interests.

[6] ERISA section 3(14)
[7] ERISA section 406

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Recordkeepers have traditionally avoided being considered ERISA administration fiduciaries when providing recordkeeping services and fulfilling other administerial duties. It is up to the court to decide if Fidelity is deemed an ERISA fiduciary (facts and circumstance tests) in this case. The standard would be significantly higher if Fidelity is considered an ERISA fiduciary by the court and the claims of this case would be viewed under the ERISA fiduciary standard lens.

Separately, the final regulation[8] regarding service provider disclosures under ERISA section 408(b)(2) in 2012 requires covered service providers to provide plan sponsors[9] with the following information they need in order to:

- Assess reasonableness of total compensation, both direct and indirect, received by the covered service provider, its affiliates and/or subcontractors;
- Identify potential conflicts of interest; and
- Satisfy reporting and disclosure requirements[10] under Title I of ERISA.

Although Fidelity is called out specifically in this class action regarding its disclosure and potential conflicts pertaining to its practices involving the operation of its proprietary mutual fund platform – the "Funds Network", the potential industry implication is wide and deep. Today, all recordkeepers and custodians are subject to the same growth and revenue pressures to maintain service competitiveness and survival; favorable court findings in support of the Plaintiffs could affect the "open architecture" approach altogether. The biggest negative impact may be felt by plan participants as the investment selection universe would likely shrink as recordkeepers have no obligation nor incentives to offer every mutual fund under the sun.

p.s. "The Labor Department is investigating Fidelity Investments over an obscure and confidential fee it imposes on some mutual funds, according to a person familiar with the inquiry" reporting by Gretchen Morgensonay, Wall Street Journal[11] on Feb. 27, 2019.

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[8] https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/final-regulation-service-provider-disclosures-under-408b2.pdf

[9] This includes recordkeepers or brokers who make designated investment alternatives available to the covered plan (e.g., a "platform provider")

[10] https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/reporting-and-disclosure-guide-for-employee-benefit-plans.pdf

[11] https://www.wsj.com/articles/fidelitys-fees-on-low-cost-funds-eyed-in-government-probe-11551263401?mod=searchresults&page=1&pos=8

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