Can Service Providers be Trusted?

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Service providers to retirement plans are changing their stripes. That makes the job of selecting and monitoring them more challenging than ever.

Organizations that sponsor employee benefit plans are generally responsible for ensuring that their plans comply with federal law—including the Employee Retirement Income Security Act of 1974 (ERISA). Many sponsors rely on service providers to advise and assist them with their employee benefit plan duties. For this reason, selecting competent vendors is one of the most critical responsibilities of a plan sponsor. Hiring a service provider is a matter of significant importance because it is a regulated fiduciary function. The pace of litigation against employers related to vendors that serve their retirement and welfare benefit plans raises questions about the trustworthiness of those service providers.

THE DEADLY TWINS: ILLITERACY AND INEXPERIENCE

Less than a decade ago, "trust" was a go-to descriptor for enterprises and executives seeking to alleviate personal or public concerns regarding employees' financial futures. Chief Executive Officers (CEOs) trusted well-reputed investment and administration service firms to deliver on their promises of exponential returns and the safety of their employees' Personally Identifiable Information (PII). Executive committees trusted that investment firms and recordkeepers abated critical aspects of the committees' fiduciary risk.

That was before the outbreak of many lawsuits against employers for breaches of their fiduciary duty. Expensive and debilitating litigation quickly squashed the notion of complete trust in service providers and shifted the burden of awareness squarely back onto the executive class' shoulders.

A large number of ERISA plan sponsors, mainly 401(k) and 403(b) plans, are sanctioned every year by the Department of Labor (DOL) for failing to *select and monitor service providers prudently*. 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

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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.

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 otherwise well-intentioned Primary Fiduciaries' ability to make proper choices of service providers. Consequently, they expose themselves and their employers to needless risk, as ERISA ignorance is not a legal defense.

Other problems emerge for Primary Fiduciaries when they exercise poor judgment caused by inexperience, fall victim to vendors' misleading statements, or lack relevant internal controls. The consequences can be severe for participants in ERISA plans. The DOL's enforcement reports abound with cases of ERISA plans whose participants pay much higher fees for routine services than they should. In contrast, 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 breaches of fiduciary duty against retirement plan sponsors indicates that a large portion of the cases involves small- to medium-sized defined contribution and Taft-Hartley plans. 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 select and monitor service providers prudently) 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 retirement plan vendors prudently. After all, most businesses hire vendors for all kinds of services in their routine place of commerce. The lack of adequately trained buyers of 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 retirement plan officials and include: a perceived complexity of investments (which many providers overstate); the minutiae involved in recordkeeping; and the tendency to rely on vendors for guidelines on vendor selection. The recent trend among recordkeepers and investment advisors to hold themselves out as "3(16) fiduciaries" is an example of how vendors invoke empty claims to enhance their mystique. These factors create a dangerous brew.

PRINCIPLES OF SUPPLY CHAIN MANAGEMENT

Every business uses an interconnected "supply chain" to create its products or services and deliver them to its customers. Supply chain management oversees materials, information, and finances as they move 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 extensive time getting accustomed to its vendors and managing the supply chain.

Managing the employee benefit plan supply chain is the most fundamental duty of a Primary Fiduciary. ERISA expressly requires prudence in its execution. Prudence focuses on the *process* of making decisions. Therefore, it is wise to document findings and the basis for those decisions. When hiring any plan service provider, a Primary Fiduciary should survey many potential providers, request the same information from each, and provide the exact requirements. By doing so, primary accountability is satisfied. Vendor selection is subject to standards that prohibit bias. Accordingly, plan sponsors should be wary of using an incumbent vendor to manage a service provider search project. Many breach of fiduciary duty lawsuits against plan sponsors have weak defenses due to conflicts of interest that infest, as a whole, the vendor selection and monitoring process.

The difference between this "fiduciary vendor supply chain" and a typical vendor supply chain is how executives can evaluate and select these vendors. Ordinary vendors must satisfy several examination levels—not the least of which would be on capability, pricing, quality, and integrity. But for the fiduciary vendor supply chain, these typical evaluation rules do not, and cannot, apply in the same way.

The complicated nature of vendors' service offerings and pricing models, as well as the disproportionate emphasis they place on their "brand," dilutes the executive team's ability to examine the traits that count—namely, whether the vendor charges reasonable (and transparent) fees for their services, whether they engage in conflicts of interest (and thus more pricing complexity) with other vendors in their supply chain, and whether they define fiduciary duty based on actual legal statutes or their invented terms. This complexity leaves the corporate or executive team susceptible to potential fee gouging, or worse, inadvertent neglect of its fiduciary duties.

What tools are needed for plan sponsors to manage their fiduciary supply chain under ERISA? We will address this especially critical issue next, as most Primary Fiduciaries are not prepared to perform at ERISA's competency level in terms of knowledge and experience.

CONFLICTS OF INTEREST MUST BE UNCOVERED AND EVALUATED

Service provider "multiple hat" business models threaten the legal safety of every plan sponsor entangled in such an arrangement. That is because multiple hat vendors are inherently conflicted. It is worthy to note that the mere disclosure by a vendor of a conflict of interest will not save a Primary Fiduciary or a plan sponsor from substantial liability. The standards for managing conflicts of interest for employee benefit plans require Primary Fiduciaries to evaluate their vendors' conflicts of interest and decide if they are acceptable. Here are three guidelines found in best practices for Primary Fiduciaries:

- Any employer that hires vendors providing a multitude of services (that is, 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 or ignore conflicts of interest.
- An excellent way to avoid conflicts of interest risk is to examine each of your plan's services

separately. That is especially important if more than one of your plan's services is delivered by the same vendor.

Here is wisdom imparted by *Black's Law Dictionary*:[1]

> *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 severe consequences as a "real" conflict.

The mere appearance of conflicts of interest has triggered breach of fiduciary duty complaints against employers all over the United States. Class action lawsuits currently fill court dockets, filed by employees alleging that their employers picked service providers from whom they received improper economic inducements. ERISA expects plan sponsors to uncover all conflicts of interest in and around their plans and determine whether they are acceptable with properly documented deliberations.

VENDORS HAVE AN IMPORTANT ADVANTAGE OVER EMPLOYERS

In the preamble to its introduction of a change to ERISA § 408(b)(2), the so-called "reasonable fee" rule, the DOL revealed a chilling finding that every person who serves as a Primary Fiduciary should take seriously. When addressing characteristics of the employee benefit plan supply chain, the DOL entered into the public record the following warning:[2]

> 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.
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> 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.

The DOL's comments should lead a reasonable person to grasp the reality that Primary Fiduciaries need training and unbiased advice on how to procure services and evaluate vendors on an ongoing basis.

The DOL's opinion of the information imbalance between service providers and their plan sponsor clients suggests that Primary Fiduciaries should not trust their vendors blindly. Many executives and committees dubbed with the responsibility of overseeing their employees' retirement plans abdicate their fiduciary duties unknowingly to investment advisors, recordkeepers, and other third parties that do not have the same responsibilities to uphold the law. As such, vendors can (and do) invent their own standards for "safeguarding" and "growing" wealth for employees to whom they have no legal accountability. Misled by a guise of trustworthiness, Primary Fiduciaries frequently partner with these vendors. When, in fact, such partnerships can strip executives of their decision-making power and place them—inadvertently or not—in the line of fire if and when consequences for ethical or financial failure result in regulatory action or litigation.

PRUDENT STEPS FOR MONITORING SERVICE PROVIDERS

Below are concrete ways Primary Fiduciaries can take back from vendors their decision-making control and protect the future of their employees and their personal reputations:

1. **Get training.** Implement

a training program that covers all levels of relevant fiduciary duties. Training programs can range from one-day classroom sessions to online seminars that allow for completion as time permits. Some programs also offer certification. At a minimum, training topics should include:

- Vendor selection and monitoring;
- Determining the reasonableness of fees from service providers;
- Evaluating conflicts of interest; and
- Differentiating effective governance and abdication of duty.

2. **Conduct a review.** Hire a qualified, independent, third-party firm to conduct a review of your fiduciary committee's practices. The study should evaluate all parties' roles and responsibilities, written policies and procedures for examining conflicts of interest, the investment policy, cybersecurity procedures, and how to measure the plan's success. Once an evaluation of current practices is complete, the independent firm can assist in upgrading the committee's procedures as needed and undertake the responsibility of ongoing monitoring of committee practices and vendor compliance.

3. **Reread your service agreements.** A study of your plan's existing service agreements with all of its vendors may clarify the vendor's actual role as it relates to your committee's fiduciary duty. If a vendor makes verbal claims that it is a "plan fiduciary" or "co-fiduciary," be sure the detail behind such a claim is in writing and appropriately defined. If it is not, your vendor may have misrepresented their role (and thus, your responsibility), placing you at risk. Contact a qualified, independent fiduciary risk management consultant to discuss alternative service provider options.

Lessons from litigation involving breaches of fiduciary duty reveal that Primary Fiduciaries need to do a better job of diligence in picking and managing their service providers. The failure to monitor them ongoing against ERISA's standard of care is a dangerous 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]Black's Law Dictionary (Eighth Ed., Thomson West, St Paul, MN 2004).

[2]75 FR 41599.