THE EXCELLENT FIDUCIARY

The "Gotchas" of Retirement Services Purchasing

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The executives who make procurement decisions for their organization's retirement plans, and who are responsible for negotiating the best arrangements with their vendors, are typically experts in the field of finance or human resources. Because of this, often times, these plan sponsors do not speak their retirement plan vendors' esoteric language. The information gap that has existed between retirement services vendors and retirement plan sponsors has created fertile ground for "gotchas" in vendor service arrangements that continue to waste millions of dollars of retirement plan savings annually. This article explores the most common "gotchas" plan sponsors face, and offers real-world solutions for those organizations seeking to improve their fiduciary supply chain management approach.

THE BREADTH OF THE RETIREMENT PLAN MARKET

When one examines the expanse of the retirement plan market, it is evident why this burgeoning industry might attract vendors with an opportunistic bent. In 2012, the defined benefit (DB) and defined contribution (DC) plan markets totaled $7.7 trillion in assets. This combined market, which addresses the vast majority of employer-sponsored retirement plans in the private corporate sector, grew by $700 billion in just one year.[1]

By contrast, if one researches vendor fee trends in recent years, it is reported that vendors have reduced their expense ratio related to retirement plan fees, and continue to do so. Indeed, a study by the Investment Company Institute showed that expenses incurred by 401(k) plan participants from investing in mutual funds have declined substantially over the past 15 years. "In 1998," the report stated, "401(k) plan participants incurred expenses of 0.74 percent of the 401(k) assets they held in equity funds. By 2012, that had fallen to 0.63 percent, a 15 percent decline." At first glance, these statistics seem overwhelmingly positive for retirement plan sponsors and their participants. However, the key fact that is omitted from this particular report is that while vendors may have been reducing the percentage of their

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collectible fees, the market value of the underlying assets that are used in order to compute their compensation, and retirement plan participants' costs, was increasing. The dollar costs to participants generated by a charge of 0.74 percentage points in 1998, when the DB/DC market totaled ***$987 billion***, falls well below what a 2012 vendor would take home from his 0.63 percent of a ***$7.7 trillion*** market.[2]

Figure A. Growth in Retirement Plan Assets: 2011—2013

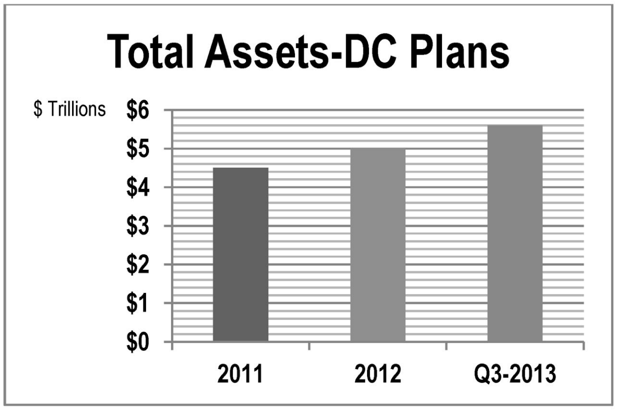
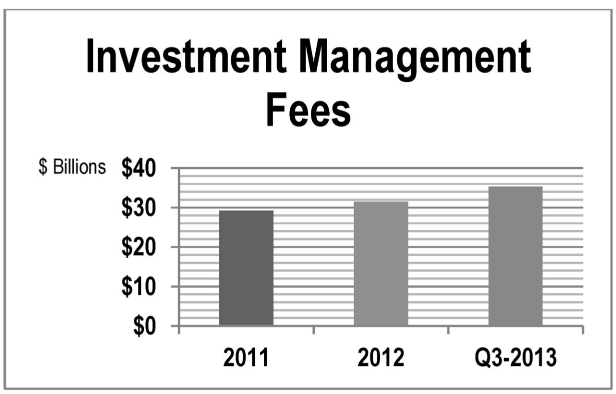


Figure A. shows the growth in retirement plan assets among defined contribution plans such as 401(k) and 403(b) for the period 2011 through the third quarter of 2013. During that period, total assets increased from $4.5 trillion to $5.6 trillion. It would appear that the costs incurred by the retirement plans' participants fell between 2011 and late 2013 because the asset-based ratio charged by mutual fund managers declined on average from 0.65 percent in 2011 to 0.63 percent in 2012 and held at that level for 2013.

Figure B. "Decline" in Investment Management Fees: 2011—2013



A different picture of the cost for investment management services emerges when the fund expense ratios are applied to the actual assets in each of the recent years. In spite of lower asset–based percentages used for pricing services, investment vendors' compensation and the dollars actually paid by defined contribution plan participants increased from $29 billion in 2011 to over $35 billion by 2013, as shown in the chart in Figure B.

VENDOR FEES AND PLAN SPONSOR RESPONSIBILITY

Unfortunately, although some sectors of the vendor market may claim that their asset based charges are decreasing, the opposite is true for the actual dollars the general vendor population is extracting from retirement plans' assets. The Department of Labor ("DOL") has responded to this trend by declaring that there is a dangerous "information gap" that exists between vendors and their plan sponsor clients. In a statement published in the *Federal Register,* the DOL said that due to this information gap:

> . . . vendors can reap excess profit by concealing indirect compensation (and attendant conflicts of interest) from clients, thereby making their prices appear lower and their product quality higher. Current ERISA rules hold plan sponsors rather than vendors accountable for evaluating the cost and quality of plan services.

Indeed, retirement plan sponsors must be more vigilant than ever about their vendors' fees, as the burden falls on the plan sponsors—not vendors—to ensure those fees are reasonable. Regardless of plan sponsors' lack of knowledge or training in the retirement plan arena, the DOL still holds them to a standard of competency that requires sufficient knowledge to avoid being overmatched by their vendors. ERISA's recently-enacted regulation 408(b)(2), also called the fee disclosure rule, further crystallized this responsibility for plan sponsors, mandating that they must fulfill three distinct duties under this new regulation, as shown in Figure C below, and they include:

1. **Verify** that they have received the appropriate disclosures from vendors;
2. **Test** that these disclosures are adequate under the new rule; and
3. **Determine** that the fees provided within the disclosure are reasonable, or fair, given the vendor services rendered.

Figure C. Plan Sponsors' Responsibilities Under ERISA Regulation 408(b)(2)

COUNTERACTING COMMON "GOTCHAS": SMART PROCUREMENT STRATEGIES

In light of plan sponsors' duties related to selecting and monitoring their retirement plan's vendors, what are strategies that a plan sponsor can implement to help ensure he is complying with ERISA regulations and choosing vendors that are serving his participants' best interests? There are several tips that plan sponsors may choose to follow to help them counteract common "gotchas" in their fiduciary supply chain vendor partnerships. These include:

1. **Pricing Structure.** The type of pricing structure that is negotiated at the outset of a vendor relationship can greatly affect that vendor's fee impact on the plan participants and the plan sponsor. A flat fee can be preferable to asset-based pricing, as the latter often can vary unfairly against a plan's participants due to it being based upon the total amount of assets invested in the plan irrespective of whether a vendor delivers any added value when assets grow and his compensation also grows, which funds are selected within the plan, and/or a combination of these factors.
2. **Contract Term.** Vendor contracts typically may be terminated with relatively short notice. Even if the

contract is for a longer term, vendors (and their fees) should be evaluated no less often than every year. This evaluation should include an assessment of the particular vendor's services and specific value rendered for their fee, as well as a study of the market to compare pricing for equivalent services.

3. **Termination Penalties.** Prior to signing on with a new vendor, or during the annual review process of an existing vendor, it should be discussed whether there are termination penalties associated with particular investments or restrictions on the plan's freedom to move assets from an existing investment vehicle at will. In some cases, these penalties are not obviously stated in the contract, but could impose significant fees if the plan sponsor or plan participants chose to extricate themselves from a certain investment line-up (or switch vendors altogether).

4. **Fee Disclosure.** As mentioned above, in accordance with ERISA regulation 408(b)(2), plan sponsors should annually expect vendors to provide and update their fee disclosures. Although an annual fee disclosure update from vendors is not required by law, it certainly is emerging as an industry best practice. Emphasizing the point in 2013, the DOL included 408(b)(2) related reports on the list of documents it expects plan sponsors to make available during the DOL's field audits. An annual fee analysis by a qualified and unbiased third party assists plan sponsors in gathering the information they need in a timely manner so they may make necessary vendor evaluations. It also helps preempt "creeping" fees year over year that a vendor may be able to hide if he is not subjected to an annual examination by the plan sponsor.

5. **Expert Help.** Plan sponsors' responsibility to act as a steward of their participants' assets, maintain compliance with new regulations, and minimize their legal risk has grown significantly in recent years. In the next section, we'll address plan sponsors options for outsourcing a large portion of these responsibilities, while remaining in full compliance with ERISA mandates.

"GOTCHA" MANAGEMENT STRATEGY #1: ENLISTING AN EXPERT'S HELP

For those plan sponsors who are not interested in the challenge of staying abreast of each new regulation and legal nuance related to their role as a fiduciary, there is an alternate option. When ERISA was designed as a governing system for the retirement plan industry, regulators' intent was not for plan sponsors to be solely responsible for the management of their retirement plans. In fact, ERISA was designed with a robust fiduciary supply chain in mind. While ERISA's rules default to a single fiduciary responsible for the plan (most often times, the plan sponsor), the regulation provides ample opportunity for a plan sponsor to enlist help from vendors who are experts in their respective fields, and who can aid in the plan sponsor's duties to "prudently" oversee the plan. A plan document may set forth procedures for allocating fiduciary responsibilities (other than trustee responsibilities) amongst named fiduciaries, and for named fiduciaries to designate other persons to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan. [Refer to ERISA Section 405(c)(1).]

Two types of experts that can be particularly helpful to a plan sponsor, and who are independent sources of counsel, are 1) a 3(16) Plan Administrator and 2) a legal advisor. A Plan Administrator is an independent third party who absorbs much of the legal responsibility to manage the prudently, as well as the majority of the plan sponsor's duties under ERISA, including delegating roles to other fiduciaries. By legally adopting the primary fiduciary role, the plan sponsor is relieved from the daily burden of many fiduciary tasks related to the retirement plan, and is protected from much of the risk a plan sponsor would face without the aid of the outsourced 3(16) Plan Administrator. A 3(16) Plan Administrator only adds worthwhile value to a plan sponsor's role, however, if it does not sell other ERISA plan services.

A legal advisor can be enormously helpful with the process of reviewing vendor contracts. Ensuring that the appropriate language is included in (or omitted from) certain sections of a contract can protect both the plan sponsor and his participants—from unnecessary fees, penalties, conflicts of interest, or less-than-transparent business practices. Having a lawyer on the fiduciary team bolsters the plan sponsor's audit preparedness, ensures an extra layer of protection against potential accusations of breach of fiduciary duty, and provides sound counsel regarding vendor hiring considerations and risks.

"GOTCHA" MANAGEMENT STRATEGY #2: ENGAGING AN INDEPENDENT REVIEW

Many retirement plan sponsors use an in-house approach to managing their ERISA fiduciary role, as opposed to outsourcing these duties. The in-house approach imposes on the executive class the burden of complying competently with all four disciplines of fiduciary duty, including 1) governance, 2) administration, 3) investments, and 4) controls. For those who choose not to outsource their ERISA 3(16) Plan Administrator role, an independent review can test their management approach for its conformance to ERISA's fiduciary rules and industry best practices. The review should be conducted by an independent supply chain management firm that refrains from offering any operational services to retirement plans such as investment advice or recordkeeping.

Because the vast majority of fiduciary failures can be linked to plan sponsors' errors of omission caused by "gotchas" in their vendor arrangements, an independent review should answer issues such as:

- **Authentication of authority for fiduciary-centric decisions.** Who is involved in making decisions regarding the retirement plan, what are their specific responsibilities, and how are they evaluated?
- **Testing of the practices used by the responsible plan fiduciary for meeting ERISA's stewardship standard.** How is the fiduciary process used for managing the retirement plan measured against fiduciary best practices?
- **Management of resources, both the plan sponsor's and the plan's participants.** How is the named fiduciary managing and measuring the performance of the investments related to the plan?
- **Administration of the vendors and operational systems involved with the plan.** Are the management processes, fiduciaries and vendors associated with the plan regularly monitored to ensure compliance with ERISA mandates?

For the plan sponsor who chooses to maintain ownership over her fiduciary responsibility, an annual independent review provides peace of mind that any "gotchas" hidden inside vendor contracts or fees are identified and corrected in a timely manner. In addition, the independent review assures that all four disciplines of the fiduciary role are being fulfilled in a manner that complies with ERISA regulations and protects the interests of the plan participants.

THE CURRENT AND FUTURE STATE OF FIDUCIARY SUPPLY CHAIN MANAGEMENT

While it may seem as though the fiduciary landscape is littered with potential land mines at every turn, the only true "gotcha" in retirement plan management is often a plan sponsor's belief that he can handle fiduciary responsibility—and its inherent liabilities—all on his own. In reality, executives who are named as primary fiduciaries to their company's retirement plan have a plethora of other pressing responsibilities, worries, and obligations that fall outside of the scope of their retirement plan's management. Choosing the right vendors—as well as independent fiduciary partners and legal counsel—to help navigate this ever-changing regulatory pathway can help plan sponsors to adeptly and efficiently manage their fiduciary supply chain.

Luckily, plan sponsors and their independent counselors are not alone in the quest to create a more functional retirement plan process. Many vendors are taking the lead in transforming the retirement plan services market into one characterized by transparency, honesty and stewardship. There are examples of recordkeepers, investment managers and third party administrators who are aligning with fiduciary best practices, and making it easier for plan sponsors to fulfill their fiduciary responsibility, stay apprised of key developments with their plan, and protect their plan participants' assets. With any luck—and with the go-forward collaboration of these various entities of the fiduciary supply chain—the current "gotchas" of retirement plan servicing will soon be a forgotten trend of the past.

Note: Be sure to check out next issue's "The Excellent Fiduciary" column for interviews with leading vendors who will share tips on how they are improving their service models, partnering more seamlessly with their retirement plan sponsor clients, and transforming the fiduciary landscape with their best-practice approach.

NOTES:

[1]Sources: Investment Company Institute, Federal Reserve Board, Department of Labor, National Association of Government Defined Contribution Administrators, Internal Revenue Service Statistics of Income Division.

[2]Source: Investment Company Institute