THE EXCELLENT FIDUCIARY

Pension Vendors Must Be Prudently Selected and Monitored

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Organizations that sponsor pension plans are generally responsible for ensuring that their plans comply with federal law—including the Employee Retirement Income Security Act (ERISA). Many sponsors rely on other professionals to advise and assist them with their employee benefit plan duties. For this reason, selecting competent service providers is one of the most important responsibilities of a plan sponsor. In fact, hiring a service provider is a regulated fiduciary function.

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A large number of ERISA plan sponsors, mainly 401(k) plans, are sanctioned every year by the Department of Labor (the DOL) for failing to *prudently select and monitor service providers*. Judging by the numbers, the people who administer plans for their employers (the Primary Fiduciaries) represent a large community that is either unaware that it is required to do so, or uneducated as to the meaning of "prudent selection and monitoring."

Not only are Primary Fiduciaries required to conduct substantial evaluations before and after they hire a service provider, but in the case of investment managers, Primary Fiduciaries also face the difficult task of evaluating the risk in the underlying investment(s) proposed by the vendor.

THE DEADLY TWINS: LACK OF FORMAL FIDUCIARY TRAINING AND INEXPERIENCE

Many problems with service providers arise because Primary Fiduciaries do not understand their roles and accountabilities. Lack of formal training, which the DOL reports is a rampant deficiency among plan sponsors, undermines the ability of otherwise well intentioned Primary Fiduciaries to make proper choices in service providers. Consequently, they expose themselves and their employers to needless risk, as ignorance of ERISA is not a legal defense.

Other problems emerge for Primary Fiduciaries when they exercise poor judgment, which

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can be caused by inexperience, misleading statements by vendors, and a lack of prudent procedures. The consequences can be severe for participants in ERISA pension plans. The DOL's enforcement reports are loaded with cases of ERISA plans whose participants pay much higher fees for routine services than they should, while the Primary Fiduciaries of the plans in these cases appear oblivious to the abuses.

ERISA PLANS OF ALL SIZES MISS THE MARK

A review of court cases involving breach of fiduciary duty against pension plan sponsors indicates that a large portion of the cases involves small-to medium-sized defined contribution and Taft-Hartley plans.[1] The misunderstandings and poor judgment that emerge in these cases also affect larger plans. Invariably, lack of formal training and inexperience of the Primary Fiduciaries are the culprits. In single employer defined benefit plans, where the sponsor is ultimately responsible for funding the plan benefits, or where plan assets are not at issue, the financial consequences of poor selection and monitoring of service providers damage primarily the plan sponsor. The lesson to be drawn from lawsuits against Primary Fiduciaries (for failing in their duty to prudently select and monitor service providers) is that overseers of plans of all sizes need to change their approach.

In some respects, it is difficult to understand how so many well-run organizations get into trouble for not selecting pension vendors prudently. After all, most businesses hire vendors for all kinds of services in their routine place of commerce. The lack of properly trained buyers of pension services exemplifies how even the most intelligent and astute businesses can easily overlook, and thus, fail, in their essential fiduciary duties. Other factors equally critical to the lack of training contribute to trouble for pension plan officials and include: a perceived complexity of investments (which is overstated by many providers); the minutiae involved in recordkeeping; and the tendency to rely on vendors for guidelines on vendor selection. These factors create a dangerous brew.

PRINCIPLES OF SUPPLY CHAIN MANAGEMENT

Every business uses an interconnected "supply chain" for creating its products or services and delivering them to their customers. Supply chain management is the oversight of materials, information, and finances as they move in a process from supplier to manufacturer to wholesaler to retailer to consumer. Supply chain management involves coordinating and integrating these flows both within and among companies. Every well-established business spends an extensive amount of time getting accustomed to its vendors and managing the supply chain.

Managing the pension plan supply chain is the most fundamental duty of a Primary Fiduciary. ERISA expressly requires that it be performed prudently. Prudence focuses on the *process* for making decisions. Therefore, it is wise to document decisions and the basis for those decisions. When hiring any plan service provider, a Primary Fiduciary should survey a number of potential providers, requesting the same information from each, and providing the same requirements to them. By doing so, a major accountability is satisfied. Since proving that vendor selection is conducted in an unbiased way, plan sponsors should be wary of using investment firms to manage a service provider search project. Many breaches of fiduciary duty cases against plan sponsors have weak defenses due to conflicts of interest that infest, as a whole, the vendor selection and monitoring process.

What tools are needed for plan sponsors to manage their fiduciary supply chain in accordance with ERISA? We will ad-

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dress this especially critical issue next, as most Primary Fiduciaries are not prepared, in terms of training and experience, to perform at ERISA's competency level.

CONFLICTS OF INTEREST MUST BE UNCOVERED AND EVALUATED

Service provider "multiple hat" business models threaten the legal safety of every plan sponsor that is entangled in such an arrangement. On June 19, 2008, the U.S. Supreme Court sent out its own red flag in a case involving Metropolitan Life Insurance Company. The precedent that it set means that mere disclosure of conflicts of interest will not save a Primary Fiduciary or a plan sponsor from substantial liability. The Supreme Court's decision addressed the standards for managing conflicts of interest for employee benefit plans, as well as the consequences to Primary Fiduciaries if they do not evaluate their vendors' conflicts of interest and decide if they are acceptable. We don't know yet what the full effect of the Supreme Court's decision will be, but as news broadcasters say, "Here is what we do know":

- Any Primary Fiduciary that hires vendors providing a multitude of services (i.e., services other than a single category of deliverables) heightens the need for diligence in monitoring such vendors, and exposes the Primary Fiduciary to greater legal risk.
- Primary Fiduciaries cannot waive conflicts of interest.
- The way to avoid conflicts of interest liability is to require plan vendors to perform only one service on behalf of the pension plan.

Here is wisdom imparted by our Supreme Court's Justices:

> *"Conflict of interest is a real or **seeming** incompatibility between one's private interests and one's public or fiduciary duties.*" Notice the implication that the appearance of a conflict of interest may have nearly as serious consequences as a "real" conflict.

The mere appearance of conflicts of interest has triggered breach of fiduciary duty complaints against plan sponsors all over the U.S. Court dockets are lined with class action lawsuits by employees alleging that their employers picked service providers from whom they received improper economic inducements.

For example, scores of lawsuits involve businesses that received improved loan terms for agreeing to use their commercial banks' 401(k) plan programs even though the fees paid by participants in the plans were higher, and the services of less quality, than other pension vendors offered. ERISA expects plan sponsors to uncover all conflicts of interest in and around their plans and to determine, with properly documented deliberations, whether they are acceptable.

VENDORS HAVE AN IMPORTANT ADVANTAGE OVER PENSION PLAN SPONSORS

Last year, the Department of Labor revealed a chilling finding that every person who serves as a Primary Fiduciary should take seriously. An entry in the *Federal Register* dated July 16, 2010, contains the DOL's comments about its new fee disclosure Regulation 408(b)(2). When addressing characteristics of the pension supply chain, the DOL entered into the public record the following warning:

> Vendors are specialists in the design of their products, services, and compensation arrangements, and are continually engaged in marketing to plan sponsors. Plan sponsors often lack this 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. As a result, vendors are able to maintain an information advantage over their plan sponsor clients. 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

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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.

The DOL's comments should lead a reasonable person to grasp the reality that Primary Fiduciaries need training in how to procure pension services and evaluate vendors on an ongoing basis. If Primary Fiduciaries do not receive periodic formal training, they should get help in evaluating vendors by hiring a qualified consultant whose firm does not sell investments, third party administration, custody, or directed trustee services.

The new Regulation 408(b)(2), which requires plan sponsors to determine if the fees their participants pay for pension services are reasonable, has spawned a new class of service provider. Vendors in this class are known as "Fee Benchmarkers." The leading Benchmarkers publish reports that show cost comparisons based on information filed on Form 5500s. Plan sponsors may purchase the reports directly, or in some cases investment advisors foot the bill and give the reports to their clients. Here is a word of caution. The leading vendors of fee benchmarking reports are funded by other pension vendors which could comprise the independence of the published data. The content of their reports is extracted from Form 5500s, which means the data can be obsolete by as much as two years. If you use a Fee Benchmarker's service, be sure to cross-check its recommendations with an unbiased expert. Otherwise, you may be making important decisions based on less than independent advice.

PRUDENT STEPS FOR SERVICE PROVIDER SELECTION AND MONITORING

As referenced earlier in this article, ERISA requires that plan sponsors select and monitor service providers, proving they use a *prudent* process. The following are examples of questions which fiduciaries may consider when hiring and monitoring the performance of a service provider.

1. What services will the Primary Fiduciaries and the plan's participants need?
2. Does each candidate possess the expertise and qualifications needed to perform the services they propose to deliver?
3. Are the proposed vendors completely transparent about their ownership, business affiliations, and revenue partners?
4. Obtain in writing these additional disclosures:
   - Form of organization of a candidate's business,
   - Identity of the client liaison person the candidate will assign to your account,
   - The number of people the candidate will commit for serving your plan,
   - Professional designations and education of all servicing personnel,
   - Business references,
   - Regulatory filings,
   - Ratings of the candidates' technical and support systems,
   - Financial status, and
   - History of enforcement actions and lawsuits.
5. How do the candidates' fees compare against other vendors of the same services?
6. To what extent does each candidate acknowledge its share of the plan's fiduciary duty under ERISA? Be sure any investment vendor you employ acknowledges an ERISA fiduciary duty, not just a fiduciary duty under federal

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securities law. If a candidate refuses ERISA fiduciary status, move on to one that will.

7. What is the form of the legal agreement and does it reveal all costs for all services to be provided?

Lessons from litigation in cases involving breach of fiduciary duty reveal that Primary Fiduciaries need to do a better job of diligence in picking their pension vendors. The failure to monitor them ongoing against ERISA's standard of care is very risky behavior that could result in serious repercussions. Managing the fiduciary supply chain requires knowledge, defined procedures, and energy. The benefits are worth the effort, especially for plan sponsors who seek to minimize risk and aspire to stewardship excellence.

NOTES:

[1]The following list identifies court cases that set precedents regarding ERISA's fiduciary responsibility for the selection and monitoring of service providers:

- Donovan v. Mazola
- Donovan v. Tricario
- Brock v. Robbins
- Benvenuto v. Schneider
- McLaughlin v. Bendersky
- Morgan v. Independent Drivers Association
- In Re: Unisys Savings Plan Litigation
- Glaziers and Glassworkers Local 252
- Metropolitan Life Insurance Company et. al. v. Glenn.

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