408(b)(2) and the Rise of Benchmarking

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Change is coming. When the Department of Labor's 408(b)(2) regulation takes effect, covered service providers – including record keepers – will be required to make written disclosures to responsible plan fiduciaries about their services, status as a fiduciary or a registered investment advisor, and the direct and indirect compensation they expect to receive. In the absence of those disclosures, the arrangement between the record keeper and the plan will be a prohibited transaction.

While most of the 401(k) community has been focused on the preparation and delivery of the disclosures, little has been said about the next step – the evaluation of the disclosures. This article discusses the fiduciary responsibility of plan sponsors to evaluate the disclosures, how they will do that job and what the impact on record keepers will be.

As a practical matter, once plan sponsors begin receiving these disclosures, even though their legal responsibilities have not changed (see, e.g., a 1997 DOL Advisory Opinion 97-15A which states that fiduciaries must evaluate the compensation of service providers), the expectation that they evaluate the information will be greater than ever before. As a result, plan sponsors will likely turn to benchmarking services as a reasonably-priced means of doing this fiduciary job.

The General Rule – Arrangements with Plans

The relationship between plans and service providers – and the compensation that service providers receive – is governed by ERISA. The analysis begins with the rule in ERISA §406(a) that makes it a prohibited transaction for a "party in

interest" to provide services to a plan. Of course, if plans were precluded from obtaining services – such as record keeping services – they would be unable to operate at all. So, the statute – in §408(b)(2) – provides relief for "reasonable" service arrangements, if the services are needed for the plan's operation and if no more than reasonable compensation is paid. Correspondingly, "arrangements" that are not "reasonable" are prohibited transactions.

The 408(b)(2) regulation clarifies that, in order for arrangements between covered plans to be reasonable, covered service providers – including record keepers – must disclose the services they provide, their status as a fiduciary or RIA, and the direct and indirect compensation they receive.

The Plan Sponsor's Duty

Technically speaking, the 408(b)(2) regulation does nothing to change plan sponsors' obligations to prudently select and monitor their service providers, to evaluate whether the compensation they receive is reasonable, and to take appropriate action if the arrangements are unreasonable.

But, as a practical matter, the pre- and post-408(b)(2) worlds will be very different. Once the regulation takes effect, information about service provider compensation will be more readily available to plan sponsors. This is particularly true for information about indirect compensation such as 12b-1 fees, sub-transfer agency fees, and other forms of revenue sharing that providers may receive from investments or other service providers, which in the past may have gone unnoticed by plan sponsors.

With increased information, sponsors will face heightened expectations. That is, once the obstacle of incomplete or hard to get information is disposed of, plan sponsors will face greater expectations to engage in a prudent process of (1) reviewing information that is presented to them, (2) investigating pricing in the marketplace, and (3) evaluating whether the service provider arrangement is reasonable in light of the services and the total compensation that the service provider receives.

An approach that is generally considered a reasonable alternative to the RFP process is the use of a benchmarking service.

The Rise of Benchmarking

The DOL has taken the position that plan sponsors should evaluate the disclosures that they are receiving from their service providers. (See Preamble to Interim Final Rule, 75 FR 41600 [July 16, 2010]).

Perhaps the most accurate way for plan sponsors to evaluate service provider compensation is through a competitive bidding process initiated by a request for proposal (RFP). (See, e.g., DOL Adv. Op. 2002-08A). The advantage of an RFP is that it results in multiple offers to provide services at a particular price. It indicates the terms under which competitive service providers will work today and into the future. The main problem with the RFP process is that it is time consuming and expensive.

An approach that is generally considered a reasonable alternative to the RFP process is the use of a benchmarking service. These services compare several measures of a plan's operation – including service provider compensation – against other similar plans. For example, a benchmarking service might compare total plan fees, record keeper fees, advisor/consultant fees and investment management fees to those in a selected peer group, and report whether the fees in each category are above or below the peer group average.

However, a plan should benchmark against an appropriate peer group in order to place substantial reliance on the data. There are a number of factors for fiduciaries to consider in determining the relevance of the benchmarking data and the degree of reliance they can put on that data. (The type of data which could be used for determining relevance would include, but not be limited to, total plan assets and number of participants with account balances).

The 408(b)(2) regulation imposes additional disclosure requirements on record keepers for participant-directed plans. Such record keepers must disclose all direct and indirect compensation that they or any affiliate or subcontractor expects to receive in connection with the record keeping services; and, if there is no explicit fee for the record keeping service (because it is included within a bundle of services or will be offset or rebated based on other compensation the provider will receive), the record keeper must provide a reasonable and good

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faith estimate of the cost to the plan of the record keeping services. The record keeper must also include an explanation of the methodology and assumptions used to prepare the estimate.

While record keepers are using different methods for calculating the estimated cost, it is that number that plan fiduciaries are likely to focus on for RFPs and for benchmarking.

Almost inevitably, benchmarking reports will show whether a service provider's compensation is above or below a designated "norm" – most likely, the average of the compensation of other similar service providers for similar plans. It is important to recognize that under ERISA, compensation falling anywhere within a range – from somewhat below to somewhat above average – may be considered reasonable. (See, e.g., Dupree v. The Prudential Ins. Co. of America, 2007 WL 2263892 at *41 [S.D. Fla. 2007]). Despite this, because most plan sponsors are not experts in the retirement industry in general, or are not familiar with the benchmarking process in particular, it is easy to imagine that some will equate a statement in a benchmarking report that a plan's fees are "above average" to a conclusion that the fees are unreasonable.

The Record keeper Response

Record keepers should be prepared to address such kneejerk responses directly. Nothing in ERISA requires that a plan sponsor select the least expensive service provider. As the DOL has stated in its own website, "[f]ees are just one of several factors fiduciaries need to consider in deciding on service providers and plan investments." The issue is not whether the plan sponsor selects the least expensive record keeper, but rather whether it engages in a prudent, comparative process that takes into consideration the range of services provided and the results the service provider has obtained.

Consequently, record keepers should be prepared to address the results of benchmarking before the client benchmarks the provider. For example, if the record keeper's compensation will compare favorably to its peers – i.e., is below average – this could be the value proposition it provides to its clients and prospective clients. However, if the record keeper is in the higher end of the range, its efforts to educate its clients and prospective clients could focus on additional services it provides, such as gap analysis, and the results it achieves in making its client's plans successful, for example, how the services result in a plan that delivers better retirement benefits for employees. This may be demonstrated by, for instance, showing that the record keeper's clients obtained:

1. higher participation rates than the industry standard;
2. deferral rates that exceed those of the client's industry peer group;
3. better overall participant investing (as defined by portfolio investing);
4. better benefit adequacy, measured by the retirement income replacement relative to pre-retirement income.

Consequently, record keepers should be prepared to address the results of benchmarking before the client benchmarks the provider.

In other words, record keepers need to educate their plan sponsor clients about the services they provide and the value of those services. That way, the client's focus will be on the "reasonableness" of the record keeper's fees, and not just whether those fees may be above an average that fails to take into account factors other than price.

Record keepers should also consider reviewing their current contracts and engage in their own evaluation before their clients do. Contracts that are priced so that the record keeper is above average (or above a reasonable amount) should be reviewed and, perhaps, repriced. This could occur where, for example, the plan assets have increased substantially since the plan was last priced or where the plan has not been repriced in many years. ■