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Selecting Benchmarking Services to Help Meet Fiduciary Requirements

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Abstract

Under the Employee Retirement Income Security Act (ERISA) of 1974, employers and other plan fiduciaries have a duty to ensure that all fees paid by the plan to its service providers are reasonable. Unfortunately, many plan sponsors are not equipped with the necessary expertise and resources to determine the reasonableness of the plan's fees. This creates a serious problem for plan fiduciaries. A mounting number of lawsuits have been filed against employers on the grounds that plan fees are excessive. Although the current legal climate surrounding the 401(k) plan industry is litigious, plan fiduciaries must follow three primary rules to ensure fees paid to service providers are reasonable. Through benchmarking fees, plan fiduciaries can meet critical requirements under ERISA; however, fiduciaries need to select a reliable benchmarking service. Financial advisors can play a pivotal role in helping the plan sponsor incorporate these services into a prudent plan review process that is intended to satisfy the requirements of ERISA.

Keywords

benchmarking, prudent review process, prudent expert, hidden fees, fiduciaries

401(k) Plan Legal Climate

Many employers who sponsor 401(k) plans and other defined contribution plans are increasingly aware that they face a daunting challenge under the Employee Retirement Income Security Act (ERISA) of 1974. Service fees in the 401(k) plan industry are undergoing constant scrutiny by regulators, Congress, the plaintiffs' bar and the U.S. Department of Labor (DOL). The 401(k) plan industry has experienced a recent explosion in fee litigation, involving complaints that plan sponsors breached their fiduciary duties by authorizing the use of plan assets to pay excessive fees.

Furthermore, the DOL has launched a regulatory initiative to improve fee-related disclosures in defined contribution plans. Meanwhile, Congress is proposing legislation to uncover "hidden" plan fees, which is included the 401(k) Fair Disclosure for Retirement Security Act and the Defined Contribution Fee Disclosure Act.

In hopes of resolving these issues, several firms are now offering side-by-side comparisons of fees paid by individual plans against the fees paid by a representative benchmark group of plans. Benchmarking services ultimately serve to benefit plan participants and minimizes fiduciary liability risk for the plan sponsor. Benchmarking services run the gamut of being highly ambitious and attempting to gauge not only plan fees but also the value received by the plan in return, whereas other services strictly assess fees. In addition to varying considerably in scope, cost and quality, other factors such as timeliness of data, size of the database, method of data verification and construction of benchmark groups can also vary from one service provider to another.

ERISA Requirements

Employers and other plan fiduciaries have a responsibility under ERISA to ensure that all fees paid by the plan to its service providers are reasonable. However, employers and other plan fiduciaries may lack the specialized knowledge of the 401(k) plan industry necessary to satisfy the requirements under ERISA. Benchmarking services are on the rise and are proving to be an important tool in helping plan fiduciaries mitigate legal liability risks.

To gain a full understanding of the value of benchmarking services, it is important to understand a plan fiduciary's responsibilities with respect to plan fees. ERISA imposes three sets of rules requiring plan fiduciaries to

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ensure that any fees paid by the plan to its service providers are reasonable:

1. Establishment of Trust rules under ERISA Section 403
2. Prudent Man standard of care under ERISA Section 404
3. The Prohibited Transaction (PT) exemption under ERISA Section 408(b)(2)

Establishment of Trust Rules

Under ERISA Section 403, the Establishment of Trust rules specifically require plan assets to be held in a qualifying trust "for the exclusive purposes of providing benefits and defraying reasonable expenses of administering the plan."

Prudent Man Standard of Care

Plan fiduciaries are required to exhibit the same level of expertise a prudent expert would in assessing the reasonableness of plan fees. Similar to ERISA Section 403, the Prudent Man standard of care similarly permits reasonable expenses to be "defrayed" with plan assets. To make things even more challenging, the Prudent Man standard of care presents a twist. ERISA Section 404 is also known as the "prudent expert" standard because it requires fiduciaries to discharge their duties to the plan with the care, skill, prudence and diligence 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." Under this rule, an employer must discharge all of its fiduciary duties to the plan, including its duty to limit plan fees to reasonable expenses only, with the same level of skill and diligence that a prudent expert would use.

Prohibited Transaction Exemption

The PT rules under ERISA are intended to stop any type of self-dealing by plan fiduciaries; however, they do much more. Under ERISA Section 406, "prohibited transactions" include virtually any type of transaction involving plan assets—for example, the PT exemption occurs when the plan assets are used to pay a plan's service provider.[1] Luckily, plan fiduciaries can find reprieve under the DOL's proposed regulations under ERISA Section 408(b)(2). This section has granted an exemption, allowing the use of plan assets to pay fees for services. It is important to note that the exemption applies strictly to a fiduciary's "contracting or making reasonable arrangements" with the plan's service provider for "services that are necessary" for plan operation and only if no more than "reasonable compensation" is paid for them. The applicable DOL regulations simply state that the determination of whether compensation is reasonable depends on the particular facts and circumstances of each case.

The DOL proposed new regulations under ERISA Section 408(b)(2) in 2007, which would require service providers to disclose indirect compensation and any conflicts of interest to plan fiduciaries when contracting for services. These regulations are scheduled to become finalized later this year. The DOL released an "interim final regulation" in July 2010. However, these rules would not affect a fiduciary's substantive duty to limit the plan fees paid to no more than "reasonable compensation."

Penalties for Breaching Duties

Under ERISA, the employer could face substantial penalties for breaching any of its fiduciary duties.[2] A growing number of lawsuits have already been filed against some of the nation's largest employers and investment providers, alleging, in part, that they breached their fiduciary duties under ERISA by failing to monitor the direct and indirect compensation paid to the plan's service providers.[3]

One notable fact is that trial courts have generally been cautious in dismissing these lawsuits at an early stage, which seems to have resulted in encouraging the plaintiffs' bar to file additional lawsuits over fees.[4] Furthermore, ERISA Section 502(a) gives the plan participants the power to file legal claims against a plan fiduciary for breaching its duties. Table 1 provides a listing of penalties under ERISA.

Role of the Financial Advisor

Given the fact that employers typically have limited knowledge of the 401(k) plan industry (other than the experience they have with their individual plans), employers may be exposing themselves to significant fiduciary liability when they sign off on plan fees without any outside assistance or formal review process. To offset the chance of violating federal law and the related penalties under ERISA, employers and plan fiduciaries should seek the assistance of financial advisors. Qualified financial advisors can assist plan fiduciaries with selecting a reliable benchmarking services provider, incorporating the services into a disciplined review process that is intended to satisfy the requirements of ERISA and using the plan's benchmarking results effectively to properly evaluate the plan's fees in light of the services provided.

Qualified financial advisors sensitize and educate plan sponsors with respect to the employer's duties under ERISA to monitor and evaluate the plan's fees. Employers must

Table 1. ERISA Penalties

ERISA Code	Description
ERISA 409	Imposes personal liability for losses
ERISA 502(l)	Imposes a 20% civil penalty on amounts recovered
ERISA 502(a)	Gives participants the power to sue for fiduciary breaches.

Note. ERISA = Employee Retirement Income Security Act.

also confirm that any and all fees paid with plan assets are reasonable, and the employer must make this determination with the same standard that would be required of a prudent expert.

Facing the Fiduciary Challenge

Benchmarking services are instrumental in assisting employers meet their obligations under ERISA with respect to plan fees. The following section outlines how benchmarking services can help plan fiduciaries combat the challenge of satisfying requirements under ERISA.

1. Assist the employer with the process of identifying and calculating all plan fees, including any "hidden" indirect compensation paid by the plan's investments (or investment providers)

Identify "hidden" indirect compensation. The U.S. Government Accountability Office (GAO), an independent, nonpartisan agency that works for Congress, concluded in its July 2008 report, *Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors*, that plan sponsors were unable to satisfy their fiduciary obligations without disclosure of the "hidden" compensation flowing from the plan's investments to its service providers (e.g., record keeper, pension consultant).[5]

For example, a plan's service provider may receive "soft dollar" payments from the plan's investment funds in the form of shareholder servicing fees as well as 12b-1 fees and subtransfer agency fees or other revenue-sharing payments directly from the funds' investment managers. Although a plan sponsor would undoubtedly be aware of the "hard dollar" fees charged directly to the plan or plan sponsor, the employer may not necessarily understand that the service provider can also receive indirect compensation from the plan's investment funds and the managers of such funds.

Thus, a plan sponsor could conceivably select what appears to be a "free" administrative service for the plan, without understanding that the provider's compensation was being passed on to plan participants in the form of higher embedded costs in the plan's investment funds. The plan's service provider would also have a conflict of interest to the extent it had a financial incentive to steer the plan sponsor to arrangements or funds that increased the provider's indirect compensation.

DOL Advisory Opinion 97-16A. In DOL Advisory Opinion 97-16A, the DOL advised that fiduciaries must assure that the compensation paid directly or indirectly by the plan to a service provider is reasonable. Plan fiduciaries therefore must obtain sufficient information regarding any such indirect compensation, to make an informed decision whether such compensation is no more than reasonable. Revenue sharing among a plan's investment and service providers is not prohibited under ERISA. But without full disclosure of the indirect compensation paid to the plan's service providers, the employer might approve a service arrangement with fees in the aggregate that are unreasonable, resulting in a breach of its fiduciary duties under ERISA.

Work with the plan's record keeper to obtain indirect compensation information. With the consent of the plan sponsor, many benchmarking service firms will work directly with the plan's record keeper to obtain the information necessary to determine the various types of revenue sharing payments flowing from the plan's investments (and/or investment providers) to the plan's service providers. Providers of these types of benchmarking services can greatly simplify the employer's review of plan fees.

New reporting rules under Form 5500. These revenue-sharing data can also be used by the plan sponsor to confirm the direct and indirect compensation information that, beginning with the plan year for 2009, must be reported on the plan's annual 5500 tax form.[6] This recent change to the form 5500 is just a part of the DOL's regulatory initiative to improve fee transparency. This revenue-sharing information will continue to be relevant as the DOL moves to finalize its other related regulations, including the 408(b)(2) regulations.[7]

2. Enable the employer to incorporate benchmarking services as part of a prudent review process to evaluate and monitor the plan's services and fees on an ongoing basis

Prudent review process to monitor fees. The DOL issues Information Letters that are intended to call attention to well-established principles under ERISA. The DOL has repeatedly summarized in multiple Information Letters and in other related pronouncements (the "DOL Procedural Guidance," which includes Field Assistance Bulletins and proposed 408(b)(2) regulations) the procedural rules which

plan fiduciaries should follow in connection with the selection of a service provider.[8] Based on this DOL Procedural Guidance, the responsible fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered and the reasonableness of the fees charged in light of the services provided.

Soliciting bids among providers at the outset is a means by which the fiduciary can obtain the necessary information relevant to the decision-making process. Whether such a process is appropriate in subsequent years may depend, among other things, on the fiduciary's knowledge of the service provider's work, the cost and quality of the services provided and the fiduciary's knowledge of prevailing rates for similar services, as well as the cost to the plan of conducting a particular selection process.

According to the established principles articulated in the DOL Procedural Guidance, in order to be compliant, a plan sponsor should follow an objective process for gathering information about the provider, its services and the reasonableness of its fees. Given the enormous effort and time, which is typically involved in soliciting bids from prospective service providers for the plan, it would be much more efficient for a plan sponsor to implement a simple procedure under which (a) it requests updated information concerning the qualifications of the plan's existing service provider, (b) objectively assesses the provider's historical performance and (c) it uses benchmarking services to determine the prevailing rates for similar services. This results in a simple procedure that is less burdensome than soliciting bids.

The advantage of this simple procedure is that the plan sponsor can use it regularly as part of a formal and prudent review process, and it will help the plan fiduciary monitor the reasonableness of the plan's services and fees on an ongoing basis. Financial advisors who work closely with plan sponsors can assist them in the development and adoption of a simple but disciplined review procedure for monitoring plan fees.

3. Equip the employer with "expert knowledge" of competitive pricing information that a prudent expert might have. Having this information helps the employer and other plan fiduciaries assess the reasonableness of the plan's current service arrangement

Gain expert's knowledge with competitive pricing information. Although many employers intuitively believe the key to satisfying the prudence standard under ERISA is following a set of prudent procedures, it cannot be satisfied through process alone. Financial advisors should also remind plan sponsors that the fiduciary decision-making process requires substantive expertise. The standard of care under ERISA Section 404 requires the plan sponsor to evaluate the reasonableness of plan fees with the skill and knowledge of a de facto prudent expert who is familiar with the service fees in the 401(k) plan industry.

Evaluate the reasonableness of fees with the skill and knowledge of a prudent expert. One of the few ways in which an employer can acquire this requisite knowledge is to obtain competitive pricing information from a reliable benchmarking service. And with the assistance of the benchmarking service provider and the support of the plan's financial advisor, the plan sponsor should be able to position itself so that it is able to interpret and use the competitive pricing information effectively and also complete its fiduciary review in the same manner as a prudent expert would.

Selecting a Reliable Service

Selection of a Benchmarking Service Provider Is Also Subject to ERISA Fiduciary Standards

The use of a reliable benchmarking service may assist in assessing the reasonableness of plan fees and thus help satisfy ERISA requirements. However, there are many different types of benchmarking services. In addition to guiding clients with their selection, it is important for financial advisors to inform the plan sponsors that the decision to use the services of a benchmarking firm is also subject to the same fiduciary standards under ERISA that would apply to selecting service providers for the plan generally.

Encourage Plan Sponsors to Make Inquiries

In addition, financial advisors who work with plan sponsors should encourage them to make the following inquiries with respect to any prospective provider of benchmarking services:

- What are the qualifications and credentials of the provider? For how long has the provider been offering benchmark services? How many clients has the provider served over the years?
- Does the provider offer benchmarking analyses for all of the plan's investment and administrative service fees? To what extent are benchmarking analyses provided separately for each individual fee (as opposed to total fees)?
- Will the provider be able to identify all indirect compensation paid to the plan's service providers from the plan's investments and investment providers? Does the provider consider all indirect

compensation paid with respect to the benchmark group of plans?
- How reliable are the provider's data for the benchmark group of plans? Are data obtained directly from the various plans' record keepers? Does the data-gathering method used by the provider prevent inaccurate data submission? Are stale and outdated data disregarded?
- What is the size and profile of the plans included in the benchmark group? How many plans are included in the benchmark group? Can the benchmark group be customized?
- Does the provider offer any benchmarking analyses with respect to the quality of the investment and administrative services provided to the plan?
- To make a direct comparison, the actual fees of the various plans are often converted into a per-participant fee or asset-based fee. Does the provider use both per-participant fees and asset-based fees as baselines for its comparisons? If not, why?
- After the benchmarking analyses are completed, what type of consulting services and support will be available to the plan fiduciary in interpreting such analyses?

Interpreting the Benchmarking Analysis

One of the most common questions plan sponsors ask when considering the use of benchmarking services is "What should my next step be if the benchmarking analysis says that my plan is too expensive?" Financial advisors should assure their plan clients that nothing in ERISA requires them to search the industry to find the cheapest investment and service providers.[9]

On the contrary, the DOL Procedural Guidance provides that plan fiduciaries should never consider one factor, such as the lowest fee for services, to the exclusion of any other factor, such as the quality of the work product. Rather, the decision regarding which service provider to select should be based on an assessment of all the relevant factors, including both the quality and cost of the services. Accordingly, a plan fiduciary should never conclude that its plan's services are too expensive, based on the results of a benchmarking analysis alone.

Remind Plan Sponsors to Review/Document the Quality of Services

Plan sponsors have the flexibility to maintain arrangements with plan service providers that charge relatively expensive fees, so long as they are appropriate in light of the services provided. If a plan sponsor is in this situation, financial advisors should remind the employer to document the reasons for concluding that plan fees are reasonable in light of the services provided (e.g., responsiveness to inquiries, prompt resolution of issues, high number of benefit transactions, complexity of plan design, low processing errors, customized services, etc.). Such documentation will be instrumental in demonstrating that the employer considered both plan fees and the quality of the services in its fiduciary duties under ERISA.

Table 2. What If the Plan Is Too Expensive?

Fees Issues	Action Taken by the Plan Fiduciary
Too expensive in light of the services provided	Renegotiate the plan's fees or ask for additional services
Indirect compensation received by the service provider	Create an "ERISA fee recapture account"
Refusal by the service provider to renegotiate its fees or change the scope of its services	Terminate the arrangement

Note. ERISA = Employee Retirement Income Security Act.

If the plan sponsor concludes that the fees are too expensive in light of the services provided, the plan sponsor should renegotiate the plan's fees or ask for additional services. If the fees are too high because of the indirect compensation received by the service provider from the plan's investments or investment providers, the employer can also request that the service provider create an "ERISA fee recapture account" under the plan, where all or a portion of the revenue sharing received by the provider is deposited into such account and then used at the direction of the employer to pay administrative expenses or for allocations to participants in accordance with the plan document.[10]

As a last resort, if the service provider refuses to renegotiate its fees or change the scope of its services, the plan fiduciary would have to terminate the arrangement to avoid a violation of the applicable rules under ERISA. Table 2 outlines the actions to take if fees are determined to be excessive.

Every plan sponsor in its capacity as an ERISA fiduciary has a duty to ensure the fees incurred by the plan are reasonable. Advisors can play a crucial role in helping the plan sponsor select a reliable benchmarking provider, develop a simple review process and evaluate the plan's fees in light of services.

- With the assistance of a reliable benchmarking service provider and the support of the plan's

financial advisor, employers can discharge their fiduciary duties in the same manner as would a prudent expert.

- However, it is important that plan fiduciaries recognize that benchmarking services are a tool to be included as part of a broader, prudent review process.
- Plan benchmarking results need to be evaluated in the proper context and critically examined, and decisions involving the hiring and firing of service providers should be based on all relevant factors and never based on the benchmarking results alone. Financial advisors should remind sponsors to review/document quality of services.
- ERISA does not require plan fiduciaries to select the least expensive service provider. In fact, selecting one or more service providers whose fees are above average may be appropriate depending on the relative value of the services provided to the plan. The employer or plan sponsor should take into consideration both plan fees and the quality of the services provided to fulfill its fiduciary duties under the ERISA requirements.

ERISA has imposed a set of rules consisting of three parts to ensure fees incurred by the plan are reasonable in light of the services provided. Despite the overwhelming task of meeting the requirements, coupled with the potentially imminent threat of being sued for breach of fiduciary duties, satisfying the critical requirements under ERISA and limiting exposure to legal risks is possible by engaging the assistance of benchmarking service providers. Although these services are also subject to the same fiduciary standards under ERISA, a reliable benchmarking service effectively assesses the reasonableness of plan fees and helps minimize being penalized for failure to meet the requirements.

Qualified financial advisors are key in ensuring plan sponsors adhere to their fiduciary duties in monitoring and evaluating fees. Financial advisors can assist employers and plan fiduciaries expand their prudent expert knowledge through the evaluation of plan benchmarking results, selection of a reliable provider and assistance in incorporating benchmarking services into a prudent plan review process that is intended to satisfy the requirements of ERISA.

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Notes

1. ERISA Section 406 provides, among other requirements, that a fiduciary must not cause the plan to engage in a transaction that constitutes a direct or indirect (a) sale or exchange of any property between the plan and a party in interest, (b) lending or extension of credit between the plan and a party in interest, (c) furnishing of goods or services between the plan and a party in interest or (d) transfer to, or use by, a party in interest of any plan assets. A "party in interest" is broadly defined to include the plan's service providers, fiduciaries, the employer sponsoring the plan and their respective affiliates.
2. Under ERISA Section 409, a fiduciary is personally liable for plan losses resulting from a breach, such as the use of plan assets to pay unreasonable fees. ERISA Section 502(l) imposes a 20% civil penalty on amounts recovered pursuant to a settlement with the DOL. Under Internal Revenue Code Section 4975, the excise tax for prohibited transactions is assessed against the service provider receiving unreasonable compensation from the plan.
3. See, for example, Abbot v. Lockheed Martin Corp. (S.D. Ill. Aug. 13, 2007), Beesely v. International Paper Company (S.D. Ill. Sept. 30, 2008), George v. Kraft Goods Global, Inc. (S.D. Ill. Mar. 16, 2007), Martin v. Caterpillar, Inc. (C.D. Ill. May 15, 2007) and Spano v. The Boeing Co. (S.D. Ill. Apr. 18, 2007).
4. In Hecker v. Deere & Co. (7th Cir. Feb. 12, 2009), the Court of Appeals, in its grant of a motion to dismiss, held that revenue sharing was not prohibited and that ERISA did not require disclosure of such payments to participants.
5. The GAO is an independent, nonpartisan agency that works for Congress and is sometimes referred to as the "investigative arm of Congress."
6. The GAO in its December 2009 report, *Additional Changes Could Improve Employee Benefit Plan Financial Reporting*, recommended that the DOL further increase its Form 5500 disclosure requirements for indirect compensation and that it should coordinate these requirements with the pending ERISA 408(b)(2) regulations.
7. The DOL proposed new regulations under ERISA Section 408(b)(2) in 2007, which, if adopted, would require the plan's service provider to disclose any indirect compensation and potential conflicts of interest. The DOL also proposed regulations in 2008, which, if adopted, would require plan sponsors to furnish fee information to plan participants.
8. See, for example, Information Letters to D. Ceresi (February 19, 1998) and to T. Konshak (December 1, 1997), the preamble to DOL proposed regulations under ERISA Section 408(b)(2) and DOL Field Assistance Bulletin 2002-2003.

9. See Hecker v. Deere & Co. (7th Cir. Feb. 12, 2009).
10. For more information about ERISA fee recapture accounts, see Q&A 13 of the Supplemental FAQs About the 2009 Schedule C on the DOL's website, http://www.dol.gov/ebsa/faqs/faq-sch-C-supplement.html.

Bio

Marcia S. Wagner is the managing director of The Wagner Law Group, one of the largest law firms focused solely on ERISA, employee benefits and executive compensation law. She was recently named as the one of the top 40 most influential people in the 401(k) industry. She is a frequent speaker at national conferences and corporate training programs. Since 2007, she has served on the Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities and was the 2010 Chair of the Employee Plans Section of the Advisory Council, which provides advice and consultation to the IRS on pension matters. She can be reached at Marcia@WagnerLawGroup.com.