The EXCELLENT FIDUCIARY

Fiduciary Vulnerability Takes a Hit

*Ronald E. Hagan**

Fiduciary liability insurers have taken note of the recent surge in lawsuits leveled against employers and their executives for allowing service providers to charge excessive fees to the retirement plans they sponsor and manage. The result is a significant increase in many employers' risk exposure.

INTRODUCTION

The legal community's persistent emphasis on fees paid by retirement plans to their service providers has set the stage for a turn in the vulnerability of the individuals who oversee retirement plans. If liability insurance underwriters continue on the path they seem to be headed, the safety of employers, human resources executives, and others who serve on retirement plan committees will suffer.

Changes in insurers' qualification examinations threaten liability coverage for thousands of plan sponsors and their plans' fiduciaries, adding a whole new dimension to their legal exposure. We explore in this article the new underwriting standards used by executive liability insurers and discuss ways to align with their requirements.

THE IMPETUS FOR CHANGING INSURANCE STANDARDS

Fiduciary liability insurers are now making pointed inquiries based on the playbook used by the attorneys who file excessive fee lawsuits. A significant increase in such suits is the impetus for the changing insurance atmosphere. Underwriters have revamped their process for evaluating fiduciary coverage applications, starting with a comprehensive questionnaire. This "new" generation of questionnaires covers the same questions as previously asked. The categories covered have expanded, however, to include: how fiduciaries are selected, whether a periodic review conducted (including benchmarking) to determine the reasonableness and competitiveness of fees of service providers—"in particular for recordkeepers," how often are studies conducted, are they documented, and what are the fees calculated on a per capita basis?

There are detailed questions about revenue-sharing, including whether a process is in place to recoup excess compensation for the benefit of

*RONALD E. HAGAN is Chairman of Roland|Criss' Risk Standards Committee. Roland|Criss is the premier risk manager for employee benefit plan sponsors, foundations, and endowments. Mr. Hagan has a lengthy career in enterprise risk management. He has pioneered many certification programs, standards practices, and fiduciary risk management strategies preferred by boards of directors and C-level executives. Reach him by e-mail at ronhagan@rolandcriss.com.

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participants and requests to describe all those processes. All insurers want to see a copy of the service providers' Employee Retirement Income Security Act of 1974 (ERISA) § 408(b)(2) fee disclosures.

However, these questionnaires are not just asking *what*; they are pressing for *why* (and *why not*) in some vital litigation issues. For example, they not only ask if the plan offers any index funds—but if not, they want to know the rationale. Similarly, they ask if the plan offers the least expensive share class available to each such fund, and for an explanation if it is not. More pointedly, they press for a confirmation that the plan does not use any funds that are proprietary to an affiliate of the recordkeeper or investment consultant—and if that confirmation is not forthcoming, to ". . . please describe the process used to ensure the independent evaluation of such investments."

Some inquire as to whether there has been "any online/social media solicitation of your employees to contact a law firm about their defined contribution plan fees or investments,"—but all ask about any communications by a law firm involving fees.

The questionnaires we have seen follow the roadmap outlined by the plaintiffs' bar in excessive fee litigation and seem to presume as "right" or prudent the positions staked out by the plaintiffs—rather than the law—and it is sure to result in higher costs for employers—and more exposure for plan fiduciaries.

PREPARING FOR A NEW PARADIGM

A paradigm shift is underway among insurers of fiduciary liability risk. Wisdom dictates that all organizations that sponsor ERISA qualified employee benefit plans adjust their risk management systems to meet the challenge. We have assembled an outline of action steps that will serve as a guide for revamping an employee benefit plan's readiness to meet insurance underwriters' evaluations:

1. ***Develop and Follow a Process***

   Describe the process used by the plan committee or investment committee (collectively "Committee") to evaluate the reasonableness of service providers' fees. Focus particularly on the recordkeeper(s), and record how often the fees are reviewed and benchmarked by the Committee.

   - Comment on the current payment structure of the recordkeeper(s) and if any items were amended or revised within the preceding 12 months. Include a calculation that shows the per participant fee for recordkeeping services over the past five years.
   - Assemble details regarding the last Request for Proposal (RFP) conducted for recordkeeping services for the plan.
   - Set a date for the next RFP the Committee expects to conduct for the plan.
   - If the Committee uses an outside consultant or advisor to help review and benchmark its recordkeeping services, identify the advisor and when the Committee retained it.

2. ***Investments Review***

   Design and document the steps used by the Committee to evaluate the plan's investment options, including both the performance and expense of each investment option.

   - Specify the fre-

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quency by which the Committee reviews the performance and expense of outside investment managers, preferably every quarter. If not quarterly, be prepared to explain when the Committee conducts a formal review.

- Be prepared to discuss whether any of the plan's outside investment managers, or investment options were removed or replaced within the past 12 months. Insurers want to know if performance or expense metrics drive such decisions by the Committee.
- Verify that the least expensive share class option available for each mutual fund investment option is in place. If not, document the factors that lead to retaining higher-cost share classes.
- If the Committee uses an outside consultant or advisor to help review the plan's investment managers and investment options, identify the advisor and when the Committee retained it.

3. ***Committee Charter and Structure***

   Maintain a written charter that specifies the duties and responsibilities of the individuals who oversee the plan's operations. List the current composition of the Committee and identify if any turnover occurred within the past 12 months.

   - Describe the Committee's regular meeting frequency (for example, monthly, quarterly, or annually). Quarterly is ideal.
   - Confirm whether the Committee maintains written meeting minutes for each session. If so, document whether an outside advisor maintains the meeting minutes.
   - Verify whether the Committee maintains a formal Investment Policy Statement.

4. ***Corporate or Plan Reorganization***

   If either the plan's sponsor or the plan participated in a recent acquisition or merger, describe how the Committee evaluated the likelihood of any reduction in benefits or increased administrative expenses as part of the acquisition or merger.

MAINTAINING INSURANCE COVERAGE REQUIRES PRIORITIZING EMPLOYEE BENEFIT PLAN RISK

By any measure, enterprise risk related to ERISA qualified benefit plans is worthy of the high priority typically assigned to such regulatory programs as those administered by the Occupational Safety and Health Administration (OSHA), the Office of Civil Rights (OCR), and the Environmental Protection Agency (EPA). Evidence exists, however, that employers are not yet adjusting to a paradigm shift in the degree to which employee benefit plans expose an organization to liability.

For example, despite continuous growth in the number of well-publicized adverse regulatory and legal actions against organizations for breach of their fiduciary duty, recent lawsuits reveal that the targeted organizations have not yet learned fully the lessons taught by the experiences of others. Many simply rely on past experiences in setting their risk priorities—"That's the way we've always done

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things"—or by a collective consensus to arrive at an acceptable ranking. But the pattern of risk management that adjusts to the changing environment rewards senior leaders who match risk appetite with internal controls that measure *what* is done and *how* it is accomplished.

RESTRUCTURE AND REVITALIZE

Four action steps form a blueprint for revamping a service provider risk management system to fit the modern fiduciary liability insurance environment:

1. Get help from an unbiased third party to evaluate your plan's recordkeeper(s) fees and services, investment managers, and participant investment advice provider. Suppose the party conducting the assessment is independent. In that case, if it does not offer any of the services just mentioned, you may have confidence that the results of their analysis will be defensible.

2. Conduct an RFP at least every three years for recordkeeping services. Recently, the vendor market has undergone significant consolidation, with many more mergers and acquisitions among recordkeepers pending. Consolidation activity has a significant impact on pricing among the competitors. Vigilance is required of Committees to stay abreast of rapidly changing fee structures.

3. Committees need to be aware of the move toward outsourcing in the recordkeeping sector. Some vendors have shipped their processing offshore to fourth parties who rarely appear by name in a plan's recordkeeping contract. That can make assessing the fairness of recordkeeping fees problematic, not to mention the data security implications when third and fourth parties pass the Personally Identifiable Information (PII) of a plan's participants from one to the other.

4. Get help from an unbiased qualified fiduciary risk management firm to lighten the burden on the human resources group where the effort to manage service provider relationships usually falls.

CONCLUSION

With an 80% growth in ERISA fee litigation, the perceived risk among insurers is mounting. The insurance community is telling us by its actions that benchmarking fees alone will not satisfy their coverage requirements from now on. Scores of employers have seen fiduciary liability insurance rates increase, and for many of them, insurers declined renewals outright. New underwriting requirements—specifically the completion of an excessive fee questionnaire are the new normal. Use the outline presented in this article as a basis for your committee's effort to revitalize its fiduciary risk management methods.

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