

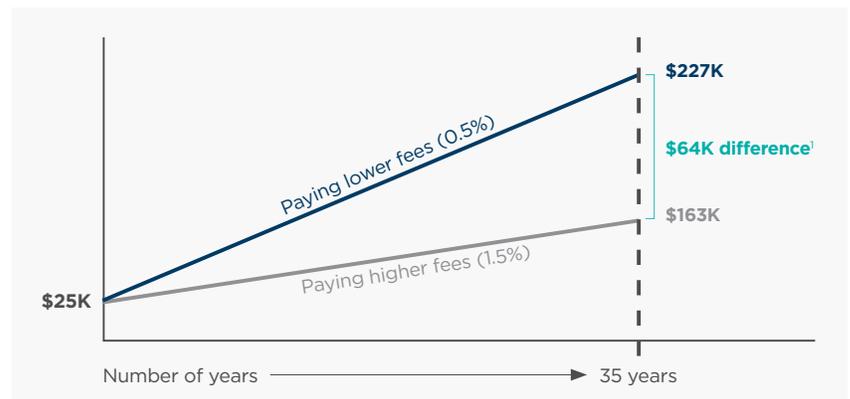
Benchmarking: a tool for evaluating retirement plan fees, services and investment options

Christine Cushman, JD, LLM, CLU®

Summary

- I. Fiduciary duties
- II. Fee benchmarking
- III. Request for Proposals
- IV. Benchmarking other aspects of plan effectiveness
- V. DOL tips for selecting service providers

Do fees matter? Let's do the math . . .



- Assume that an employee has 35 years until retirement and a current 401(k) account balance of \$25,000.
- If returns on investments in the account over the next 35 years average 7% and fees and expenses reduce average returns by 0.5%, the account balance will grow to \$227,000 at retirement, even if there are no further contributions to the account.
- If fees and expenses are 1.5%, however, the account balance will grow to only \$163,000.
- The one percentage point difference in fees and expenses would reduce the account balance at retirement by 28% or \$64,000.¹

This illustration is hypothetical and is not intended to predict or project investment results of any specific investment. Investment return is not guaranteed and will vary depending upon your investments and market experience.

This simple example demonstrates that the answer is clearly “yes, fees do matter.” A rush to the bottom in search of the lowest fees, however, is not always the best answer either. There is an old adage that “you get what you pay for” and we all know that (almost) nothing is free in this world. So when evaluating retirement plans fees, consider the most appropriate balance between costs on the one hand and service and benefits on the other.

I. Fiduciary duties

When retirement plan assets are used to pay service provider fees and other plan expenses, we must consider the implications of the Employee Retirement Income Security Act, better known as ERISA. Among the many duties imposed on plan fiduciaries by ERISA is the duty of loyalty which requires that a fiduciary act solely in the interests of plan participants for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan.²



The responsible plan fiduciary has an obligation to determine on an ongoing basis that fees and expenses paid out of plan assets remain necessary and reasonable.

Failure to do so could lead to a breach of fiduciary duty claim by plan participants or the Department of Labor (“DOL”) for which the fiduciary may be held personally liable.

The DOL has reiterated this need to review fees and services in the preamble to the regulations issued under ERISA section 408(b)(2) stating “ERISA section 404(a) also obligates plan fiduciaries to obtain and carefully consider

information necessary to assess the services to be provided to the plan, the reasonableness of the compensation being paid for such services, and potential conflicts of interest that might affect the quality of the provided services.”³ In addition to the DOL’s focus on fees, there have been numerous judicial decisions and settlements involving fiduciary breach claims against plan sponsors and their service providers associated with excessive fees. Thus, plan fiduciaries are expected, like never before, to justify the decisions that they make regarding the administration and performance of the retirement plan.

II. Benchmarking

This intense focus on offering a retirement plan at a “reasonable” cost might leave a plan fiduciary wondering how he or she may show that the fees the plan pays are reasonable. Such a determination may seem like a very subjective standard. To some degree it is; therefore, plan fiduciaries should establish, implement and document a prudent process⁴ for making any determinations as to what are reasonable fees for services provided to the plan. One important step in demonstrating a prudent process is to benchmark the plan’s fees and services on a regular basis. Merriam-Webster defines “benchmark” to mean “something that can be used as a way to judge the quality or level of other, similar things.”⁵



Benchmarking reports that show comparisons to other plans, investment options, services, etc. can be used as part of the prudent process to support plan fiduciaries’ decisions about their own plans’ fees, services and investment options.

The use of benchmarking has been prevalent in investment decision-making for many years as the DOL has expected plan fiduciaries to provide prudent investment options in retirement plans. In order to show that the plan fiduciary exercised prudence in the selection and retention of certain investment options, the fiduciary might use benchmarking reports to demonstrate how the plan’s current offerings compare to other product offerings in terms of cost and performance. Now with the DOL’s push for documented prudence in the area of service provider compensation, benchmarking has moved into a new arena. The plan fiduciary should be sure any benchmarking used in his or her decision-making process is from an independent benchmarking provider, not the plan’s current service provider. In addition, the benchmarking is most valuable if it is “apples to apples,” comparing plans of similar size by assets and number of participants, plan type, design, location, and industry.

III. Request for Proposals

Benchmarking may potentially replace or supplement a more formal bidding process such as the use of a request for proposal (“RFP”) or request for information (“RFI”). If the plan sponsor does not want to issue RFPs or RFIs and utilizes a less formal means of vendor management, the plan fiduciary should, at the very least, adequately document vendor decisions including the use of benchmarking.

Whether benchmarking is sufficient or whether the plan sponsor must seek bids through the RFP process is not entirely clear. In the preamble to its 2010 service provider fee disclosure regulations, the DOL stated that it assumes plan sponsors conduct an RFP about every three years.



At least one Circuit Court has suggested that benchmarking alone (without an RFP) may not be sufficient — at least with respect to a large plan.

Participants in the Kraft Foods 401(k) plan sued the plan fiduciaries alleging that they breached their fiduciary duties by failing to issue an RFP every three years. An Illinois District Court

sided with the plan and dismissed the case based on the company’s showing that its decision to remain with its current service provider over numerous years was made with the assistance of expert outside consultants who benchmarked the service provider’s fees on multiple occasions and advised the company that the fees were competitive.⁶ On appeal, the Seventh Circuit reversed the district court and sent the case back for trial, stating “[b]ecause we find that the fiduciaries were not necessarily prudent in relying on the advice of consultants in lieu of bids, we reverse the grant of summary judgment on this claim.”⁷ The case settled for approximately \$9.5 million.

IV. Benchmarking other aspects of plan effectiveness

Benchmarking does not have to be limited to investment and service provider fees and services. It could also be used to review plan effectiveness looking at such topics as participation rates, average deferrals, average account balances, diversification and the use of loans/hardship withdrawals. This information could be used as part of an annual “health check” for the retirement plan. Such benchmarking could accompany periodic self audits by an independent third party to ensure that the plan is in compliance with applicable laws and providing retirement savings opportunities in the most effective manner.

V. DOL tips for selecting service providers

When selecting service providers for the plan, whether through the use of benchmarking or an RFP and RFI, consider the following tips from the DOL:⁸

- > Ask service providers about their services, experience with employee benefit plans, fees and expenses, customer references or other information relating to the quality of their services and customer satisfaction with such services.
- > Present each prospective service provider identical and complete information regarding the needs of your plan. You may want to get formal bids from those providers that seem best suited to your needs.
- > Ask each prospective provider to be specific about which services are covered for the estimated fees and which are not. Compare the information received, including fees and expenses to be charged by the various providers for similar services. Note that plan fiduciaries are not always required to pick the least costly provider. Cost is only one factor to be considered in selecting a service provider.

- > Prepare a written record of the process followed in reviewing potential service providers and the reasons for the selection of a particular provider. This record may be helpful in answering any future questions that may arise concerning the selection.
- > Periodically review the performance of service providers to ensure that they are providing the services in a manner and at a cost consistent with the agreements.



Remember

Satisfaction with the status quo when it comes to vendor services is not enough in discharging fiduciary responsibility.

The responsible plan fiduciary must make continued and ongoing determinations that the plan's then-current service providers are providing necessary services for reasonable compensation.

¹ See "A Look At 401(k) Plan Fees", the Department of Labor, available at http://www.dol.gov/ebsa/publications/401k_employee.html

² ERISA section 404(a)(1)

³ Referencing Field Assistance Bulletin 2002-3 (Nov. 5, 2002), Advisory Opinion 97-15A (May 22, 1997), Advisory Opinion 97-16A (May 22, 1997).

⁴ ERISA also requires that a plan fiduciary act prudently, discharging his or her duties with the care, skill, prudence, and diligence under the circumstances then prevailing 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. See ERISA sec. 404(a).

⁵ See <http://www.merriam-webster.com/dictionary/benchmark>

⁶ *George v. Kraft Foods Global, Inc.* 2010 WL 331695 (N.D. Ill. Jan. 27, 2010).

⁷ *George v. Kraft Foods*, 2011 WL 134563 (7th Cir. 2011).

⁸ See Fact Sheet: Tips For Selecting And Monitoring Service Providers For Your Employee Benefit Plan, U.S. Department of Labor, Employee Benefits Security Administration, May 2004, <http://www.dol.gov/ebsa/newsroom/fs052505.html>

This material is not a recommendation to buy, sell, hold or rollover any asset, adopt an investment strategy, retain a specific investment manager or use a particular account type. It does not take into account the specific investment objectives, tax and financial condition, or particular needs of any specific person. Investors should work with their financial professional to discuss their specific situation.

Federal income tax laws are complex and subject to change. The information in this memorandum is based on current interpretations of the law and is not guaranteed. Neither Nationwide, nor its employees, its agents, brokers or registered representatives gives legal or tax advice. You should consult an attorney or competent tax professional for answers to specific tax questions as they apply to your situation.

