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Benchmarking: A Means to Meet Compliance Obligations

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Overview

ERISA Section 408(b)(2) became effective on July 1, 2012. Under Section 408(b)(2), a covered service provider (CSP), for the first time, is obligated to disclose to plan fiduciaries certain information that historically was concealed. In particular, a CSP is obligated to disclose its fiduciary status, all direct and indirect fees received, and services rendered. The purpose is to provide the responsible plan fiduciary with sufficient information to make informed decisions about the reasonableness of fees for services rendered and whether any conflicts exist. Ultimately, the fiduciary that documents its process based on the collection of facts, the evaluation of those facts, and the execution of a plan in light of the facts has taken the necessary steps to defend procedural prudence.

In building a technology platform to benchmark plan fees, FRA PlanTools wanted to create one that was easy, cost effective, and sufficient to establish a documentation trail to support a prudent compliance process. We determined that the best approach was to build a benchmarking solution that was fact specific instead of adopting a less expensive more profitable tabulation of surveyed data.

The critical components to effective benchmarking include:

- *A database of similar plans that is independent and objective.* Benchmarking your fees and services against other plans all serviced by the same CSP is conflicted because it benchmarks fees of a CSP against itself. In fact, it is worthwhile to query any benchmarking service to determine the impact any one CSP has on the database. We restrict any one CSP to 10 percent of the data for a given category in a given benchmarking range.
- *Identifying fees for services rendered.* To date, I have identified over 70 services and nine different roles provided by advisors. In short, since all CSPs are not alike, in terms of services delivered, you should not expect their fees to be similar. Some charge more but do more by delivering more services or fewer more complex or time-consuming services. Herein lies the need for the responsible plan fiduciary to exercise its subjective opinion based on the needs of the plan and not just whether fees are above or below the average.
- *Identify all types of fees.* This includes identifying fees invoiced to the plan sponsor or plan assets, indirect fees paid by an investment company derived from asset management fees, and non-monetary compensation paid for volume of business, retention, or production. Where non-monetary compensation is provided on some but not all services, products, or investments a conflict may exist.

Practice Tip: It is important to stress that some plans realize very little benefit from benchmarking. In fact, the only means of determining fee reasonableness for plans that are highly complex, unusually large mega plans, or have a national brand that might cause a company to buy the business is to seek a formal Request for Proposal.

Benchmarking's Effect on Fees

The Labor Department and the courts look for a documented process that supports a fiduciary claim of prudence. Benchmarking is the most cost effective and efficient means to evaluate fee reasonableness assuming there is statistically significant data of similar plans for comparison.

Also, benchmarking is not a means to lower fees although that may be an end result. Instead, fiduciaries should expect to see their fees fall between a range of the 25th to 75th percentile for the following reasons:

- CSP location;
- Service menu, i.e., number and types of services;
- Personnel credentials; and/or

- Personnel experience.

In other words, CSP located in Manhattan with attorneys on staff cannot be expected to charge the same as a firm in Huntington, W.V. with no credentialed employees. Since a benchmarking database takes into consideration plans from all over the country with varying service levels and different credentialed personnel, it is unreasonable to assume that a plan should always pay an average fee.

Checklist: Best Practices

Although there is no law or regulation that requires benchmarking at any time, there remains a fiduciary obligation to assess the reasonableness of fees for services rendered. In fact, the preamble to the 408(b)(2) regulations imposes an obligation on fiduciaries to compare their disclosure of plan fees to the regulations to confirm the disclosures are complete. This is a tall task for the untrained fiduciary and could require the retention of an expert that has developed a process and procedure such as a custom checklist to conduct the assessment accurately. In our experience, developing a custom checklist is a significant body of work before it is even applied to a specific CSP engagement. Our checklist was developed over 18 months and is approximately 40 pages in length, which includes all the cross references. Of course, it is highly unlikely that every section of a comprehensive 408(b)(2) compliance checklist would apply to any one CSP. However, no responsible plan fiduciary should expect any CSP, whether they are a bundled provider, advisor, consultant, TPA or recordkeeper, to provide this service free of charge.

In light of the fiduciary demands and the focus on fees by plaintiff law firms and the DOL, I suggest the adoption of a series of best practices to mitigate litigation risks that includes:

☐ An annual benchmarking evaluation to enable the fiduciary to determine if there is a pattern that would dictate any necessary action.

☐ Distribution of an executive summary of the benchmarking results to the participants. By doing this, the statute of limitations can be reduced to three years from six years.[1] Besides, if you have done nothing wrong you have nothing to hide.

☐ A comparison of revenue sharing payouts by fund among different platforms to confirm the revenue sharing received by each fund is maximized on a net basis. ☐ *Note:* When considering the revenue sharing payments received, it is important to take into consideration the cost of custody and/or trust services. It is possible to receive more revenue sharing from one platform only to pay more custody and/or trust services, thus resulting in a net higher cost than the platform that distributes a smaller allocation of revenue sharing. Also, compare the list of services received from the platform to properly evaluate revenue sharing payments received. You may receive less revenue sharing from a platform that provides a more robust menu of services to justify the cost difference. Finally, do not forget to consider the unique pricing structure of insurance companies that do not charge a separate custody fee. Instead, an insurance company is likely to have a slightly higher operating expense for the separate accounts or a higher recordkeeping fee. This adjustment will require that you compare the insurance company's fees to a combination of recordkeeping or investment management services plus the custody/trust fees of an open architecture platform.

☐ A comparison of the operating expense ratios (OER) between multiple share classes of the same fund available under the same platform. In other words, if the same investment is available at a lower cost (as a lower class share) consider selecting the investment with the lowest cost unless you can document why you are willing to use the fund that has the higher OER. Keep in mind that there may be legitimate reasons for using the fund with the higher OER. By documenting the reasons why a particular share class was selected, fiduciaries are able to validate their understanding of the different share classes.

☐ Finally, establish a fee policy that memorializes guidelines for how the fiduciary evaluates fees plus the fiduciary's approved allocation of fees among participants. In addition, fiduciaries should document their understanding of share class pricing differences, the analysis of revenue sharing to assess the amount of indirect fee flow, and the benchmarking of fees to determine reasonableness. A fiduciary should look at Field Assistance Bulletin 2003-03 for DOL guidance on fee allocation among participants. It is highly recommended to have legal counsel review the fee policy to ensure the policy is not drafted in such a way that increases fiduciary liability.

Fiduciaries that adopt these best practices will go a long way towards documenting prudent processes as well as establishing a solid risk mitigation strategy.

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[1] ERISA § 413 limits the time fiduciary breach actions can be brought to the earlier of six years after the date the breach occurred or, in the case of an omission, the latest date the breach could have been cured, or three years after the earliest date on which the plaintiff had actual knowledge of the breach.