Introduction

Fees and expenses associated with the management of a qualified retirement plan have become a central issue with lawmakers, regulators and the courts. Plan sponsors have a fiduciary responsibility under ERISA to determine if the fees paid by a plan to its service providers are reasonable and necessary.

Since 2006, more than two dozen large 401k plan sponsors have been hit by class action lawsuits alleging that they breached their fiduciary duty to control and account for investment-related fees and expenses. The most prevalent allegations include:

1. The plan sponsor breached his or her fiduciary duties by failing to take into account excessive fees paid to plan service providers.

2. The plan sponsor failed to implement investment options prudently; specifically, selecting higher cost, retail class mutual funds when less expensive institutional class funds may have been more appropriate.

3. The plan sponsor failed to negotiate reasonable fees for administrative and investment services and disclose these fees to plan participants.

4. The plan sponsor engaged in prohibited transactions with a party in interest.

As a result, the Department of Labor (DOL) has issued interim final regulations under ERISA Section 408(b)(2) that became effective July 1, 2012 requiring that contracts and arrangements between plans and service providers be “reasonable.” Additionally, under these new 408(b)(2) guidelines service providers have to disclose in writing a description of services provided to the plan, as well as the amount of compensation received in connection with the plan and any potential conflicts of interest. The primary goal of the regulation is increased transparency between the plan and service providers by ensuring that plan fiduciaries receive information regarding what services are being provided, who is providing the services and how much compensation each service provider receives.

Benchmarking Plan Fees

Determining reasonableness or “fair market value” is part art (qualitative) and part science (quantitative). It includes identifying and comparing the cost of operating the plan to the real or perceived value of the persons or organization(s) servicing the plan. It is important to note that ERISA does not require a plan sponsor to select the service provider or the investment options with the lowest cost. The Department of Labor has stated that fees are not the only factor to consider when comparing plan providers.

It is not enough for a plan sponsor simply to know who has been compensated from plan assets; the plan sponsor also has a duty to demonstrate that a determination was made as to why the compensation being received by a service provider is fair and reasonable for the level of services being rendered. As in any transaction, the fair price relates to the value of the service being provided. Consequently, it can be reasonable to pay higher fees if a plan is receiving more or superior services. A plan sponsor is required to be able to demonstrate that a plan’s fees and expenses are “appropriate and reasonable” given the goals and objectives of the plan and the needs of the plan participants.

The first step in evaluating whether a plan’s fees are reasonable is comparing the cost of a particular plan to the costs of a group of similar plans. While it can be argued that there are many variables to consider and that no two plans are identical, benchmarking the cost of your plan is necessary and beneficial, in order to:

- help plan sponsors meet their fiduciary duties under ERISA.
- assess the reasonableness of current fees and services.
- make plan sponsors aware of fees paid directly by the company and costs embedded in a plan’s investments.
- provide plans with a basis for comparing and negotiating their fees.

In general, plan expenses fall into three categories:

a. Plan Administration Fees: Expenses associated with the basic administration of the plan, including: accounting, legal, recordkeeping and trustee services.
b. Investment Fees: Typically, investment fees will be the largest expense of the plan. In turn, investment fees can be broken down into an additional three categories:
   i. Investment Management Fees: Paid to the investment advisor for the performance of investment management services
   ii. 12b-1 Fees: An annual marketing fee which is included as part of a mutual fund’s expense ratio and typically paid to the plan’s financial advisor
   iii. Sub-Transfer Agent Fees: Payment to the plan administrator or recordkeeper for providing plan participant account services

c. Participant Transaction Fees: Expenses associated with optional services provided to individual participants, such as the fees associated with servicing a loan

Besides identifying and comparing plan cost data, it is equally important to understand the relative complexity of a plan: i.e., plan design and administrative requirements and the effect they have on the overall cost. The test of “reasonableness” depends on the size of the plan, as well as the plan design and other factors. Key drivers in determining plan cost are:

1) total plan assets
2) number of plan participants
3) average participant account balances
4) asset allocation
5) plan features

Usually, a plan with standard plan features, more assets and higher account balances will incur fewer expenses than a plan with a similar number of participants but less assets and lower average participant account balances.

Conclusion

It is a plan sponsor’s fiduciary duty to control and account for plan and investment-related fees and expenses. Benchmarking is a useful tool for helping plan sponsors understand how a plan’s costs compare to a peer group of plans of similar size and whether their plan is paying unreasonable expenses. However, evaluating plan fees is not only a comparison of relative plan costs. Plan sponsors must also make a value judgment on the quality of the services being provided and the service providers. Conducting a review of plan fees and services is an important and necessary first step for plan fiduciaries toward evaluating plan expenses in accordance with ERISA Section 408(b)(2).

Fee Benchmarking Best Practices

- Request statements of services and fees from your current service providers.
- Benchmark plan fees to ensure that they are reasonable and competitive using an independent, unbiased third-party.
- Conduct an annual review of fees and services as part of the plan’s prudent review process.
- Update the plan’s Investment Policy Statement to include policies and procedures to control and account for administration, recordkeeping, and investment expenses.
- Monitor changes in the quality, frequency and type of services relative to the fees paid by the plan.
- Maintain a record of annual plan fee reviews in a fiduciary audit file.

This article is for informational purposes only. In no way does Thornburg Investment Management assure, that by using this information, your plan is in compliance with ERISA regulations.