The Intelligent Plan Fiduciary

By Sheldon M. Geller

A dynamic segment of Employee Retirement Income Security Act (ERISA) jurisprudence, regulatory enforcement, and fiduciary best practice involves the monitoring of plan expenses, including direct fees charged to participant accounts and indirect fees payable by mutual fund companies. Indirect fees—hidden compensation embedded in fund expenses—drive excess compensation to 401(k) plan service providers.

Service provider conflicts of interest increase the amount of indirect fees paid by plan participants in several ways. For example, proprietary investment funds pay higher amounts to mutual fund companies providing record keeping services. Investment advisors recommend funds that pay disproportionate amounts to their record keeping affiliates.

Recent case law requires plan fiduciaries to avoid conflicts and to use plan assets to pay reasonable fees. Conflicts arise when an organization provides multiple services to a 401(k) plan. The White House Council of Economic Advisors released a report analyzing the economic cost of conflicts, concluding that conflicted advice lowers investment returns by approximately 1% annually.

The fiduciary standard operates as a constraint on greed. By including the duties of loyalty and prudence, the fiduciary standard eliminates conflicts that produce excessive fees and poor fund performance. A fixed advisor fee also discourages greed and avoids automatic increases in advisor compensation. It is advisable for plan sponsors to create a fiduciary-client relationship, rather than a sales relationship, taking advantage of statutory protections.

The intelligent plan fiduciary does the following:

- Removes conflict risk by appointing a fully independent organization singularly focused on named fiduciary advisor services,
- Recognizes that objectivity through independence results in good fiduciary decisions, and
- Requires that its 401(k) plan advisor be paid a fixed fee, rather than an asset-based fee.

Longstanding Retirement Industry Practices

Responsible plan fiduciaries and astute participants are increasingly challenging the retirement industry's longstanding practice of excess indirect compensation. Service providers and investment advisors are in a position to profit from their relationship with the very plans whose best interest they should protect. Increasingly, an employer enabling its plan to pay excess compensation will be at risk.

Enforcement actions and fee litigation have targeted the collection of indirect compensation received by plan service providers. In 2013, monetary sanctions against plan fiduciaries exceeded $1.5 billion for corrections and enforcements; in 2011, plan fiduciaries paid more than $1 billion to restore plan losses and pay penalties. The average penalty per plan was approximately $450,000. Moreover, plans with less than $10 million in assets paid fines averaging $300,000. Plan sponsors of 75% of the plans audited in 2011 paid monetary sanctions.

Investigations and litigation have challenged the fees charged directly to participant accounts and the compensation paid by third parties to record keepers. Regulators have focused on the extent to which employers monitor fee statement disclosures for reasonableness and conduct proper benchmarking to protect plan participants. Deceptive industry practices and unclear fee disclosures ultimately increase employer liability.

Prudent Plan Management

There is now foundational case law demonstrating the importance of prudent plan management and the consequences of service providers having discretion over their own compensation. It is increasingly important for employers to implement and maintain a prudent process that rigorously assesses the reasonableness of compensation paid to record keepers through an honest benchmarking process. Committee governance activities must include independent reviews of plan service deliverables, fund performance, plan fees, and fund expenses. Committees must monetize the asset-based fee arrangements entered into with record keepers and investment advisors to avoid excessive compensation, and thus a breach of fiduciary duty.

Plan sponsors must establish a plan oversight committee, adopt a formal investment policy, and maintain meeting minutes to evidence that management has fulfilled its fiduciary responsibility and protected participant interests. Employee benefit plan auditors cite the absence of management procedures documenting the fulfillment of fiduciary responsibility as a significant deficiency in internal controls, creating employer risk.

Courts now require employers with superior plan profiles to use leverage and bargaining power to keep fees low, taking into account increasing plan asset levels. Employer fiduciaries who benefit themselves, further their own corporate interests, and self-deal as a result of their control over plan assets are at risk. Recent case law prohibits employers from subsidizing corporate costs with any fees generated on plan assets.

Employers may not enable their 401(k) plans to pay above-market compensation to a service provider for non-401(k) plan services. Accordingly, employers may not use broker commissions generated on plan asset investments to offset corporate accounting fees. Employers also may not use indirect compensation generated on plan asset investments to offset corporate payroll service fees, pension plan

service fees, or banking service fees. Simply put, employers may not self-deal nor leverage plan assets to receive an economic benefit to the detriment of plan participants.

Employer Fiduciary Liability Risks

Emerging case law has demonstrated ongoing employer liability risks emanating from conflicts of interest, kickbacks, self-dealing, and deceptive disclosures made by nonfiduciary service providers. Revelations about compensation that was previously hidden and increased fee disclosures are now available to employer fiduciaries and would-be fee litigants. Employer plan fiduciaries have no escape from the requirement that they assess their vendor fees and demonstrate that they are reasonable.

Many vendors have offered employers various fee comparison tools and benchmarking solutions to help them determine the reasonableness of fees. These solutions often serve the record keeper, not the employer, by attempting to demonstrate the reasonableness, if not competitiveness, of their own fees. Regulatory enforcement has shown that benchmarking using these tools does not adequately measure the reasonableness of a particular plan's fee or of the vendor's value.

Determining whether plan expenses meet the legal threshold of reasonableness is a responsibility that few employer plan fiduciaries are able to perform. The lack of a proper vendor evaluation system places employer fiduciaries at great risk. Employers need to retain an independent party to benchmark service provider compensation, assess vendor value, and determine the reasonableness of fees. Benchmarking using a database does not adequately establish a fair fee, measure a vendor's value, nor satisfy an employer's requirements under the statute.

Independent 3(16) Plan Administrator Services

Employer plan sponsors may now outsource their fiduciary responsibilities and 401(k) plan management to an independent named fiduciary and an ERISA section 3(16) plan administrator to significantly reduce their risk. The employer's remaining fiduciary obligation to the plan is to monitor the activities of the named fiduciary and 3(16) plan administrator. Committee meeting minutes are *prima facie* evidence that the employer plan fiduciary has monitored the delegation of fiduciary responsibility to a named fiduciary.

Independent 3(16) plan administrators provide the following services:

- Assumes full fiduciary responsibility for plan management
- Monitors service provider agreements, performance, and compensation
- Obtains fee quotes and determines reasonable service provider compensation
- Removes conflicts of interest, reduces employer liability, and protects plan participants
- Implements plan governance, conducts committee meetings, and prepares meeting minutes
- Approves regulatory filings, reviews audit reports, and signs the management representation letter.

Case Law Precedents Creating Employer Liability

Recent case law articulates practice standards for employer fiduciaries and describes the types of conduct that create employer liability. The following are commonplace industry practices and compensation methodologies that create employer liability:

- Failure to contain share class expenses when replacing like funds
- Failure to pay market cost and the use of excess fees to subsidize corporate services
- Failure to calculate, benchmark, and negotiate indirect compensation paid to record keepers
- Failure to comply with investment policy mandates to pay reasonable fees, monitor fund performance, and replace underperforming funds.

Responsible fiduciaries are retaining independent, conflict-free fiduciary advisors and 3(16) plan administrators in response to the heightened vigilance over, and the stricter requirements placed on, employer fiduciaries. Independent named fiduciaries may also serve as investment advisors, provided they do so for a single fee, thereby avoiding the potential for conflict when the same entity offers multiple services to the plan.

Deceptive Industry Practices

It is imprudent for an employer to engage record keepers who recommend funds that pay them. It is also imprudent for an employer to engage an advisor who recommends funds that pay a record keeping affiliate. And it is especially imprudent to maintain a service provider relationship without monitoring and negotiating reductions in the fee arrangement.

Most investment advisors serve in a limited capacity and their service agreements, while acknowledging fiduciary status, disclaim fiduciary responsibility for fund selection and fee monitoring. It is deceptive to offer investment advisory services and then contract out of fiduciary status. Fiduciary advisor services that resemble nonfiduciary broker services do not protect employers.

Avoiding Fiduciary Breaches

The currently accepted revenue-sharing methodology does not mean unfettered discretion for service providers to determine their own fees to the detriment of plan participants and, ultimately, plan sponsors. Employers who fail to benchmark fees or request lower expense share classes will face greater liability. Plan fiduciaries must monetize fee arrangements and understand the ways in which service providers are paid and how much they are paid. Plan fiduciaries are at risk if they utilize high expense share classes, do not benchmark fees, do not have a prudent fund selection process, fail to assess indirect compensation, or avoid conflicts.

Intelligent plan fiduciaries and responsible employers cannot do business as usual and accept the status quo given the way in which courts and regulators are interpreting accepted practices as fiduciary breaches and applying ERISA's broad protections against plan sponsors.

Employer plan sponsors are advised to outsource fiduciary responsibility to an independent named fiduciary that has extensive experience, subject matter expertise, and proven results—and one that provides no other services to their retirement plan clients. ❑

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