Fidelity's Mutual Fund Shelf-Space Payments Targeted by Plaintiffs

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AUTHORS: Jennifer Eller, Ellen Goodwin, David Kaleda, Michael Kreps, Thomas Roberts, Stephen Saxon

A February 21st complaint filed in Massachusetts federal court alleges that Fidelity required mutual funds to make "secret" payments to it in order to obtain access to Fidelity's defined contribution plan clients through its "super market" of mutual fund investment options. *Wong v. Fidelity Management & Research Company, et. al.*, Case 1:19-cv-10335 MPK (D. Mass.). The lawsuit is brought by a participant in T-Mobile USA Inc.'s 401(k) plan, and seeks class action status to represent participants in all plans that receive recordkeeping and other services from Fidelity and its affiliates. As discussed below, the suit raises the concern that the plaintiffs' bar may believe it has identified a new approach for attacking recordkeepers and other providers in the 401(k) plan space.

The lawsuit was brought in connection with Fidelity's "FundsNetwork," which was launched in 1989 and, according to the complaint, is one of the industry's leading mutual fund supermarkets offering access to hundreds of mutual funds and other collective investment vehicles. The lawsuit alleges that, beginning in 2017, Fidelity began to require various mutual funds, their affiliates, collective trusts and other investment advisors to make "kickback" payments to Fidelity. The complaint refers to these payments as a "pay to play scheme" and states --

> While the kickbacks are internally described by Fidelity as 'infrastructure payments' and reimbursement for expenses incurred in providing services for, to, or on behalf of the mutual funds, and deceptively characterized as such to plans and their participants to the extent obliquely referenced by Fidelity as 'mutual fund supermarket fees,' the amounts of these kickbacks bear absolutely no relationship to the cost or value of any such services and, instead, plainly are a replacement for declining amount of revenue sharing payments received by Fidelity.

The complaint alleges that although Fidelity attempts to describe the fees as "flat dollar payments" the payments are, in fact, calculated based upon the total assets invested in the mutual funds (multiplied by a basis point amount) and are offset by the amount of revenue sharing generated by the assets for which Fidelity provides recordkeeping services. The complaint alleges that the payments were required by Fidelity as a replacement for declining revenue sharing payments received by Fidelity based on the proliferation of R6 shareclasses, collective trusts, and passively managed mutual funds, which are increasingly used and generate little or no revenue sharing payments.

According to the complaint, the services provided by Fidelity to the mutual funds, beyond mere access to Fidelity's customers, are actually services that Fidelity has historically provided to its plan customers in return for fees paid by the plans. The plaintiff argues that the fees paid by the plans did not change as a result of the "kickback" payments and were not reduced in a way that corresponds with the amount of the "kickback" payments. Allegedly, Fidelity had the right to increase the amount of the payments it received from mutual funds at its discretion. The payments were said to amount to at least tens of millions of dollars per year to Fidelity, and likely hundreds of millions of dollars.

The complaint asserts that the "secret payments" clearly constitute indirect compensation that Fidelity is required to disclose to its ERISA plan customers under ERISA section 408(b)(2), the statutory exemption for reasonable services arrangements between a plan and a party in interest. The plaintiffs argue that not only did Fidelity refuse to disclose the amount of mutual fund payments to its plan customers, but it also explicitly prohibited the mutual funds from disclosing the amount of the payments.

In the plaintiff's view, Fidelity acquires fiduciary status with respect to the plans it services because it has and exercises discretionary control over the amount of its compensation when negotiating the amounts of these mutual fund payments. The complaint also includes allegations that Fidelity "manages" the assets of its retirement plan clients and is therefore a fiduciary to the plans by virtue of pooling client investments before collectively investing them in so-called omnibus accounts. The complaint alleges that for each fund offered on Fidelity's FundsNetwork, Fidelity maintains a single omnibus account to process trades and maintain positions. The omnibus accounts are divided into "accumulation units" which are designed to replicate the performance of the mutual fund and reflect the interests held by various plan customers. However, both the omnibus accounts and the accumulation units are held and owned by Fidelity. The complaint alleges that Fidelity is a fiduciary based on its discretion and control over both the omnibus accounts and "accumulation units," both of which constitute plan assets.

The complaint alleges that Fidelity breached its fiduciary duty to its plan customers, and committed prohibited transactions within the meaning of ERISA section 406(a) and 406(b), by setting and retaining the payments, as well as by not disclosing them. In this regard, the plaintiffs argue that "Fidelity literally has lined its pockets with at least hundreds of millions of dollars in secret payments by and through self-dealing, other prohibited transactions and breaches of its fiduciary duties."

The complaint seeks a declaratory judgment holding that Fidelity has violated ERISA, an injunction prohibiting the kickback payments, and disgorgement of all the kickback payments improperly earned by Fidelity, or the profits earned by Fidelity in connection with its receipt of the payments. It is possible that the plaintiffs are not the only party reviewing Fidelity's so-called "infrastructure payments." This week the Wall Street Journal ran an article in which it reported that the Labor Department is currently investigating the same fees paid by mutual fund companies to Fidelity. Gretchen Morgenson, *Government Probes Fidelity over Obscure Mutual-Fund Fees*, Wall St. J., Feb. 27, 2019.

The allegations in the lawsuit blur certain important distinctions between the exercise of discretionary authority and control over the management of plan assets, which is always a fiduciary function, and non-fiduciary negotiations between a platform provider and third party entities seeking favorable platform positioning. Although the "secret" payments that the lawsuit takes aim at were apparently not made directly by the funds in which the plans invested, but by third party service providers, the lawsuit appears to adopt the theory that by extracting payments from those service providers, Fidelity indirectly exerted fiduciary control over fund expenses, since the cost of the payments would ultimately be passed through to investors.

Only time will tell whether this new theory will gain any traction in the courts. In the meantime, we think the lawsuit serves as a reminder of the risks and potential pitfalls associated with shelf-space and other types of "mutual fund support" payment programs under ERISA. These types of payments deserve careful consideration by non-fiduciary recordkeepers and platform providers. They merit particular scrutiny where fiduciary investment advice to 401(k) plan sponsors or their participants is offered. We think the payment of compensation as a flat dollar amount is helpful in developing a defense to potential fiduciary breach allegations. Nonetheless, there are several other measures that should be taken to avoid attracting the attention of the Department of Labor or the plaintiff's bar, including clear disclosure of the amounts of such payments.