ERISA's Reasonable Fee Requirement

By Sheldon M. Geller

Concerns regarding litigation over excessive 401(k) plan fees and conflicts of interest dominate the current thinking of plan fiduciaries. More plan sponsors are engaged in plan cost reviews to determine and benchmark investment expenses, recordkeeping fees, and advisory fees, as well as how these plan costs are paid by their 401(k) plans.

Although 401(k) plan fees have declined as a result of fee litigation, fee disclosure statements, the fiduciary rule, the increased use of index funds, and marketplace competition, many plan fiduciaries continue to pay excessive fees with plan assets in violation of the Employee Retirement Income Security Act of 1974 (ERISA).

Legal Obligation

Most plan fiduciaries are unaware of their legal obligation to prove that they used plan assets to pay reasonable fees. Plan fiduciaries who have little or no knowledge as to the nature and extent of compensation paid to their 401(k) plan service providers may enable those service providers to collect excessive fees. Moreover, most plan fiduciaries have little or no knowledge as to what constitutes a reasonable fee arrangement for each category of 401(k) plan service.

Understanding and monitoring indirect payments made to recordkeepers and ensuring that they are not overcompensated may be the most challenging fiduciary duty for employers sponsoring 401(k) plans. Eight out of 19 settlements examined by the Financial Times require employers involved in litigation to offer lower-cost share classes of mutual funds in their plans. It is clear that very little attention was being paid by employers to making certain that 401(k) plan fees were reasonable (Beagan Wilcox Volz and Emily Laermer, "Legal Settlements Squeeze Fees for U.S. Employee Retirement Plans," Financial Times, May 21, 2017, http://on.ft.com/2rE5WAN).

401(k) plan service providers are not fiduciaries with respect to their client plans and thus may conceal sources of compensation and engage in conflicts, thereby inflating fees. Moreover, asset-based fee arrangements result in automatic and unmonitored fee increases as plan assets increase due to contributions and market valuation.

Plan fiduciaries must review service provider fees annually against reliable indicators as part of proper plan governance. The efficacy of any such review depends upon the ability to break out fees for each service and to utilize acceptable benchmarks, rather than self-serving benchmarks supporting excessive fee arrangements.

Plan fiduciaries must reduce the risk associated with Department of Labor (DOL) investigations and plan participant fiduciary breach claims. Current thinking is that 50 basis points is a reasonable estimate of savings to investors as a result of eliminating conflicted advice.

The real challenge for an employer is to determine what is a reasonable fee arrangement for a 401(k) plan. To determine fee reasonableness, employers must understand the nature and extent of asset-based fees and segment fees by service component, then measure service, benchmark fees, and implement oversight controls. Most employers retain an independent fiduciary advisor to fulfill the obligation to pay reasonable fees with plan assets and to manage plan governance.

Fiduciary Advisor

A fiduciary advisor, subject to the legal duties of prudence and loyalty and thus a professional purchaser of retirement plan services on behalf of clients, can control plan costs associated with recordkeeping, plan administration, employee benefit plan audits, fund management, and custody services. Such a fiduciary is also a risk manager specializing in proper plan governance, which provides a layer of protection to plan sponsors.

Many plan fiduciaries are increasingly retaining fiduciary advisors that specialize in ERISA risk management services. These advisors monitor service provider fees, fund expense, and fund performance, as well as manage plan governance. Effective plan governance and compliance reduces fiduciary risk, increases plan performance, and results in operational excellence.

Employer Fiduciary Liability

ERISA provides remedies to plan participants that can cause in-house plan fiduciaries to be individually and personally liable to make good on plan losses, to restore profits, and to provide any other equitable or remedial relief, including the removal of plan fiduciaries [section 502(a)(2)]. In addition to financial damages, settlements have required plan fiduciaries to retain an independent fiduciary, improve plan governance processes, and exercise greater care in fund and share class selection.

Plan Governance

Plan fiduciaries need to demonstrate that they have reviewed annual service provider compensation disclosure statements and fund expense disclosure statements and have determined that service fees and fund expenses are reasonable. Plan fiduciaries can manage the risk associated with their fiduciary duties by implementing and maintaining procedural prudence defined by appropriate processes and compliance efforts, such as the following:

- Establish investment fund performance criteria and fund replacement protocol
- Review service provider fees and fund expense disclosure statements annually
- Engage in plan investment and plan administration compliance reviews annually
- Document plan governance activities, decision-making processes, and decisions voted
- Establish a framework to delegate fiduciary responsibility and monitor that delegation
- Engage an expert fiduciary advisor to accept fiduciary responsibility without disclaimer
- Delegate plan governance, plan cost reviews, and investment performance monitoring
- Conduct committee meetings to monitor the delegation to, and activities of, the advisor
- Analyze plan fees, fund expenses, and service value against reliable marketplace benchmarks triennially

Fund Expense and Performance Monitoring

Recent case law makes clear that plan fiduciaries are required to monitor fund expense and fund performance after their initial fund selection [Tibble v. Edison, No. 13-550 (U.S. 2015)]. The court in Tibble stated that "cost-conscious management is fundamental to prudence in the investment function," and should be applied "not only in making investments but in monitoring and reviewing investments. Implicit in a trustee's [plan fiduciary's] duties is a duty to be cost-conscious."

Plan fiduciaries are increasingly demanding fiduciary investment services because they are concerned with the potential remedies available to plan participants, including their liability to cause plan fiduciaries to restore any losses due to excessive fees suffered by plan participants. Fiduciary investment advisory services are provided by 3(21) investment advisors and 3(38) investment managers, who have two very different levels of responsibility.

3(21) Advisor versus 3(38) Advisor

A 3(21) advisor acts as a co-fiduciary, providing advice to plan fiduciaries regarding investment funds made a part of a 401(k) plan investment menu. The employer retains the discretion to accept or reject that advice. In contrast, a 3(38) advisor has the discretion to make fund selection decisions. Plan fiduciaries have much less liability in the 3(38) relationship, as they delegate the fiduciary risk associated with fund selection and the duty to monitor fund performance and expense and retain only the duty to monitor the 3(38) advisor.

The 3(21) advisor relationship is much more available in the marketplace, amounting to 82% of retirement plan advisors. Only 47% of these advisors are willing to provide 3(38) advisor services, often at a 20%–25% higher fee. Accordingly, 3(38) services may be priced 10–15 basis points higher than 3(21) services. In addition, the demand for 3(21) investment advisor services has remained flat over the past five years, whereas the demand for 3(38) advisor services has doubled from 20% in 2011 [Greg Iacurci, "3(38) vs. 3(21) Investment Fiduciary Services: The Pros and Cons for 401(k) Advisers," InvestmentNews, Apr. 7, 2017, http://bit.ly/2sjznKi].

Plan fiduciaries have become acutely aware of their fiduciary risk and that they need the requisite level of expertise and protection. Packaged, outsourced 3(38) services offered by less specialized advisors are merely fund selection services without any focus on benchmarking and plan governance. These service agreements often include disclaimers of responsibility, resulting in less than a complete fiduciary risk management offering.

Plan fiduciaries are expected to continue to retain 3(38) advisors who accept a delegation of fiduciary duties and to monitor plan cost, fund performance, fiduciary compliance, and plan governance. Indeed, plan fiduciaries are increasingly replacing their non-fiduciary brokers with 3(21) advisors—and their 3(21) advisors with 3(38) advisors—as they become more knowledgeable about fiduciary risk and marketplace offerings. ❑

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