No. 09-447

In The
Supreme Court of the United States

DENNIS HECKER, JONNA DUANE,
AND JANICE RIGGINS,

Petitioners,

v.

DEERE & COMPANY,

Respondent.

**On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit**

BRIEF OF *AMICI CURIAE* RICHARD KOPCKE AND FRANCIS VITAGLIANO IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Amici will address the following question:

Whether the court below erred in holding – contrary to numerous other circuit decisions and the considered views of the DOL – that petitioners' allegations that a plan fiduciary selected retail mutual funds with excessive fees, without adequate investigation and without any effort to explore readily available, lower-cost options, failed to state a claim under § 404(a) of ERISA.

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INTERESTS OF THE *AMICI CURIAE*[1]

Richard Kopcke, Ph.D., CFA, has conducted and supervised research on financial markets and institutions throughout his professional life. For thirty years he served as a research officer in the Federal Reserve Bank of Boston, retiring as the Vice President in charge of financial market research. Since leaving the Fed, he taught finance and portfolio management in business school. He also served as an adviser to foreign central banks and finance ministries. Mr. Kopcke currently is a financial consultant working for the United States Department of the Treasury and for the Center for Retirement Research at Boston College.

Francis Vitagliano, has been an ERISA compliance officer for over thirty years. He served as an Assistant Vice President of Merrill Lynch, 401(k) division, in charge of ERISA Compliance. Following Merrill Lynch, Mr. Vitagliano served as a Vice President at State Street Bank and Trust Company becoming head of the bank's Fiduciary Control Committee, focused on ERISA fiduciary issues. For the

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[1] The parties were notified ten days prior to the due date of this brief of the intention to file. The parties have consented to the filing of this brief.

No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici curiae*, or its counsel, made a monetary contribution to its preparation or submission.

last five years Mr. Vitagliano has been a Visiting Scholar at the Center for Retirement Research at Boston College.

Amici support the petition for a writ of certiorari in this case because it presents an important question concerning the definition of the appropriate competitive background for evaluating the investment alternatives that sponsors select for the participants in their 401(k) plans. This definition sets critical standards for sponsors' fiduciary obligations and significantly affects employees' cost of funding their retirement.

REASONS FOR GRANTING THE PETITION

The Seventh Circuit's holding that sponsors of large 401(k) plans like Deere's satisfy their fiduciary obligations to their employees by providing them a wide variety of retail mutual funds in which to invest their retirement savings is profoundly misinformed and has significant implications for employees and retirees throughout the nation. Employers have increasingly come to rely upon defined contribution plans like 401(k) plans, instead of defined benefit plans, as a result of which participants pay more of their plans' costs, and in many plans, the employees pay all those costs. Plans with assets of as little as a few million dollars are large enough to allow employers to negotiate the lower fees that institutional investors pay, rather than the higher fees charged by retail mutual funds. Many employers who maintain both sizable defined contribution and sizable defined benefit plans select mutual funds for their defined contribution plans while the assets in their defined benefit plans are invested in lower-cost alternatives to mutual funds. The Seventh Circuit's decision, however, absolves employers of any responsibility to negotiate such lower, institutional-type fees on behalf of their employees in 401(k) plans, leaving their employees saddled with significantly higher costs.[2]

Financial markets are a collection of many submarkets, each serving the particular needs of a specific type of customer. Retail mutual funds, which are the convenience stores for equity and bond investors, price their services competitively within submarkets serving retail investors who require full-service attention. These mutual funds, as a result, typically are not priced competitively for submarkets that serve larger institutional investors, including sizable 401(k) plans, who can buy stocks and bonds through trusts and separate accounts, which are the supermarkets and wholesale outlets for pooled investments. These institutional investors are able to achieve substantial economies by buying accounting, administration, and management services *a la carte*, tailoring them to their needs. The substitution of commingled trusts for actively managed mutual

[2] Over a 30-year career, for example, paying an annual fee of 70 basis points can reduce the purchasing power of savings at the time of retirement by one-eighth.

funds in a 401(k) can lead to savings for the plans' participants of 0.70 percent of assets, or more, each year.

We recognize that the market for a commodity like flour has many submarkets. A family needing to replenish its pantry might regard the price of flour in the neighborhood retail store a bargain. But a university food service would purchase its monthly allocation of flour from a wholesaler. Although the price for flour in the neighborhood retail store might be competitive for retail customers, the retail price of flour is not competitive for wholesale customers. A university food service buying its provisions in a retail market would be regarded as extravagant.

The Design of Mutual Funds

Retail mutual funds are designed for investors who do not have substantial financial wealth and who wish to build their wealth by investing relatively small sums in stocks or bonds. Retail mutual funds provide these investors the valuable benefits of diversification, brokerage services, legal services, record keeping, and investment management services for a simple fee. This fee typically comprises one-time loads and annual charges per dollar of account balance (the expense ratio). This simple, one-size-fits-all wrap fee can be very appealing and economical for many retail investors, for whom participation in stock and bond investments otherwise would not be economical.

This simple, universal fee for retail mutual funds becomes increasingly unattractive for investors as their account balances grow. Fees increase in proportion with investors' balances, but the cost of accounting, administering, and, perhaps, managing the assets for each account does not increase commensurately. Accounting and administration fees, in particular, are essentially the same for each account, regardless of size. Accordingly, more wealthy investors who wished to participate in investment pools historically have placed their money in trust accounts and in separate accounts at financial institutions to gain the benefits of economies of size which are not available from mutual funds. In these wholesale arrangements, wealthier investors typically negotiate the range of services they buy and the price they pay for each service. In many cases, these services are not all provided by the financial institutions that manage the investment pools.

To expand their appeal, most investment companies offer different classes of shares with different fee structures against a single pool. This design tailors fees to match better the interests of different types of investors. For long-term, buy-and-hold investors, pools offer a class of shares with lower annual expense ratios, often accompanied by higher one-time loads. For short-term investors, pools offer a class of shares with no loads, but higher annual expense ratios.

Investment companies also have introduced classes of shares to appeal to investors who maintain large balances, do not churn their accounts, and do not require all of the services included in the traditional retail product. "Institutional shares," for example, require minimum balances of several million dollars and charge shareholders substantially lower fees reflecting the substantially lower accounting and administration expenses per dollar of assets in these accounts. Recently, investment companies also have begun offering exchange traded funds (ETFs) with very low fees against their pools of assets. These shares offer no services other than essential asset management services.

Mutual funds, a retail product, have remained an expensive investment option for institutional investors. Commingled trusts and separate accounts allow institutional investors to unbundle the accounting, legal, administration, and management services they buy. Not only does this unbundling allow them to match the fees to the services they require, but it also permits them to obtain these services from the most economical or suitable providers. For individual retail investors this unbundling would be prohibitively costly, but for institutional investors it is critical for achieving the highest net returns. Furthermore, as wholesale products limited to less than 100 accounts, commingled trusts and separate accounts can avoid much of the sales expense as well as the expense for registration and compliance requirements that retail mutual funds incur.

As wholesale vendors, providers of commingled trusts and separate accounts also can restrict their accounts to investors who maintain adequate balances and consistent cash flows, which reduce the cost of offering these accounts. Larger 401(k) plans can easily meet these requirements. Most commingled trusts require minimum investments of $3 million per account and become significantly less expensive than mutual funds for investments as low as $10 million per account. Many separate accounts require minimum investments exceeding $15 million per account and offer significant savings compared to commingled trusts for investments of $30 million or more per account. Lisa Florentine, *Investment Vehicle Matters!* at 1-4 (May 2009), *available at* http://www.rogerscasey.com/rc/dmdocuments/brief_invvehicle.pdf.

The genius of mutual funds is that they are structured and priced to serve the needs of smaller retail investors relatively economically. As a result, the design and pricing of mutual funds are not competitive in wholesale markets. Consequently, institutional investors – which include foundations, endowments, large defined-benefit pension plans, banks, savings institutions, insurance companies, state and local retirement funds – do not invest a significant share of their assets in mutual funds. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States* at 71, 75-78, 111, 115 (Sept. 2009), *available at* http://www.federalreserve.gov/RELEASES/z1; Investment Company Institute, *The U.S. Retirement Market, Second Quarter 2009*, RESEARCH FUNDAMENTALS, vol. 18, no. 5-Q2, Oct. 2009, at 7, *available at* http://www.ici.org/pdf/09_q2_retmrkt_update.pdf.

Mutual Funds, Commingled Trusts, and Separate Accounts in 401(k) Plans

With the introduction of 401(k) plans, retail mutual funds were ideally situated to meet the needs of the sponsors of these plans quickly and completely. Investment companies, through their mutual funds, could provide the necessary accounting, legal, administration, and management services for 401(k) plans with minimal effort on the part of sponsors. Moreover, the fee structure of mutual funds meant that sponsors could control the cost of their 401(k) plans by adopting investment companies' funds for their investment options. The participants in the plans would pay for the cost of their mutual fund accounts through the mutual funds' fees to the extent that the employer did not reimburse participants' expenses.

As 401(k) plans spread and grew, the aggregate balances in many of these plans became substantial. Consequently, the structure and pricing of retail mutual funds became a poor fit for these new institutional investors. The larger plans increasingly use commingled trusts and separate accounts as investment options for participants. Deloitte Consulting LLP, Investment Company Institute, *Defined Contribution/401(k) Fee Study* at 14, 20 (June 2009) (hereinafter Deloitte), *available at* http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf; Florentine, *supra*, at 1-6. Sponsors who had been accustomed to these wholesale investment options within their defined-benefit pension plans instead of mutual funds would be aware of the similar savings that commingled trusts and separate accounts could offer participants in their 401(k) plans.

The savings offered by commingled trusts to large 401(k) plans are significant. The median expense ratio for equity mutual funds held in 401(k) plans is near 0.80 percent of assets. Deloitte at 6, 24; Investment Company Institute, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses 2008*, RESEARCH FUNDAMENTALS, vol. 18, no. 6, Aug. 2009, at 13, *available at* http://www.ici.org/pdf/fm-v18n6.pdf; Richard W. Kopcke, Francis M. Vitagliano, & Zhenya S. Karamcheva, *Fees and Trading Costs of Equity Mutual Funds in 401(k) Plans and Potential Savings from ETFs and Commingled Trusts*, at 9, 10, 13 (Ctr. for Retirement Research at Boston College, Working Paper No. 2009-27, November 2009), *available at* http://crr.bc.edu/images/stories/Working_Papers/wp_2009-27.pdf; Roger M. Edelen, Richard Evans, & Gregory B. Kadlec, *Scale Effects in Mutual Fund Performance: The Role of Trading Costs* at 1 (Social Science Research Network, Working Paper No. 951367, March 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951367. This fee amounts to about $350 for the median participant, who holds an average balance of nearly $50,000. Total administration cost, including recordkeeping expense, currently is less than $50 per year per participant, or less than

0.10 percent of assets for the median participant. DAVID HUNTLEY & JOSEPH VALLETTA, 401K AVERAGES BOOK at 33-34, 45-46 (8th ed. 2007). In large plans, this cost can be less than $10 per participant or 0.03 percent of assets. Commingled trusts currently provide managed funds and funds with different investment styles that can replicate the investment style of many managed mutual funds. The expense ratios for these trusts can range from 0.25 to 0.40 percent of assets. Deloitte at 14, 19, 20; HUNTLEY, *supra*, at 33-34, 45-46. Consequently, these alternatives would reduce overall fees by 0.22 to 0.35 percent of assets ((0.72 – (0.10+0.40)) and (0.72 – (0.10+0.25))).

In addition to these potential savings, commingled trusts containing ETFs also can reduce transaction cost significantly. This saving is greatest for ETFs that replicate the market strategies of actively managed funds. Median trading costs for mutual funds held in 401(k) plans, 0.66 percent of assets, suggests that commingled trusts holding ETFs can reduce trading costs by 0.50 percent of assets, or more, for active strategies. Kopcke, *supra*, at 10; Edelen, *supra*, at 1. With this reduction in transaction cost plus the reduction in fees discussed above, commingled trusts and separate accounts holding ETFs that mirror the market exposures of actively managed equity funds could reduce overall fees for participants in 401(k) plans by 0.70 percent of assets or more.

The burden of paying this additional expense is substantial. An additional fee of 0.70 percent of assets represents about one-tenth of the return, after adjusting for inflation, which participants in 401(k) plans can expect to earn on their investments in equities. Employees who participate in 401(k) plans over 35-year careers can lose more than one-eighth of their potential savings in these plans as a result of this expense. For example, suppose new employees earn a salary of $25,000 and receive 4 percent annual raises. If these employees contribute 5 percent of their salaries to 401(k) accounts, investing in equities that return 9 percent a year, they will accumulate balances of $430,200 after 35 years at work. If, instead, the net return on their investment in equities is reduced to 8.3 percent as a result of additional fees and expenses, they will accumulate only $373,800, a drop of 13 percent.

CONCLUSION

The petition for a writ of certiorari should be granted.

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