The Evolution of ERISA Fiduciary Best Practices

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At one time, retirement plans were sold for “free.” In reality, retirement plans were never free, because the true costs were hidden inside the expense ratios of plan investments. These hidden costs have many names but the industry has been content to settle on a rather descriptive phrase, “revenue sharing.”

The defined contribution marketplace and the sophistication of the Employee Retirement Income Security Act of 1974 (ERISA) plan fiduciary have come a long way since those days. Understanding revenue sharing practices, as well as many other new and difficult concepts, face today’s ERISA fiduciaries. Indeed, revenue sharing is just part of a much larger story about the retirement safety net we have in the United States. When ERISA became law more than 40 years ago, the world was one of defined benefit pension plans. These plans promised employees a set monthly benefit if only they provided years of loyal labor to their employers. The reasons are many and too complicated to get into in this article, but defined benefit plans are fading into history and defined contribution plans have become the dominant type of retirement plan. Defined contribution plans include 401(k) plans (for employees of private companies) as well as 403(b) plans (offered by nonprofits, churches, and educational institutions) and 457 plans (offered by governmental entities).

The differences between the defined benefit plan and the defined contribution plan are more than simply the name. In a defined benefit plan, the plan sponsor (i.e., the employer) is responsible for funding the plan, investing the plan assets in order to meet the plan’s liability, and paying for the plan’s costs. With a defined contribution plan, these responsibilities have been shifted to the plan’s participants, but in a way where the plan sponsor continues to retain fiduciary responsibility over all three. Instead of funding a plan, we now call it savings or deferrals. Putting enough money away for retirement is now up to the participant. Plan participants are left to figure out how to allocate their savings among the investments available to them, but the plan sponsor must choose which investments will be available, and the plan sponsor is subject to ERISA’s stringent fiduciary standards in doing so.

When it comes to costs for most plans, participants are paying the costs through revenue sharing or more explicit costs charged against their accounts, but plan sponsors have the fiduciary responsibility to select providers to service the plans and must prudently negotiate the associated costs. As a result, defined contribution plans have created a world with plenty of gray areas. One of the biggest gray areas in the past 10 years has been the filing of so-called “excessive fee cases.” On September 11, 2006, a law firm based in St. Louis, Missouri, filed a half-dozen lawsuits against Fortune 500 companies, including many defense contractors, accusing the fiduciaries of their 401(k) plans of breaching ERISA by causing the plans to pay excessive fees out of plan-participant accounts. The claims centered around the use of revenue sharing and how the practice had masked the true costs of these plans. Other claims argued that investments were inappropriate or imprudent under ERISA. Again, the true breadth of these cases is too much to be covered in this article, so a concise summary is more appropriate. In the early days, the allegations against the ERISA plan fiduciaries were very broad, with lots of claims but sparse on details, which if they could have been proven improper would have applied to the vast majority of all plans. In the early days, the cases struggled to gain traction in the federal courts. It seemed that district and appellate court judges had trouble finding harm; the claims seemed to essentially boil down to ERISA plan fiduciaries being asleep at the switch.

But then one case with a unique fact pattern changed the course of all these cases. In Braden v. Walmart, the Eighth Circuit Court of Appeals reversed a district court dismissal of the action, finding the claims in the case plausible. What about it was plausible? Claims of self-dealing by the ERISA plan fiduciary in carrying out its duties. In the ERISA context, self-dealing is another way of saying that the fiduciaries were trying to benefit themselves at the expense of the plan participants, or at least that is what the plaintiffs were alleging. From that day forward, excessive fee cases have focused heavily on claims of self-dealing, even though the bottom-line harm complained about still may simply be the fact that revenue sharing is causing excessive fees to be paid and that fact is hidden or masked from plan participants. In the past four years, the plaintiffs in these cases have had many successful settlements as well as a few victories at trial. These have resulted in hundreds of millions of dollars being paid by the large plan sponsor defendants.
Although these cases have been against sponsors of very large plans, their effects have come downstream to the average plan sponsor in two ways. First, the industry has responded through changed practices, increased disclosures, and more competition. Second, some of those factors have been brought about by a changing Department of Labor (DOL), the federal agency responsible for enforcing ERISA and regulating the hundreds of thousands of employee benefits plans subject to it. The DOL once was focused on defined benefit plans, but it has begun to redefine itself in the past six to seven years to focus on defined contribution plans.

The DOL has manifested this change by addressing the issues of fees and investments through a 2009 change to the paperwork required to be filed by most plans governed by ERISA. The change involved increased disclosure to the DOL about the direct compensation and indirect compensation (with the latter being the name DOL uses for revenue sharing) paid from a plan’s assets. The agency also promulgated regulations in 2012 that required robust disclosures to be provided to ERISA plan fiduciaries by service providers involved with plans, as well as requiring ERISA plan fiduciaries to disclose less-robust information about investments and fees to plan participants.

The colossal shift described above has resulted in changes in the best practices of those tasked with sponsoring and administering retirement plans governed by ERISA. A summary of some of those best practices follows.

Ensure Fees Are Reasonable
With the increased focus on fees inside ERISA governed plans by the plaintiffs’ bar and by the DOL, plan sponsors have become more sophisticated in ensuring that the fees paid by plan participants are reasonable. In fact, doing so has been a requirement since 2012 when the 408(b)(2) disclosure rules came into effect. The fact that the industry calls them simply disclosure rules is something of a misnomer. The 408(b)(2) regulation included a robust mandate that ERISA plan fiduciaries must review the disclosures they receive for completeness compared to the regulations and also must be able to demonstrate that the disclosures are truthful and accurate. Assuming they pass that hurdle, ERISA plan fiduciaries must then demonstrate that the fees paid are reasonable.

On the end of the spectrum of low cost and minimal time investment, an ERISA plan fiduciary can benchmark a plan’s fees. A number of well-developed providers offer this service, and a few offer to do it right over the Internet. On the other end of the spectrum, an ERISA plan fiduciary can conduct a full-scope request for proposal (RFP). Traditionally, RFPs have been done when retaining a new plan recordkeeper, but this process has become increasingly popular when searching for a new plan-level investment advisor. Full-scope RFPs have been around for a long time in the large plan market, but now they are used regularly by small plan sponsors as well.

The single most important thing ERISA plan sponsors can do is to document whatever processes they are using to show they have determined a plan’s fees are reasonable. This is usually done in the form of meeting minutes, but declarations or resolutions can work just as well.

Investment Policy Statements
Although the adoption of an investment policy statement (IPS) has been a topic discussed for many years now, ERISA plan fiduciaries increasingly are addressing the appropriate use of share classes and the revenue sharing generated in the IPS. This might include requiring a process to determine the best possible share class that reduces ultimate cost and increases the amount of revenue sharing available for plan expenses. Other ERISA plan fiduciaries may determine that they will not consider any investments that use revenue sharing. On the extreme end, some ERISA plan fiduciaries are taking the sections that address fees and moving them to a separate document called an expense policy statement.

Forming Fiduciary Committees
In most standard plan documents available from the big providers, the default named fiduciary of a plan is the plan sponsor company itself. This at times has led to the decision maker (i.e., the fiduciary) of default being the chief executive officer (CEO) or chief financial officer or even the head of human resources. In the past 10 years, best practices have developed that involve creating a committee of appropriate parties from within a plan sponsor company. For smaller companies, this often involves the CEO or other owners, but in larger companies, especially those that are publicly traded, removing the CEO and other C-Suite executives from the fiduciary committee is seen as reducing risk. Committees can be from three to as many as nine people or more. Often, the people on the committee are selected for their different roles in the company that may touch the plan in one way or the other, including finance, human resources, labor, etc.

A relatively new trend moving down to smaller plans is the adoption of a committee charter that lays out the specific roles and responsibilities of the fiduciary committee. Committee members typically are asked to sign the charter to show that they have read it, understand it, and will follow it.
Fiduciary committees often agree to meet multiple times a year but no less than annually. Committees keep meeting minutes and document their fiduciary process, such as meeting the requirement of 408(b)(2) to review the disclosures they receive from plan service providers. Fiduciary committees also may keep a well-organized filing system of all plan-related documents that might include copies of the plan document, the trust agreement, current and previous copies of the summary plan descriptions, meeting minutes, service agreements, and disclosures. Often times the filing system is on paper in a binder or a folder, but it also can be done electronically. Many plan service providers have rolled out a secure document lockbox online where plan-specific documents are stored.

**Fiduciary Training**

An area of increasing popularity is formalized fiduciary training for the ERISA plan fiduciary. The DOL has been asking increasingly about training in its examinations and audits of defined contribution plans. Although not specifically required by ERISA, training is becoming increasingly a best practice for the ERISA plan fiduciary. Fiduciary training can be done in person or over the Internet. It can be done all in one day or split up in pieces over the course of a year or years. Like all other things fiduciary, it is best to keep written records that can prove that ERISA plan fiduciaries attended training.

**Fiduciary Insurance**

Another hot topic in light of the growing number of ERISA lawsuits and DOL examinations is fiduciary liability insurance purchased by ERISA plan fiduciaries. Often, this kind of insurance is purchased as a rider to an errors and omissions policy purchased to cover the general liability of a plan sponsor. The key to purchasing this type of insurance is to fully understand who it covers, for what, and how much liability it covers. Smaller plans need smaller policy limits, and larger plans need larger limits. As for coverage, the ERISA plan fiduciary must ensure that the policy covers the plan sponsor company as well as any formal fiduciaries that have responsibilities over the plan, such as committee members, and that it also covers accidental fiduciaries within the company that may not have a formal role but might become ERISA plan fiduciaries by taking some kind of discretion with or control of the plan’s administration or its assets. We recommend that ERISA plan fiduciaries work with consultants who specialize in this area and fully understand the policies.

**Better Outcomes for Plan Participants**

Finally, ERISA plan fiduciaries increasingly are addressing the issue of better outcomes for plan participants, although a mandated outcome or level of benefits is not required under ERISA. Fees have largely been the focus of litigation and regulation, but ensuring that plan participants save enough and are choosing investment allocations wisely have not been addressed as widely.

On the first issue of savings, ERISA plan fiduciaries increasingly are designing plans that include auto-enrollment features where employees are enrolled automatically at a certain savings level unless they specifically opt out. Research has shown that this can significantly increase overall participation in a plan. A related feature is auto-escalation. At set time intervals, a plan participant’s savings rate is increased until it is at a level sufficient to have the required funds at retirement that the plan participant will need.

The second issue of proper investment allocations is one of the areas being addressed in many different forms. On one end of the spectrum, the introduction of target-date funds by mutual fund complexes has allowed participants who lack desire or skills to choose the correct allocation of funds. Participants choose from funds that are dated according to the year they want to retire. Funds with dates further from the present will have more in equities and less in bonds. Over time, the allocation will become more conservative as the participant nears retirement. Moving down the spectrum, ERISA plan fiduciaries increasingly have been hiring investment advisors that offer custom model allocations using a plan’s core lineup of funds. These can be designed as either risk-based portfolios or target-date-based, and some are even mixing the two (for example, conservative, moderate, and aggressive flavors of the 2050 fund). On the opposite end of the spectrum are solutions that manage the allocation entirely for the plan participants. This can be in the form of fully managed accounts where an investment manager selects, monitors, and removes investments. This type of service is also increasingly being done by robo-advisors through websites and/or phone apps.

**Conclusion**

ERISA plan fiduciaries are caught in a sea change between the old world of defined benefit plans and the new world of defined contribution plans and its shared responsibility with plan participants. Best practices are continually changing and new products and services are continually being offered to address these fiduciary responsibilities. ERISA plan fiduciaries will have the best interest of the participants at heart if they continue to stay abreast of the constant evolution.

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