EATON VANCE INVESTMENT MANAGERS

BENCHMARKING SERVICES: A POTENTIAL SOLUTION TO EVERY 401(K) PLAN FIDUCIARY'S PROBLEM

A White Paper by The Wagner Law Group

EXECUTIVE SUMMARY

- Employers and other plan fiduciaries have a responsibility under ERISA to ensure that all fees paid by the plan to its service providers are reasonable in light of the services provided.

- Plan fiduciaries are required to exhibit the same level of expertise a prudent expert would in assessing the reasonableness of plan fees. However, plan fiduciaries may lack the specialized knowledge of the 401(k) plan industry necessary to satisfy this requirement.

- ERISA does not require plan fiduciaries to select the least expensive service provider. In fact, selecting one or more service providers whose fees are above average may be appropriate depending on the relative value of the services provided to the plan.

- The use of a reliable benchmarking service may assist in assessing the reasonableness of plan fees and thus help satisfy ERISA requirements.

- The decision to engage a benchmarking service provider is itself subject to the same fiduciary standards under ERISA which would apply to selecting service providers for the plan generally.

- Qualified financial advisors can assist plan fiduciaries with the evaluation of plan benchmarking results, and also help them incorporate benchmarking services into a prudent plan review process that is intended to satisfy the requirements of ERISA.

INTRODUCTION

Many employers who sponsor 401(k) plans and other defined contribution plans are becoming increasingly aware that they face a daunting challenge under the Employee Retirement Income Security Act of 1974 ("ERISA"): In their capacity as ERISA fiduciaries, each employer has a duty to ensure the fees incurred by the plan are reasonable. Does the typical employer have the necessary expertise and resources to determine the reasonableness of its plan's fees? For many plan sponsors, the answer to this question is a definitive no. This poses a serious problem given the ongoing scrutiny of service fees in the 401(k) plan industry by Congress and the U.S. Department of Labor ("DOL"), and the mounting number of lawsuits filed against employers on the grounds that plan fees are excessive.

As a potential remedy to these issues, several firms are now offering services that aim to compare the fees paid by individual plans against the fees paid by a representative benchmark group of plans. The scope, cost, and, potentially, the quality of these "Benchmarking Services" varies considerably. Certain Benchmarking Services are quite ambitious and attempt to gauge not only plan fees but also the value received by the plan in return, while others strictly assess fees. In addition, the timeliness of data, size of the database, method of data verification, and construction of benchmark groups all may vary from one service provider to another. In this white paper, we will examine how Benchmarking Services can be used by plan fiduciaries to meet critical requirements under ERISA, in a manner which ultimately benefits plan participants and minimizes fiduciary liability risk for the employer. Additionally, we will examine how a qualified financial advisor can assist plan sponsors in both selecting a Benchmarking Service and in incorporating these services into a prudent plan review process that is intended to satisfy the requirements of ERISA.

FIDUCIARY REQUIREMENTS WITH RESPECT TO PLAN FEES

In order to understand the intrinsic value of Benchmarking Services and the underlying reasons behind their proliferation, it is important to understand a plan fiduciary's responsibilities under ERISA. ERISA imposes three sets of rules requiring plan fiduciaries to ensure that any fees paid by the plan to its service providers are reasonable:

- the "Establishment of Trust" rules under ERISA Section 403,
- the "Prudent Man" standard of care under ERISA Section 404, and
- the prohibited transaction exemption under ERISA Section 408(b)(2).

Establishment of Trust Rules. The Establishment of Trust rules under ERISA Section 403 specifically require plan assets to be held in a qualifying trust "for the exclusive purposes of providing benefits and defraying reasonable expenses of administering the plan" (emphasis added).

Prudent Man Standard of Care. The Prudent Man standard of care similarly permits reasonable expenses to be "defrayed" with plan assets, but it adds a challenging twist to the rule. The Prudent Man standard of care under ERISA Section 404 is informally known as the "prudent expert" standard, because it requires fiduciaries to discharge their duties to the plan with the care, skill, prudence and diligence that a "prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Thus, an employer must discharge all of its fiduciary duties to the plan, including its duty to limit plan fees to reasonable expenses only, with the same level of skill and diligence that a prudent expert would use.

Prohibited Transaction Exemption. ERISA Section 406 states that various types of transactions, including the use of plan assets to pay a plan's service provider, are "Prohibited

Transactions."[1] Fortunately, ERISA Section 408(b)(2) provides an exemption from these rules, allowing the use of plan assets to pay fees for services. However, the exemption applies strictly to a fiduciary's "contracting or making reasonable arrangements" with the plan's service provider for "services that are necessary" for plan operation, and only if no more than "reasonable compensation" is paid for them. The applicable DOL regulations simply state that the determination of whether compensation is reasonable depends on the particular facts and circumstances of each case.

PENALTY FOR BREACHING FIDUCIARY DUTIES

The penalties under ERISA are substantial if the employer breaches any of its fiduciary duties.[2] ERISA Section 502(a) also gives participants the power to file legal claims against a plan fiduciary for breaching its duties under ERISA. A growing number of lawsuits have been filed against some of the nation's largest employers and investment providers alleging, in part, that they breached their fiduciary duties under ERISA by failing to monitor the direct and indirect compensation paid to the plan's service providers.[3] With one notable exception, the trial courts have been cautious in dismissing these lawsuits at an early stage, a fact which seems to have encouraged the plaintiffs' bar to file additional lawsuits over fees.[4]

Given the fact that employers typically have limited knowledge of the 401(k) plan industry (other than the experience they have with their individual plans), employers may be exposing themselves to significant fiduciary liability when they sign off on plan fees without any outside assistance or formal review process. Financial advisors can play a crucial role in sensitizing and educating plan sponsors with respect to the employer's duties under ERISA to monitor and evaluate the plan's fees. To avoid violating federal law and the related penalties under ERISA, the employer must confirm that any and all fees paid with plan assets are reasonable, and the employer must make this determination with the same standard of care that would be required of a prudent expert.

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[1] ERISA Section 406 provides, among other requirements, that a fiduciary must not cause the plan to engage in a transaction that constitutes a direct or indirect (1) sale or exchange of any property between the plan and a party in interest, (2) lending or extension of credit between the plan and a party in interest, (3) furnishing of goods or services between the plan and a party in interest, or (4) transfer to, or use by, a party in interest of any plan assets. A "party in interest" is broadly defined to include the plan's service providers, fiduciaries, the employer sponsoring the plan, and their respective affiliates.

[2] Under ERISA Section 409, a fiduciary is personally liable for plan losses resulting from a breach, such as the use of plan assets to pay unreasonable fees. ERISA Section 502(l) imposes a 20% civil penalty on amounts recovered pursuant to a settlement with the DOL. Under Internal Revenue Code Section 4975, the excise tax for prohibited transactions is assessed against the service provider receiving unreasonable compensation from the plan.

[3] See, e.g., Abbot v. Lockheed Martin Corp. (S.D. Ill. Aug. 13, 2007), Beesely v. International Paper Company (S.D. Ill. Sept. 30, 2008), George v. Kraft Goods Global, Inc. (S.D. Ill. Mar. 16, 2007), Martin v. Caterpillar, Inc. (C.D. Ill. May 15, 2007), and Spano v. The Boeing Co. (S.D. Ill. Apr. 18, 2007).

[4] In Hecker v. Deere & Co. (7th Cir. Feb. 12, 2009), the Court of Appeals in its grant of a motion to dismiss, held that revenue sharing was not prohibited and that ERISA did not require disclosure of such payments to participants.

HOW BENCHMARKING SERVICES CAN HELP PLAN FIDUCIARIES

Benchmarking Services can help employers meet their obligations under ERISA with respect to plan fees in the following ways:

- Assist the employer in its efforts to identify and calculate all plan fees, including any "hidden" indirect compensation paid by the plan's investments (or investment providers).

- Equip the employer with the ability to use Benchmarking Services as part of a prudent review process to evaluate and monitor the plan's services and fees on an ongoing basis.

- Provide the employer with the competitive pricing information that a prudent expert might have, to help assess the reasonableness of the plan's current service arrangement.

Identify "Hidden" Indirect Compensation. The U. S. Government Accountability Office (GAO) concluded in its July 2008 report, *Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors*, that plan sponsors were unable to satisfy their fiduciary obligations without disclosure of the "hidden" compensation flowing from the plan's investments to its service providers (e.g., recordkeeper, pension consultant).[5] For example, a plan's service provider may receive "soft dollar" payments from the plan's investment funds in the form of shareholder servicing fees (as well as 12b-1 fees and sub-transfer agency fees) or other revenue sharing payments directly from the funds' investment managers. Although a plan sponsor would undoubtedly be aware of the "hard dollar" fees charged directly to the plan or plan sponsor, the employer may not necessarily understand that the service provider can also receive indirect compensation from the plan's investment funds and the managers of such funds.

Thus, a plan sponsor could conceivably select what appears to be a "free" administrative service for the plan, without understanding that the provider's compensation was being passed on to plan participants in the form of higher embedded costs in the plan's investment funds. The plan's service provider would also have a conflict of interest to the extent it had a financial incentive to steer the plan sponsor to arrangements or funds that increased the provider's indirect compensation. In DOL Advisory Opinion 97-16A, the DOL advised that fiduciaries must assure that the compensation paid directly or indirectly by the plan to a service provider is reasonable. plan fiduciaries therefore must obtain sufficient information regarding any such indirect compensation, to make an informed decision whether such compensation is no more than reasonable. Revenue sharing among a plan's investment and service providers is not prohibited under ERISA. But without full disclosure of the indirect compensation paid to the plan's service providers, the employer might approve a service arrangement with fees in the aggregate that are unreasonable, resulting in a breach of its fiduciary duties under ERISA.

With the consent of the plan sponsor, many providers of Benchmarking Services will work directly with the plan's recordkeeper to obtain the information necessary to determine the various types of revenue sharing payments flowing from the plan's investments (and/or investment providers) to the plan's service providers. Providers of these types of Benchmarking

[5] The GAO is an independent, non-partisan agency that works for Congress, and is sometimes referred to as the "investigative arm of Congress."

Services can greatly simplify the employer's review of plan fees. This revenue sharing data can also be used by the plan sponsor to confirm the direct and indirect compensation information which, beginning with the plan year for 2009, must be reported on the plan's Form 5500 information return annually.[6] This recent change to the Form 5500 is just a part of the DOL's regulatory initiative to improve fee transparency, and any such revenue sharing information will continue to be relevant as the DOL moves to finalize its other related regulations.[7]

Prudent Review Process to Monitor Fees. The DOL issues Information Letters which are intended to call attention to well-established principles under ERISA. The DOL has repeatedly summarized in multiple Information Letters and in other related pronouncements (the "DOL Procedural Guidance") the procedural rules which plan fiduciaries should follow in connection with the selection of a service provider.[8] The responsible fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. Soliciting bids among providers at the outset is a means by which the fiduciary can obtain the necessary information relevant to the decision-making process. Whether such a process is appropriate in subsequent years may depend, among other things, upon the fiduciary's knowledge of the service provider's work, the cost and quality of the services provided, the fiduciary's knowledge of prevailing rates for similar services, as well as the cost to the plan of conducting a particular selection process.

In other words, according to the established principles articulated in the DOL Procedural Guidance, a plan sponsor should follow an objective process for gathering information about the provider, its services, and the reasonableness of its fees. Given the enormous effort and time which is typically involved in soliciting bids from prospective service providers for the plan, it would be much more efficient for a plan sponsor to implement a simple procedure under which (1) it requests updated information concerning the qualifications of the plan's existing service provider, (2) objectively assesses the provider's historical performance, and (3) it uses Benchmarking Services to determine the prevailing rates for similar services. The advantage of this simple procedure is that the plan sponsor can use it regularly as part of a formal and prudent review process, and it will help the plan fiduciary monitor the reasonableness of the plan's services and fees on an ongoing basis. Financial advisors who work closely with plan sponsors can assist them in the development and adoption of a simple but disciplined review procedure for monitoring plan fees.

Gain Expert's Knowledge With Competitive Pricing Information. Although many employers intuitively believe the key to satisfying the prudence standard under ERISA is following a set of prudent procedures, financial advisors should also remind plan sponsors that

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[6] The GAO in its December 2009 report, *Additional Changes Could Improve Employee Benefit Plan Financial Reporting*, recommended that the DOL further increase its Form 5500 disclosure requirements for indirect compensation and that it should coordinate these requirements with the pending ERISA 408(b)(2) regulations.

[7] The DOL proposed new regulations under ERISA Section 408(b)(2) in 2007 which, if adopted, would require the plan's service provider to disclose any indirect compensation and potential conflicts of interest. The DOL also proposed regulations in 2008 which, if adopted, would require plan sponsors to furnish fee information to plan participants.

[8] See, e.g., Information Letters to D. Ceresi (February 19, 1998) and to T. Konshak (December 1, 1997), the preamble to DOL proposed regulations under ERISA Section 408(b)(2), and DOL Field Assistance Bulletin 2002-3.

the fiduciary decision-making process requires substantive expertise. As discussed above, the standard of care under ERISA Section 404 requires the plan sponsor to evaluate the reasonableness of plan fees with the skill and knowledge of a *de facto* prudent expert who is familiar with the service fees in the 401(k) plan industry. One of the few ways in which an employer can acquire this requisite knowledge is to obtain competitive pricing information from a reliable Benchmarking Service. And with the assistance of the Benchmarking Service provider and the support of the plan's financial advisor, the plan sponsor should be able to position itself so that it is able to interpret and utilize the competitive pricing information effectively and also complete its fiduciary review in the same manner as would a prudent expert.

SELECTING A BENCHMARKING SERVICE

Benchmarking Services are offered in all sorts of shapes and sizes. Financial advisors should inform their plan sponsor clients that the decision to engage a Benchmarking Service provider is itself subject to the same fiduciary standards under ERISA which would apply to selecting service providers for the plan generally. In addition, financial advisors who work with plan sponsors should encourage them to make the following inquiries with respect to any prospective provider of Benchmarking Services:

- What are the qualifications and credentials of the provider? How long and to how many clients has the provider been offering Benchmarking Services?

- Does the provider offer benchmarking analyses for all of the plan's investment and administrative service fees? To what extent are benchmarking analyses provided separately for each individual fee (as opposed to total fees)?

- Will the provider be able to identify all indirect compensation paid to the plan's service providers from the plan's investments and investment providers? Does the provider consider all indirect compensation paid with respect to the benchmark group of plans?

- How reliable is the provider's data for the benchmark group of plans? Is data obtained directly from the various plans' recordkeepers? Does the data gathering method used by the provider prevent inaccurate data submission? Is stale and outdated data disregarded?

- What is the size and profile of the plans included in the benchmark group? How many plans are included in the benchmark group? Can the benchmark group be customized?

- Does the provider offer any benchmarking analyses with respect to the quality of the investment and administrative services provided to the plan?

- In order to make a direct comparison, the actual fees of the various plans are often converted into a per-participant fee or asset-based fee. Does the provider use both per-participant fees and asset-based fees as baselines for its comparisons? If not, why?

- After the benchmarking analyses are completed, what type of consulting services and support will be available to the plan fiduciary in interpreting such analyses?

INTERPRETING THE BENCHMARKING ANALYSIS PROPERLY

When considering the use of Benchmarking Services, the question that plan sponsors invariably ask is: "What do I do if the benchmarking analysis says that my plan is too expensive?" Financial advisors should assure their plan clients that nothing in ERISA requires them to "scour" the markets to find the cheapest investment and service providers.[9] To the contrary, the DOL Procedural Guidance provides that plan fiduciaries should never consider one factor, such as the lowest fee for services, to the exclusion of any other factor, such as the quality of the work product. Rather, the decision regarding which service provider to select should be based on an assessment of all the relevant factors, including both the quality and cost of the services. Accordingly, a plan fiduciary should never conclude that its plan's services are too expensive, based on the results of a benchmarking analysis alone.

Plan sponsors have the flexibility to maintain arrangements with plan service providers that charge relatively expensive fees, so long as they are appropriate in light of the services provided. If a plan client is in this situation, financial advisors should remind the employer to document the reasons for concluding that plan fees are reasonable in light of the services provided (e.g., responsiveness to inquiries, prompt resolution of issues, high number of benefit transactions, complexity of plan design, low processing errors, customized services, etc.). Such documentation will be instrumental in demonstrating that the employer considered both plan fees and the quality of the services provided, in discharging its fiduciary duties under ERISA.

If the plan sponsor concludes that the fees are too expensive in light of the services provided, the plan sponsor should renegotiate the plan's fees or ask for additional services. If the fees are too high because of the indirect compensation received by the service provider from the plan's investments or investment providers, the employer can also request that the service provider create an "ERISA fee recapture account" under the plan, where all or a portion of the revenue sharing received by the provider is deposited into such account and then used at the direction of the employer to pay administrative expenses or for allocations to participants in accordance with the plan document.[10] As a last resort, if the service provider refuses to renegotiate its fees or change the scope of its services, the plan fiduciary would have to terminate the arrangement to avoid a violation of the applicable rules under ERISA.

CONCLUSION

Every plan sponsor in its capacity as an ERISA fiduciary has a duty to ensure the fees incurred by the plan are reasonable.

- With the assistance of a reliable Benchmarking Service provider and the support of the plan's financial advisor, employers can discharge their fiduciary duties in the same manner as would a prudent expert.

[9] See Hecker v. Deere & Co. (7th Cir. Feb. 12, 2009).

[10] For more information about ERISA fee recapture accounts, see Q&A 13 of the Supplemental FAQs About the 2009 Schedule C on the DOL's website, http://www.dol.gov/ebsa/faqs/faq-sch-C-supplement.html.

- However, it is important that plan fiduciaries recognize that Benchmarking Services are a tool to be included as part of a broader, prudent review process.

- Plan benchmarking results need to be evaluated in the proper context and critically examined, and decisions involving the hiring and firing of service providers should be based on all relevant factors, and never based on the benchmarking results alone.

Financial advisors can play a crucial role in helping the plan fiduciary (1) select a reliable provider of Benchmarking Services, (2) develop a simple but disciplined review process for the plan's services and fees, and (3) use the plan's benchmarking results effectively to properly evaluate the plan's fees in light of the services provided.