THE EXCELLENT FIDUCIARY

What Every Qualified Sponsor Should Know about Fee Disclosure

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INTRODUCTION

The Journal of Compensation and Benefits has provided us the opportunity to write what we hope will be a highly useful series of columns on fiduciary practices and standards. Our goal in these columns is to provide practical ways for readers to improve their understanding and execution of fiduciary duties as stewards of other people's money. More importantly, we aim to help readers modify their practices where necessary, in order to be more effective overseers while avoiding undue trouble.

THE NEW REGULATION

Currently, there is a high sensitivity to the need for independent standards, and the measurements used for comparisons to them. Thus, the Department of Labor's new fee disclosure regulation, (the "Regulation") is of profound interest to those who evaluate and implement fiduciary practices. In a nutshell, the Regulation imposes a heavy burden on ERISA retirement plan sponsors. It requires that primary fiduciaries determine that their plans' fees are reasonable. The directive may seem simple enough but executing it is not so simple. A little background on how and why the Regulation emerged will help illustrate this point.

THE UNEVEN PLAYING FIELD

Last year the Department of Labor (the "DOL") explained its reasons for making the Regulation. Its justification is based on several conditions that alarmed the DOL's watchdogs.

First among them is an acute information imbalance that exists in the market between the sellers of services (investment and administrative services vendors) and the buyers of services (primary fiduciaries). The imbalance persists because the information costs of vendors are far lower than for their clients.

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Who is an ERISA Service Provider?

On July 16, 2011 the Department of Labor's new Regulation 408(b)(2) will become effective. It imposes on plan sponsors a demand that the arrangements and fees they enter into with vendors that the Regulation defines as "covered service providers" be reasonable.

The Regulation defines who fits the category of a Service Provider. The list includes:

1. *Any person or entity who is deemed a fiduciary by ERISA;*
2. *Any person or entity who is deemed a fiduciary by the Investment Advisers Act of 1940;*
3. *Any provider of recordkeeping, TPA, investment management, securities brokerage, custody of assets, consulting, insurance, or banking services;*
4. *Any provider that is paid indirectly and delivers accounting, audit, actuary, legal, appraisal, or valuation services.*

Furthermore, vendors are specialists in the design of their products, services, and compensation arrangements, and are continually engaged in marketing to plan sponsors. While on the other hand, plan sponsors often lack their vendors' degree of specialization. Even very large, relatively sophisticated plan sponsors shop for services only periodically, generally once every three to five years. Smaller, less sophisticated plan sponsors face still higher information costs.

The DOL also explained that vendors are able to maintain an information advantage over their plan sponsor clients. In comments posted in the Federal Register, the DOL wrote, "vendors have a strong incentive to use their information advantage to distort market outcomes in their own favor."

Current ERISA rules hold plan sponsors rather than vendors accountable for evaluating the cost and quality of plan services. And 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.

In order to cure the imbalance of information, the Regulation demands unprecedented disclosures of information by firms and individuals that deliver services to ERISA plans. The Regulation calls them "Service Providers." Failure to make the disclosures carries the specter of a prohibited transaction, which could require offending vendors to return revenue earned earlier. The related consequences for a plan sponsor caught in such an event could be catastrophic.

While the Regulation requires strong action from Service Providers, plan sponsors have their own stone to carry. The penalty for plan sponsors that ignore the Regulation's demand to learn if fees paid to vendors are reasonable, could lead to a finding of a breach of fiduciary duty.

The new disclosures require vendors to focus on compensation paid to them, both direct and indirect. It is possible that the information will overwhelm fiduciaries, and even disturb them and their plans' participants.

While the Regulation strikes all plan sponsors evenly, it hits some Service Providers harder than others. For example, investment advisors whose only compensation is paid to it directly from an ERISA plan's assets will have a much easier job of satisfying the Regulation than a vendor that bundles multiple services into a single arrangement. Consequently, plan sponsors should have an easier time proving the reasonableness of certain types of vendor arrangements and fees than others.

Ensuring that fees paid by an ERISA plan's participants are fair is a long standing duty of a plan's officials. The current lack of full disclosure of fees by Service Providers, complex vendor structures, inadequate management processes among plan sponsors, and the absence of a neutral fee database have left a vital fiduciary duty unfulfilled throughout the ERISA plan community.

Not surprisingly, plan sponsors are taking a beating. The number of lawsuits and enforcement sanctions against them continue to spiral upward. Recent lawsuits against plan sponsors for breach of fiduciary duty reveal that many plan officials have little knowledge of how to determine the reasonableness of fees. More damaging is the DOL's discovery in recent years that few primary fiduciaries even try to figure out what is reasonable. It found that many plan sponsors operate under the mistaken belief that they satisfy their fiduciary duty by hiring the lowest cost providers.

Participants are suffering even more. Unjustified fees bite into their investment returns and unfairly deplete their retirement savings.

The Regulation sets plan officials straight on what is required of them. It demands that plan officials investigate and understand their Service Provider arrangements including how the providers are paid. While this will be difficult enough, the tougher part will be proving that fees paid to Service Providers are reasonable.

TEN STEPS TO COMPLIANCE

In light of the potential penalties for failing to satisfy the Regulation, many plan sponsors are asking, "where should I start?"

Before plan sponsors attempt to evaluate the reasonableness of the fees that their plan pays to its Service Providers, they should perform the following ten steps.

1. Be sure all vendor arrangements are in writing and current.

Due to the expanded disclosure demands of the Regulation, many existing contracts between plan sponsors and their Service Providers will need to be rewritten. Plan sponsors shouldn't wait until July 2011 to get started. They should ask their Service Providers now for their contract forms that they say will comply with their side of the Regulation.

2. Services and Compensation Defined and Disclosed

All services to be provided to sponsors' plans must be defined. For each service, direct and indirect compensation to be received by each Service Provider and its affiliates must be revealed.

3. Acknowledgement of Fiduciary Status

Each Service Provider should disclose if it, or any of its affiliates, will provide services to the plan as a fiduciary as defined under either ERISA section 3(21) or the Investment Advisers Act of 1940.

4. Disclosure of Financial or Other Business Interest with Affiliates

Service Providers should reveal in writing if they or an affiliate will have any financial or other interest in any transaction to be entered into by a sponsor's plan in connection with services covered by the Regulation.

5. Other Material Relationships

Material financial, referral or other relationships with a money manager, broker, or other Service Provider to the plan that creates or may create a conflict of interest should be disclosed to plan sponsors.

6. Ability to Affect Own Compensation

Service Providers should disclose if they have the ability to affect their compensation, or that of any affiliate, without the prior approval of a primary fiduciary.

7. Policies to Address Conflicts of Interest

A sponsor's plan should adopt and enforce a requirement that each of its Service Providers provide a copy of its policies or procedures that address or prevent conflicts of interest.

8. Material Changes

Within 30 days of any material change in the information required for disclosure by the Regulation each Service Provider should report it to plan sponsors.

9. Reporting Assistance

Any request for information that plan sponsors submit to a Service Provider must be complied with promptly.

10. Actual Disclosure

The Regulation requires that Service Providers actually make the disclosures that it demands. All disclosures required by the Regulation must be made prior to entering into an arrangement with an ERISA-qualified plan.

The above list of steps plan sponsors should take will prepare them for the job of evaluating the reasonableness of their plan's fees. Since doing so can only by achieved by comparing costs to comparable services, third party help will be needed for most plan sponsors.

BENCHMARKING SERVICES AND FEES

Benchmarking vendors' costs is a long-standing management discipline that businesses of all size perform. Few persons, who obtain services or products for their employers, whether it is a manufacturing, distribution, or service business, would do so without knowing exactly what they are paying for. Yet the U.S. retirement plan industry is saturated with service arrangements that lack the slightest hint of competent comparison with alternatives.

Reasons for this vary, but the most common excuse heard is "fees are too complex." In spite of the excuses, ERISA makes testing of fees for services a fundamental duty of primary fiduciaries.

The reality exists that fees are complex. Worse, no central database is available for comparing fees.

An opportunistic new class of Service Provider is emerging. We will call its members the benchmarkers. If plan sponsors have not been solicited already, they should beware. They will likely be approached by marketers that promise an easy fix to the Regulation's requirements by offering plan sponsors an "indexed solution" or other voodoo answer to the question of what is a reasonable vendor arrangement. (Remember, satisfying the Regulation embraces more than just the amount the plan pays.)

At least one of the benchmarkers that were reviewed for this article is actually a front operation for a network of investment advisors who is seeking to capitalize on plan sponsors' ignorance of the Regulation. So, plan sponsors should be careful who they ask to help with their analysis.

HOW PLAN SPONSORS ARE REACTING TO THE REGULATION

Evidence is emerging that plan sponsors are migrating into one of three groups. Some clearly are adopting this view; "I am not a fiduciary." Sponsors in this class will disregard the Regulation.

Another group will convince themselves that; "My plan's investment advisor/ recordkeeper/ custodian/ outside trustee is the fiduciary and they will take of anything the Regulation requires of me."

The third group will evaluate independently produced insights about the Regulation and take necessary steps necessary to ensure that their fiduciary processes are aligned with it. Regardless of the group in which you fit, get ready now. The legal community warns that the Regulation will make a ripe setting for lawsuits.

HOW TO PROCEED

Plan sponsors should seek outside help if they do not have the internal capabilities to properly evaluate and measure their current Service Providers' fees and services. Now is a good time to get help in guaranteeing that their plan's fees are reasonable.

Any firm considered for the task of studying a plan sponsor's plan fees, evaluating them against the market, and performing due diligence on vendors should have a substantial track record of success in doing so. Needless to say, it should not be a current vendor nor should it be a firm that provides the services embraced in the review.