401(k) Plan Service Provider Selection and Retention

By Sheldon M. Geller

Plan fiduciaries must take specific steps in the selection and retention of service providers to properly carry out their fiduciary duties. Retirement plan committees and administrators charged with plan governance must understand the various fee and revenue sharing arrangements available in the marketplace and the associated conflicts in order to make defensible fiduciary decisions. Moreover, committees should document their ongoing due diligence and oversight of service providers, including each investment manager, recordkeeper, investment advisor, and employee benefit plan auditor.

Fiduciary Framework

Plan sponsors are advised to establish a governing body, such as a retirement plan committee, charged with plan investment and plan administration governance. In addition, retirement plan committees are advised to engage an independent fiduciary advisor who maintains no conflicts and charges a reasonable fee to manage plan governance, including the service provider selection and retention process.

Committees are advised to adopt plan governance documents, delegate fiduciary responsibility, and allocate fiduciary duties to the independent fiduciary advisor. Plan governance documents include an organizational document, a committee charter, an investment policy statement, an investment advisor agreement, and meeting minutes. Committees should also hold regularly scheduled committee meetings and document all fiduciary and non-fiduciary decisions, citing the basis for them.

Fiduciary Duties

Committees should endeavor to understand the choice of service and fee arrangements available in the marketplace. Notwithstanding the finalization of Department of Labor (DOL) regulations governing retirement plan advice, there will continue to be marketplace conflicts, resulting in higher plan cost and poor investment performance. It is easy for committees to breach their fiduciary duties of loyalty and prudence, however unintentionally, as a consequence of excessive fees, poor fund performance, and inadequate plan governance.

Specific Advisor Considerations

There are specific considerations for the selection of an investment advisor, including the need to engage an advisor who is a 3(38) investment manager providing discretionary management services, with the service agreement explicitly acknowledging such status without disclaimer. Granting discretion to an advisor results in the assumption of complete responsibility for fund selection and retention; an advisor who does not have discretion does not assume complete fiduciary responsibility and liability for fund selection and reasonable fund expense.

Committees who instead engage a 3(21) registered investment advisor retain ultimate responsibility for fund and share class selection, although these committees often mistakenly believe that they have delegated complete responsibility. High-expense share classes drive high advisor fees, while asset-based advisor fees may become unreasonable as plan assets grow. Committees should therefore secure a fixed fee, rather than an asset-based advisor fee, to contain costs and avoid conflicts. Committees should also determine whether the advisor fee is reasonable by assessing the services received and fiduciary responsibility delegated.

Most 401(k) plan advisors acting as investment managers do not customarily exercise discretion without committee approval, instead engaging in a plan governance process and securing committee approval for fund replacements. Committee approval does not increase the committee’s responsibility; rather, it satisfies the committee's residual responsibility to oversee the fiduciary duties delegated to the advisor.

Specific Recordkeeper Considerations

There are specific considerations for the selection of a recordkeeper, including the need to understand the fee amount, the way in which the fee is paid, and whether the fee is reasonable. Committees should obtain the recordkeeper’s average weighted investment menu expense, average weighted revenue sharing amount generated upon plan asset investments, and recordkeeping fee, customarily expressed as a percentage of plan assets.

Committees must understand the nature of the recordkeeping fee arrangement—for example, a revenue requirement wherein the recordkeeper retains all revenue sharing as a fee offset; or, alternatively, a fixed fee requirement wherein revenue shortfalls result in a participant account billable and revenue excesses result in a credit to a reimbursement account. Committees should secure a fixed fee arrangement rather than an asset-based fee. If an asset-based fee is unavoidable, committees must periodically review the fee amount, especially if it significantly increases, to determine that it remains reasonable. If not, the committee should secure a fee reduction.

Most employers use plan assets to pay recordkeeping fees, whether as a part of fund expense or charged directly to participant accounts. Asset-based fees are customarily offset with revenue sharing or are charged to participant accounts with no mechanism to bill the employer. Higher-expense share classes result in higher compensation paid to recordkeepers whose fee is paid with revenue sharing. Accordingly, it is imperative for committees to monitor share class expense to avoid excessive fee claims and breaches of fiduciary duty.

Marketplace Conflicts

Bundled service arrangements, including those where the same organization provides recordkeeping and investment platform services, present a conflict when paid through revenue sharing. Recordkeepers are non-fiduciary service providers, as well as for-profit entities who naturally want to secure the most profitable fee arrangement. Recordkeepers customarily provide investment menus with higher-expense share classes to completely offset their fee, thereby acting in their own best interest and not the plan's.

Bundled service arrangements overseen by an advisor whose compensation is paid from revenue sharing or whose commission is paid from mutual fund investments also present a potential conflict. Although advisors will be required to act in the plan's best interest, the funds they recommend may be higher-expense share classes in order to offset their high advisor compensation.

Unbundled service arrangements, including a registered investment advisor and a commonly owned third-party administrator whose compensation is paid from revenue sharing, present another potential conflict. Although advisors will be required to recommend the appropriate share class, the funds they recommend may be higher-expense share classes in order to offset high recordkeeping fees paid to their recordkeeper affiliate.

Employer plan sponsors are advised to engage an independent named fiduciary or an investment advisor who is also a 3(38) investment manager providing discretionary management and accepting a delegation of fiduciary responsibility. Fiduciary advisors who accept discretion assume responsibility for fund selection and share class selection. Moreover, fiduciary advisors who accept discretion cannot maintain conflicts and therefore must act in the plan's best interest in all events.

Specific Employee Benefit Plan Auditor Considerations

The importance of engaging a quality employee benefit plan auditor cannot be overstated, as a plan audit is a specialized engagement requiring subject matter expertise and extensive experience. Committees are required to retain a competent auditor and to procure a quality audit report if their plans are eligible for audit.

The Employee Retirement Income Security Act (ERISA) holds plan administrators responsible for the proper audit of plan financial statements in accordance with GAAS. Fiduciary responsibility creates liability if the plan administrator procures a deficient audit. Recent DOL studies have cited poor audit quality and significant deficiencies resulting in penalties of up to \$1,100 per day, without limit, on plan administrators filing deficient audit reports. The \$1,100 penalty has recently been increased, up to \$2,063 per day, for failure to file IRS Form 5500.

Recent DOL studies have also found that firms with limited employee benefit plan audit practices and engagement partners with little or no plan audit continuing education have higher rates of deficient plan audit work. The most common deficiency is the failure to perform adequate testing, often related to a misunderstanding of the requirements of a limited scope audit.

Plan administrators engaging an audit firm should conduct a request for proposal or send a request for detailed information regarding the prospective firm, staffing, and engagement, including a detailed billing supporting the fee schedule. This process will help determine whether a prospective audit firm is competent. Other matters adding complexity to the reporting and audit process include changes in service organizations, plan mergers, and the unique rules governing qualified plans. Accordingly, plan administrators are likely to receive a high-quality plan audit at a fair fee if they take into account technical ability and dedicated employee benefit plan audit personnel.

Although plan audit fees vary among firms and the audit fee is only one factor in the selection process, a very low fee may be suspect unless the firm audits many plans or has a specialized practice. DOL audit activity and penalties have increased, making it important for plan administrators to review their employee benefit plan audit arrangements to make certain they are in compliance. ❑

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