Benchmarking Fee Reasonableness: A NEW Normal!

May 10, 2012

By: David J Witz, AIF®
Managing Director
Fiduciary Risk Assessment LLC
PlanTools™, LLC

A new regulatory fee disclosure regime, recent case law results, Audit obligations, current DOL enforcement activities and future DOL enforcement expectations provide meaningful incentives for benchmarking plan fees. Granted, there is no explicit statute or regulation demanding benchmarking, but there is an explicit obligation to assess reasonableness of fees and benchmarking is a logical, cost effective and efficient means to conduct an assessment of fee reasonableness.

In other words, disclosing fees is the legal OBLIGATION, fee reasonableness is the ISSUE.

While many covered service providers ("CSP") will provide a newly designed written contract to communicate fees in accordance with the 408(b)(2) fee disclosure requirements, such disclosures fail to comprehensively protect CSP compensation arrangements unless reasonableness of fees is addressed, a primary function of benchmarking. In other words, disclosing fees is the required legal obligation, fee reasonableness is the issue. If you do not provide the responsible plan fiduciary (hereinafter "fiduciary") with the ability to determine if fees are reasonable, you have met your disclosure obligation but you have not assisted the fiduciary to make a determination of fee reasonableness, an obligation emphasized by the Department of Labor ("DOL") in the preamble as follows:

> *"Both the proposal and the interim final rule required that reasonable contracts or arrangements between employee pension benefit plans and certain providers of services to such plans include specified information to assist plan fiduciaries in assessing the reasonableness of the compensation paid for services and the conflicts of interest that may affect a service provider's performance of services. The Department believes that plan fiduciaries need this information, when selecting and monitoring service providers, to satisfy their fiduciary obligations under ERISA section 404(a)(1) to act prudently and solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. 77 FR 5632 (Feb. 3, 2012)* (Emphasis added)
>
> *The Department also rejected these approaches as inadequate to achieve a central policy and legal goal – namely, enabling responsible plan fiduciaries, including especially small plan fiduciaries, to efficiently and effectively carry out their duty to assess information needed to purchase of plan services at a reasonable rate. 77 FR 5633 (Feb. 3, 2012)* (Emphasis added)
>
> *This rule is necessary to help both large and small plan fiduciaries get the information they need to negotiate with and select service providers who offer high quality services at reasonable rates and to comply with their fiduciary duties. 77 FR 5652 (Feb. 3, 2012)* (Emphasis added)

The goals and objectives of the new 408(b)(2) disclosure regulations are clear…provide a fiduciary with sufficient information so that an informed decision can be reached regarding the reasonableness of fees for services rendered. However, disclosing fees is insufficient to meet the 408(b)(2) requirements unless a competitive analysis can be made to determine if fees assessed are reasonable. Again, benchmarking is the logical cost effective approach to assist with this obligation.

In addition, the recent *Tussey v. ABB, Inc.* (W.D. Mo. Mar. 31, 2012) decision clearly emphasizes a fiduciary's obligation to determine reasonableness with regard to asset-based fees including revenue sharing which is defined as indirect compensation under the fee disclosure regulations.[1] Since the ABB opinion has been issued, numerous prominent law firms staffed with competent ERISA counsel have issued newsletters alerting clients and friends of the danger of failing to assess reasonableness of fees especially asset-based fees and fees paid from revenue sharing. For example,

> The court found that the plan fiduciaries failed to monitor the reasonableness of expenses… According to the court, ERISA and the plan's IPS required that the fiduciaries engage in a "deliberative" process to determine whether the revenue sharing arrangement…was in the plan participants' best interest. Reviewing expense ratios of the investment funds was not sufficient…Given the circumstances and ERISA's requirements, the plan fiduciaries are expected to know the exact amount of revenue sharing expenses and whether the amount is competitive... *Recent ERISA Fee Litigation: Key Lessons For Plan Fiduciaries*, Orrick Law Firm Client Alert, 4-26-12 (Emphasis added)
>
> According to the law firm of Haynes and Boone, "The court considered the revenue sharing agreement with Fidelity for recordkeeping services, as assets of the plan grew, revenue sharing with Fidelity would also grow—even if Fidelity provided no additional services…The fiduciaries never calculated the dollar amount of the recordkeeping fees the Plan paid to Fidelity Trust via revenue sharing arrangements, nor did it consider how the Plan's size could be leveraged to reduce recordkeeping costs. The fiduciaries did not obtain a **benchmark** cost of Fidelity's services prior to choosing revenue sharing..." April 2012 (Emphasis added)
>
> "…the court found that the fiduciaries did not know the amount of revenue sharing fees the service provider was receiving from year to year under its arrangements with third parties and, therefore, could not have monitored these fees or determined whether they were excessive. Without this information, the court found that the fiduciaries could not…engage in a deliberative process to justify that the fee arrangement it had with the service provider was in the participants' best interests…ERISA plan fiduciaries should keep in mind the following as they consider their plan documents, procedures and documentation practices: The potential impact of the new U.S. Department of Labor fee disclosure regulations on 401(k) fee litigation. In this area, it is not clear whether participants may initiate lawsuits with a basis on the newly disclosed information and claim first-time knowledge of alleged fiduciary breaches similar to those found in Tussey." Littler Mendelson, P.C, April 2012 (Emphasis added)
>
> "Further, the Court noted that the fiduciaries never determined whether the fees paid through revenue sharing were more than the actual costs of the fees…did not investigate the market price for **comparable** fees…**Comparing** the ABB plan to other plans, the Court found that ABB overpaid... While ABB noted that it did monitor the reasonableness of the overall expense ratio, the Court concluded that this was not enough. This was insufficient because it does not show how much revenue is flowing, does not show the competitive market for comparable funds, and fails to take into account the size of the plan…[T]he Court explained, if a fiduciary opts for revenue sharing, "it also must have gone through a deliberative process for determining why such a choice is in the Plan's

[1] See 2550.408b-2(c)(1)(viii)(B)(2)

and participants' best interest." Dorsey & Whitney LLP, April 2012. (Emphasis added)

Also, ABB did not get a **benchmark** of costs for Fidelity's services before choosing the revenue sharing arrangement…The Court also rejected ABB's argument that its monitoring of the overall expense ratio of the funds was sufficient because this monitoring did not show how much revenue Fidelity Trust was receiving or provide a basis for ABB to compare its revenue sharing arrangement to the market…the Court emphasized that "if a plan sponsor opts for revenue sharing as its method for paying…it must have gone through a deliberative process for determining why such choice is in the Plan's and participants' best interest" Trucker Huss, April 2012 (Emphasis added)

These five reputable ERISA law practices and many others with a defense focus make clear the dangers of engaging in the payment of indirect fees without a deliberative process to assess the reasonableness of the fees. Furthermore, the DOL has provided some guidance in the preamble on how a fiduciary should go about determining reasonableness. According to the preamble,

"The Department does not believe that responsible plan fiduciaries should be entitled to relief provided by the class exemption absent a reasonable belief that disclosures required to be provided to the covered plan are complete. To this end, responsible plan fiduciaries should appropriately review the disclosures made by covered service providers. Fiduciaries should be able to, at a minimum, compare the disclosures they receive from a covered service provider to the requirements of the regulation and form a reasonable belief that the required disclosures have been made." [77 FR 5647-48 (2-3-12)]

A careful reading of the above section of the preamble leads one to conclude that a fiduciary is only provided personal relief from a prohibited transaction claim under the regulation if the fiduciary can demonstrate that all fee disclosures meet the requirements of the regulation. Few plan sponsors have the internal expertise to make this assessment and where expertise is lacking; a fiduciary is obligated to seek the help of outside experts to assist with the assessment. Again, like the Judge in the ABB case, the DOL has emphasized the need for a fiduciary to secure help from outside sources when a fiduciary lacks the understanding or necessary tools to evaluate the reasonableness of fees, the obligation to document the decisions made and to adhere to prudent processes once adopted. The suggestion to hire experts should come as no surprise. In fact, the DOL emphasized the importance of seeking assistance by experts in the preamble, which states:

"If the responsible plan fiduciaries need assistance in understanding any information furnished by the service provider, as a matter of prudence, they should request assistance, either from the service provider or elsewhere." 77 FR 5636 (Feb. 3, 2012) (Emphasis added)

Of course, there is also a history of case law that encourages a fiduciary to seek outside qualified experts when a fiduciary lacks the expertise to execute their fiduciary obligations. The message to a fiduciary is clear and the path to fiduciary risk mitigation, in light of the new fee disclosure rules, is a six step process.

1. Collect your disclosures by July 1, 2012.
2. Send letters requesting disclosures on July 2, 2012 if not received by July 1, 2012. This starts the 90 day clock and protects the fiduciary from participating in the prohibited transaction.
3. Compare disclosures to the regulations to confirm the disclosures are complete. If the fiduciary does not have the sophistication to complete this task, seek help.
4. Inform any CSP that has failed to provide complete information and request the information that is missing. If not received within 90 days of request, as in #3 report the CSP to the DOL and take action to replace the CSP.
5. Replacing the CSP requires engaging in a prudent selection process i.e., a Request for

Proposal ("RFP") is a prudent course of action.

6. The CSPs that have met their disclosure obligations and those you intend to select through the RFP process should be benchmarked to confirm fee reasonableness.

Benchmarking provides that deliberative process referenced in the ABB case to support a prudent decision that fees are reasonable. In short, benchmarking is the ultimate risk mitigation strategy that positions the fiduciary to defend their decision to hire a particular CSP for the fees assessed.

A CSP that fails to engage in the process of benchmarking abdicates that responsibility to a potential competitor. The conclusions a competitor draws may or may not be in agreement with the incumbent CSP. As in the ABB Case, outside consultants did not believe the incumbent CSP fee arrangement was reasonable. ABB ignored their recommendation which was used against them when assessing a monetary award approaching $38 million. While you may not be subject to excessive fee litigation you may be subject to an annual audit. Those plans subject to an annual audit will likely experience a new conversation with the auditor who is obligated to report operational and regulatory failures including a prohibited transaction regardless of the materiality of the prohibited transaction.

Audit standards impose an obligation on an auditor to review copies of all CSP service agreements and disclosures and make an independent determination whether those disclosures meet the regulatory requirements. If necessary, the auditor should consult with the fiduciary's legal counsel or other specialists to determine if the disclosures meet the 408(b)(2) requirements.[2] In fact, the Audit & Account Guide book explicitly states that when testing material transactions an auditor should consider a "test for reasonableness the compilation of amounts to be disclosed or considered for disclosure."[3] While nothing in the Audit Guide book explicitly states an auditor should benchmark plan fees, it is clear the auditor is responsible for reporting whether fees assessed failed to meet the requirements of 408(b)(2). It is questionable how an auditor can make such an assessment without referencing an existing RFP process or benchmarking report. A fiduciary whose plan is subject to an audit is best advised to have a benchmarking report in hand before the audit begins to assist the auditor and reduce costs.

Benchmarking has legitimately earned its new role as the **NEW NORMAL**! It has evolved from unreliable surveys to reliable data on actual plans of similar size. It is cost effective, saves time and provides an independent and objective assessment of fees and services that is remiss in an RFP process which is time consuming, expensive and easily influenced by subjective processes. Benchmarking provides an incumbent CSP the ability to offer an objective assessment of fee reasonableness without conflict. Offering benchmarking services to assist a client in their fiduciary obligation is a desirable value added service. Incumbent CSPs that ignore this service do so to their own detriment. By abdicating this service to their competition, an incumbent CSP places their client relationship at great risk. For CSPs that are savvy in the art of benchmarking and are armed with a tool that has a revenue sharing database, like **PlanTools™,** the future looks promising as indirect asset-based compensation continues to be a target of regulatory action and plaintiff attorneys. Just ask ABB.

Fiduciary Risk Assessment ("FRA") provides consulting, expert witness and assessments of advisor expertise. PlanTools, a wholly owned subsidiary, delivers web-based expense analysis, benchmarking, 408(b)(2) reporting, revenue sharing database, standards-based risk management and fiduciary governance solutions. For more information about FRA/PlanTools contact David J Witz, AIF® at 704-564-0482 or dwitz@fraplantools.com

[2] Audit & Account Guide ¶ 11.13, page 223 (1-1-2011)

[3] Audit & Account Guide ¶ 11.11, page 222 (1-1-2011)