Proper 401(k) Plan Management to Reduce Liability and Optimize Performance

By Sheldon M. Geller

Plan sponsors rely upon advisors to monitor fund expense, fund performance, and plan cost, whereas plan participants rely upon plan sponsors to protect them from excessive fees and poor fund performance. Given recent litigation alleging excessive fees and Department of Labor (DOL) regulations requiring that plan assets be used to pay "reasonable" fees, effective fee management is of strong importance. Fund expense and indirect compensation oversight is an important aspect of proper plan governance and a fiduciary responsibility for plan sponsors, investment committees, and employee fiduciaries. After taking into account marketplace conflicts, fee litigation, regulatory guidelines, and plan management experience, investment committees and employee fiduciaries should implement the following best practices.

Recordkeeping Fee Benchmarking

Plan fiduciaries should assess the reasonableness and competitiveness of their fee arrangements to make certain they do not use plan assets to pay excessive fees. Plan fiduciaries are required to leverage their superior plan profiles and negotiate fee reductions. Fiduciaries should also obtain competitive fee and service quotes to demonstrate reasonableness and record the fiduciary decision-making process.

Plan fiduciaries should also negotiate fixed fees for record keeping, trustee, and advisor services, rather than accept asset-based fees, as is customary in the marketplace. If the selected service provider applies asset-based fees, fiduciaries should monitor fund expenses and service fees by comparing their asset-based fees to a fixed fee or a per-participant fee to assess reasonableness. Accordingly, plan fiduciaries should carefully review the annual fee disclosure statements issued by their service providers, which set forth direct compensation, indirect compensation, and fund expenses.

Dangers of Fee Litigation

Fee litigation involves the selection of an inappropriate share class in the absence of documenting fiduciary decisions related to plan cost. Recent litigation alleges that employers failed to identify and correct conflicts of interest that resulted in excessive compensation paid to service providers and made part of the fund expenses charged to participant accounts. Enforcement actions have targeted the payment of excessive indirect compensation to service providers in circumstances where the employer conducted no fee benchmarking and no fee negotiation.

Revenue Sharing Considerations

Many recordkeepers are compensated for their services through revenue sharing arrangements. These arrangements

customarily provide that all revenue sharing is retained by the recordkeeper as compensation for services provided to the plan. Fully bundled service deliverables rely on this pricing model to deliver record keeping and investment platform services to plan sponsors. Nevertheless, many bundled service providers now agree to fix their fee and apply any excess revenue sharing as credits to pay other plan fees or to allocate to participant accounts. Moreover, some bundled service providers offer revenue credits for the entire amount of revenue sharing and bill separately for their services.

Although the DOL has jurisdiction over the Employee Retirement Income Security Act's (ERISA) fiduciary responsibility provisions and the use of plan assets to pay plan expenses, it has not provided definitive guidance as to how to allocate revenue sharing payments. Nevertheless, the DOL has explained in Field Assistance Bulletin (FAB) 2003-3 (http://www.dol.gov/ebsa/regs/fab2003-3.html) that ERISA does not specifically address the allocation of expenses in defined contribution plans and that plan sponsors have considerable discretion in determining the method of expense allocation. This supports the position that the method of expense allocation is a settlor or plan sponsor decision, rather than a fiduciary decision. Plan sponsors opt for the revenue sharing fee offset methodology by signing service agreements, if not plan documents, that provide for fee offsets.

Fiduciaries are obligated to follow plan document provisions and service agreements, absent a clear violation of ERISA. Carrying out plan document and service agreement provisions is a nonfiduciary decision, but there is support for a fiduciary to follow an allocation methodology that is required by a mutual fund distribution plan. Accordingly, retirement plan committees should record the extent to which their plan sponsors have addressed these revenue-sharing arrangements, thus removing them from any fiduciary decision regarding the application of revenue-sharing payments and the allocation of plan fees.

Fee Equalization

Fee equalization levels the different revenue sharing amounts paid by different funds and avoids participants paying different expense and fee amounts. A participant's choice of an index fund or an actively managed fund should not affect the extent to which that participant pays service fees. Moreover, fees may be charged to participant accounts on a per capita basis, rather than on a pro rata basis, without taking into account participant account balances. Fee equalization credits revenue sharing to participant accounts instead of using revenue sharing to offset fees. Fee equalization encourages the use of funds with no revenue sharing. Fee equalization also avoids the payment of indirect compensation to service providers, resulting in hidden compensation that often goes undetected by plan sponsors. Hidden compensation drives excessive fees.

Investment Committee Governance

Employers should establish formal investment committees and adopt a committee charter authorizing the selection, retention, and replacement of investment funds. Committees should meet at least annually, apply investment policy statement provisions, review fund data, make fiduciary decisions, and document these decisions in meeting minutes. They should also monitor any delegation of responsibility to service providers, including recordkeepers and investment advisors. Delegation to subject matter experts is encouraged by ERISA, but plan fiduciaries should document the decisions they make based upon such third-party advice. Finally, committees should make certain they comply with any governance documents, including investment policy statements, by applying investment criteria, revenue sharing guidelines, and plan document provisions.

> Most employers rely upon their recordkeepers and advisors, who are not subject to the legal duties of loyalty and prudence, to protect their plans.

Conclusion

Most employers mistakenly rely upon their recordkeepers and advisors, who are not subject to the legal duties of loyalty and prudence, to protect their plans against excessive fees. Marketplace conflicts and industry practices continue to place employers at risk and make it difficult for their service providers and advisors to limit their fiduciary liability. Furthermore, nonfiduciary service providers and advisors are not bound by the exclusive benefit rule, which would otherwise protect participants from excessive fees, high investment expenses, and poor fund performance.

Proper plan management and committee governance require diligence, but they also lead to successful participant outcomes, mitigate employer risk, and enhance plan performance. ❑

Sheldon M. Geller, CPA, JD, AIF, *is a managing member of Stone Hill Fiduciary Management, LLC, Great Neck, N.Y. He is a member of* The CPA Journal *Editorial Board.*