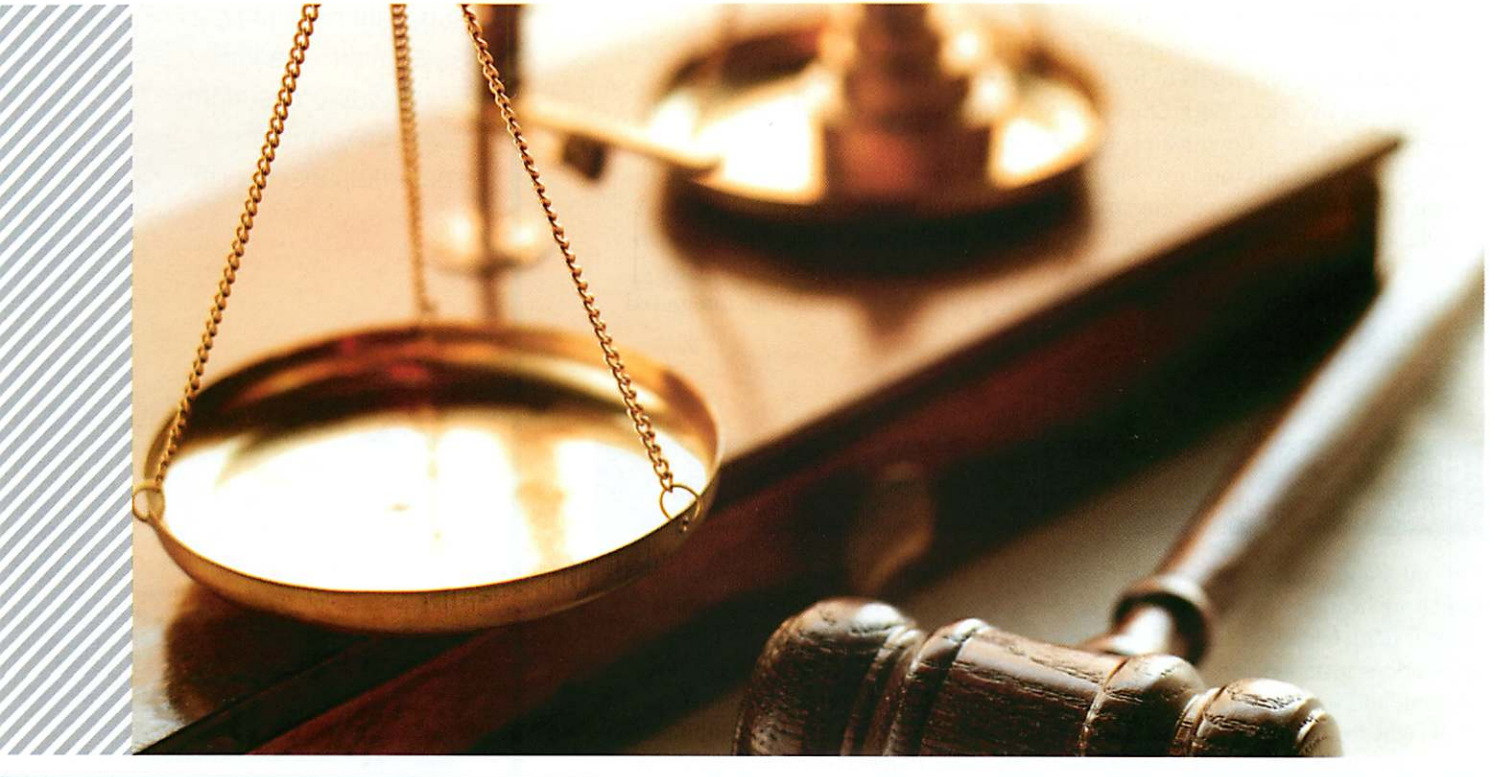


PROPER ADVISOR BENCHMARKING VALUES FACTS OVER OPINIONS



BY DAVID J. WITZ

As details of advisor compensation and business relationships are disclosed, plan sponsors will need to take action to document their files to support their continued use of the advisor as prudent, reasonable, and conflict free.

As 408(b)(2) plan level disclosures and the 404(a)(5) participant disclosures become effective, plan sponsors should have a strategy in place to address the threat of litigation. Plaintiff attorneys may *find discontented* participants a target-rich environment to leverage the Supreme Court's decision authorizing lawsuits by individual 401(k) plan participants based on

“impaired value” of plan accounts.¹

Of course, vocal participants may exude enough pressure to encourage immediate and swift action by plan fiduciaries to explore alternatives. In fact, fear of participant recourse may be sufficient incentive for a plan sponsor to replace an existing advisor in a measured response to ward off any perception that a plan sponsor violated its ERISA fiduciary obligations. In short, idle advisors who fail to assist with the documentation of reasonable fees and communications to participants may find themselves as the poster child for 404(a)(5) collateral damage.

SURVEYS ARE NO LONGER THE “CIRCUMSTANCES THEN PREVAILING”

Benchmarking has historically been the purview of surveys that are either influenced by respondent’s opinions or responses from participating firms to a closed study. Respondent opinions are subjective and in many cases influenced by lack of time, loyalty, and rewards. It’s not unusual for the survey request to be delegated to someone with less knowledge or interest in the subject matter. As a result, survey responses are highly suspect.

Alternatively, closed studies are hampered by the inherent conflict associated with the survey objective. For example, a fee survey exclusively populated with data from a restricted list of competitors provides no incentive to report anything other than the highest fees to create a benchmark that can easily be beat in a competitive

situation by any of the respondents.

The popularity of surveys has historically been tied to the low cost of collecting and assembling the data. While surveys may have offered some value in the past or in isolated cases, the future looks dim for survey providers when independent objective benchmarking databases now contain actual plan costs used to meet required compliance obligations.

The fact that plan expenses can now be benchmarked against actual fees paid by plans of a similar size is an indication that “prevailing circumstances”² have changed, making the usefulness and reliability of surveys questionable. Advisors engaged to help plan sponsors meet the “prudent man” rules will likely abandon surveys in favor of benchmarking when assessing the reasonableness fees.³

BENCHMARKING’S ROLE IN REPLACING THE INCUMBENT

Plan sponsors will have two options when seeking to populate their files with documentation to support payment of reasonable fees for services rendered by an advisor. The first is a bidding process known as a “request for proposal” (RFP), encouraged by the DOL and the courts.⁴ The RFP approach is expensive and time consuming, and it fails to support annual monitoring obligations costs effectively or satisfy an immediate need for answers and action.

Furthermore, when an RFP process is periodically engaged, benchmarking provides the needed information to validate fee

reasonableness and assist with fee negotiations among the limited number of advisors participating in the RFP process. In addition, vetting advisor qualifications using the RFP process is in the infancy stage, with only one comprehensive market solution currently available.⁵

Selecting a qualified advisor requires an analysis of the advisor’s domain-specific expertise according to standards relied upon by the legal community and the courts, and supported by academic research that has verified reliable indicators of expertise. These established standards must then be analyzed in light of ERISA fiduciary standards.

Unfortunately, most advisors are retained based on relationships and have no domain-specific expertise. Plan sponsors that have hired an advisor without a documented process to support its reasons are vulnerable to claims of fiduciary breach of loyalty and prudence as well as potential claims of self-dealing and conflicts of interest. Although not anticipated, ERISA 408(b)(2) and 404(a)(5) may become the death knell for lifetime members of the “good old boy network” that have relied on their relationship, golf score, or other entertainment value instead of their knowledge, experience, and skill to secure retirement plan engagements.

Benchmarking is a low-cost, quick, and easy alternative approach to an RFP for assessing reasonableness of fees for services rendered by the incumbent or prospective advisor. Benchmarking can be easily provided on a yearly basis to assist with the monitoring of

¹ In *LaRue v. DeWolff, Boberg & Associates, Inc.*, No. 06-856, 552 U.S. (February 20, 2008), the U.S. Supreme Court unanimously held that ERISA “authorizes a participant in a defined contribution pension plan to sue a fiduciary whose alleged misconduct impaired the value of plan assets in the participant’s individual account.”

² Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—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 - ERISA § 404(a)(1)(B) (Emphasis added).

⁴ ERISA 408(b)(2).

⁵ See FN 1; “At the very least, trustees have an obligation to (i) determine the needs of a fund’s participants, (ii) review the services provided and fees charged by a number of different providers and (iii) select the provider whose service level, quality and fees best matches the funds needs and financial situation.” *Liss v. Smith*, 991 F. Supp. 278, 300 (SDNY 1998) [Emphasis added]; Another court said that the fiduciaries must “have solicited multiple proposals” in order to be considered to have fulfilled their fiduciary duties. *Whitfield v. Tomasso*, 682 F. Supp. 1287, 1304 (E.D.N.Y. 1988); Most recently the 7th Circuit Court held that reliance on a consultant’s assessment of reasonable fees alone was inconclusive of a prudent process absent a competitive RFP process once every three years. This does not mean the plaintiffs will ultimately win but it is a wakeup call for every plan fiduciary. *George v. Kraft Foods*, 2011 WL 134563 (7th Cir. 2011).

⁵ ERISA Advisor Evaluator (“EAE”) is a commercially available combination RFP and vetting process. The software is available to plan sponsors, ERISA attorneys, CPAs and in limited circumstances consultants. The software was designed by Fiduciary Risk Assessment LLC.

advisor fees, services, and business relationships. It's an efficient process that is cost effective and delivers reliable results for decision making. If benchmarking were dovetailed with an advisor vetting process⁶ to ensure the advisor is qualified to serve in the role for which he was retained, the plan sponsor has established and documented a prudent course of action that can be defended. In short, if you can't be predictive, be comprehensive.

KNEE-JERK BENCHMARKING REACTIONS

Recent experience indicates some advisors, once informed their fees and services are being benchmarked, are quick to reduce their fees without being asked. Advisors should beware that offering a fee reduction without statistics in hand could be perceived as an admission that fees were or are unreasonable. Advisors must be cognizant that reducing their fees after the benchmarking results are in hand could be perceived as an admission of guilt.

If such perception becomes a fiduciary's reality, a plan sponsor's prudent course of action would be to terminate the relationship and pursue the advisor by whatever means necessary for a refund of excessive fees paid in the past. This course of action may be a fiduciary's only option if the fiduciary discovers that fees paid were for services that had been promised but were never or rarely delivered. Although an unintended consequence of fee disclosure to participants, advisors may find themselves in the cross-hairs of plaintiff attorneys employed by the plan sponsor.

OBJECTIVE BENCHMARKING

Because the stakes are high, plans sponsors and advisors will be seeking independent and objective benchmarking statistics. In simple terms, the goal is to benchmark the cost of services rendered against an objective standard to measure the reasonableness of fees charged for services rendered. At this point, the Department of Labor (DOL) and/or the courts haven't established or endorsed any existing benchmarking service as the universal standard. This is unlikely to change, though what appears to be universally accepted as an objective standard is the comparison of plan costs and services against plans of similar size by assets or participant count.

Since "similar size" isn't defined, the range for sample size comparisons will most likely be dictated by the size of the benchmarking database. In other words, the larger the database the more likely a larger number of sampling ranges will exist. Database size and source are important indicators that affect the reliability and statistical significance of the benchmarking results.

To determine what is statistically significant, the American Institute of Certified Public Accountants (AICPA) audit standards provide a universally accepted guide for benefit audits. At this point, this may be the best guideline for determining statistically significant benchmarking statistics until something more conclusive is developed and universally accepted.

Based on AICPA audit standards, the number of samplings to conclude the results are a reliable indicator tends to fall within a fairly tight range. According to my survey of

various CPAs engaged in audit activity, a plan with 1,000 or more participants requires a sample size of approximately 60 to provide reliable data. Of course, the reliability of the source of the data that populate the benchmarking database is equally important. The most reliable data come directly from the source (e.g., plan sponsor, advisor, or other service provider). Avoid databases that rely on unreliable IRS Form 5500 and Schedule C information.

RELEVANT BENCHMARKING FACTORS

Quantity of fees and services are the two primary factors that can be objectively benchmarked. In simple terms, if fees are equal, which advisor offers more services? Or if services are equal, which advisor delivers the same services for the lowest fees? Keep in mind, however, the DOL is on record that a plan sponsor is not obligated to buy the lowest-cost provider.⁷ It's also important to remember the DOL has never explicitly prohibited the payment of the highest fees to a service provider. What is required is the implementation of a prudent process, preferably documented, to evaluate reasonableness of fees for services rendered.

The flexibility to hire the highest-cost advisor, or an advisor at a fee that's higher than the lowest-cost advisor, is a plan sponsor's trump card. Any benchmarking service that attempts to rate an advisor or service provider does so at great risk to a plan sponsor's defense of its advisor selection in a court of law. If a rating service ever does become universally accepted, the plan sponsor might be obligated to select the highest-rated advisor or service provider.

⁶ Vetting advisors requires a criminal, financial, and industry background check including SEC, FINRA, and State Insurance Department reviews. It also analyzes education, experience, bonding, E&O insurance, structure of clientele, services offered, and resources available.

⁷ "Cost is one of the criteria, but not the only criterion, for making this evaluation...The service provider offering the lowest cost services is not necessarily the best choice for your plan." DOL 401(k) Fee Disclosure Form, U.S. Department of Labor, Employee Benefits Security Administration; "b) consider fees as one of several factors in your decision making; c) compare all services received with the total cost; and d) realize that cheaper is not necessarily better." Booklet, "A Look At 401(k) Plan Fees... for Employees," U.S. Department of Labor, Employee Benefits Security Administration, page 1: "Not is cheaper necessarily better...finally, don't consider fees in a vacuum. They are only one part of the bigger picture including investment risk and returns and the extent and quality of services provided." A Look At 401(k) Plan Fees... for Employees. A Look At 401(k) Plan Fees, page 17-18; "Cheaper is not necessarily better." A Look At 401(k) Plan Fees...for Employers; "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." Get it Right – Know Your Fiduciary Responsibilities – Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan.

To select anything less than the best could subject the plan sponsor to a claim of imprudence.

Fortunately, universal acceptance of such services has met with significant resistance, which bodes well for all concerned and protects, at least for now, the plan sponsor's liberty to hire an advisor based on a combination of both quantitative and subjective qualitative measurements.

With regard to benchmarking relevant factors, it's easier said than done. Benchmarking plans of similar size doesn't mean all plans in the database have purchased the same services from an advisor. Services purchased from advisors vary from plan to plan because the needs of each plan may vary, even if multiple similar plans hire the same advisor. In addition, other factors affect fees, including advisor overhead and/or cost-of-living, complexity of the plan, plan demographics, and plan objectives to name a few.

If fees aren't equal for the same bundle of services from equally qualified advisors where no conflicts exist, a plan sponsor will make a decision based on cost or a subjective decision based on any number of other factors. For example, personality, location, experience, resources used, philosophy, size of practice, depth of support team, size of E&O insurance coverage and deductible may all play into the decision making process.

Of course, play time with decision makers isn't something that can be claimed in any documentation as a service that is "necessary for the establishment or operation of the plan"⁸ and will unlikely influence plan sponsor decisions in the future as it has in the past. Dilettantes beware; your time is running out.

THE SUBJECTIVE VALUE PROPOSITION

The DOL has alluded to or suggested that a plan sponsor should consider "quality" of services of the service provider.⁹ Although quality is a key determinant of value, it's virtually impossible to assess either quality or value objectively. The lack of guidance by the DOL on the objective assessment of quality or value is evidence that this is a subjective assessment.

Attempts to measure quality are typically tied to surveyed opinions or subjective standards established by the benchmarking organization that are not universally accepted. Such topics as plan features, types of investment options, number of investment options, plan complexity, quantity of services, timeliness, and accuracy are typical targets for assessment of value. Ironically, these topics are subject to plan sponsor objectives, budgets, and sophistication, which aren't measured. As such, questions that should be asked of the advisor and the advisor's current and past clients include:

1. Did the advisor design a plan according to your objectives?
2. Did the advisor design a plan that fit your budget?
3. Did the advisor deliver promised services?

Does complexity of plan design, the number or type of investments, or the quantity of services delivered matter to the decision process if the advisor didn't satisfy the plan sponsor's design or budget objectives? Is it important to assess timeliness and accuracy if services promised aren't delivered?

Delivering services on time is difficult to measure because it too is subjective, whereas accuracy is

more easily quantified. However, if an advisor delivers services late or provides inaccurate information, you'd expect to see a high client attrition rate or a high volume of client claims against the advisor. If an advisor has a high retention ratio and no history of claims it's more likely that a low score for accuracy or timeliness is tied to an extremely high-maintenance and impatient clientele. Bottom line: Quantifying subjective opinions into useful information for decision-making is a virtually impossible task because the interpretation of the data is subject to the opinion of the interpreter.

CONCLUSION

Benchmarking is here to stay as a new differentiator for accomplished advisors to meet compliance objectives and assist with on-going monitoring responsibilities. It is also a valuable enhancement to any formal RFP process that should not be ignored. **PC**



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⁸ 29 CFR 2550.408b-2(a)(1); Among other duties, fiduciaries have a responsibility to ensure that the services provided to their plan are necessary and that the cost of those services is reasonable. *Understanding Retirement Plan Fees and Expenses*, page 1 (May 2004) (Emphasis added).

⁹ Other factors of equal or greater importance to consider include the quality and type of services provided... *DOL 401(k) Fee Disclosure Form*; The level and quality of service and investment risk and return will also affect your decisions. *Understanding Retirement Plan Fees and Expenses*, page 10 (May 2004); Ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided... *Look at 401(k) Plan Fees for Employees*; Ask service providers about their services...customer references or other information relating to the quality of their services and customer satisfaction with such services. *Get it Right – Know Your Fiduciary Responsibilities – Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan*. (Emphasis added).