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Understanding Reasonableness and Using Benchmarking to Avoid the Race to the Bottom

Speakers:

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Learning Objectives

- Understand the importance of monitoring to the fiduciary process.
- What “reasonable” means in the context of 408(b)(2) requirements.
- Best practices for benchmarking and communicating value to clients.

ERISA service provider requirement

- Under ERISA §408(b)(2)
  - An Investment Advisor provides services to the plan and therefore is a “party in interest” under ERISA and potentially subject to prohibited transactions rules, unless those services are, “necessary for the establishment or operation of the plan” and “no more than ***reasonable*** compensation is paid therefore.”

Practice 1.5

PRACTICE 1.5

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.5

Agreements, including service agreements under the supervision of the Investment Advisor, are in writing and do not contain provisions that conflict with fiduciary standards of care.

CRITERIA

1.5.1 The Investment Advisor fully discloses in writing all compensation arrangements and affiliations involved in the service agreement between the client and Advisor, as well as the Advisor's services and fiduciary status.

1.5.2 If the Investment Advisor is responsible for oversight of other service provider agreements, those service agreements disclose all compensation, affiliations, and fiduciary status if it is assumed by the service provider.

1.5.3 Agreements are periodically reviewed to ensure consistency with the needs of the client.

1.5.4 Comparative reviews of service agreements for which the Investment Advisor is responsible are conducted and documented approximately every three years.

Practice 4.4

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4.4 PRACTICE

STEP 4 : MONITOR

MONITOR

PRACTICE

4.4

Periodic reviews are conducted to ensure that investment-related fees, compensation and expenses are fair and reasonable for the services provided.

CRITERIA

4.4.1 A summary of all parties being compensated from client portfolios or from plan or trust assets and the amount of compensation has been documented.

4.4.2 Fees, compensation, and expenses paid from client portfolios or from plan or trust assets are periodically reviewed to ensure consistency with all applicable laws, regulations, and service agreements.

4.4.3 Fees, compensation, and expenses paid from client portfolios or from plan or trust assets are periodically reviewed to ensure such costs are fair and reasonable based upon the services rendered and the size and complexity of the portfolio or plan.

Regulation 408(b)(2) and "Reasonableness"

- Since July 2012, ERISA service providers have been required to provide enhanced disclosures, which include:
  - Compensation; direct and indirect (12b-1 fees, sub-transfer agency fees, and other forms of revenue sharing)
  - Services
  - Fiduciary status; if assumed
- Regulation also requires that plan sponsor evaluate this information and there is an increased DOL expectation that they do so
- This provides an opportunity for advisors

How does a fiduciary demonstrate that the service provider relationship is “reasonable”?

- RFP
  - Apples-to-apples comparison
  - More formal and time consuming
  - More expensive
- Benchmarking
  - Acceptable and less formal alternative
  - Faster and cheaper
  - More practical for smaller clients

A CEFEX retirement plan case study

- CEFEX utilizes four schedules, two of which facilitate the reasonableness determination:
  A. **Checklist of questions meant to evaluate the service provider agreement and ensure it meets the 408(b)(2) regulation's disclosure requirements.**
  B. ERISA 3(38) Investment manager checklist
  C. 404(a)(5) participant disclosure checklist
  D. **Checklist to determine fee reasonableness through benchmarking.**

- It's important to compare against an appropriate peer group in terms of attributes like plan assets and number of participants.

A CEFEX retirement plan case study, cont.

- Fees that fall within a reasonable range of the peer group average (e.g., plus or minus 10-15%) – reasonable? Since this has not been tested in court, it's a judgment call.
- If fees are more than 15% below average, are typical services not being provided?
- If fees are more than 10-15% above average, additional factors may justify higher fees such as:
  - Years of experience as a firm
  - % of business devoted to ERISA plans
  - Industry credentials
  - Assumption of fiduciary status
  - Assumed discretion for fiduciary decisions
  - Services that exceed what is normally provided

A CEFEX retirement plan case study, cont.

- If fees are more than 10-15% above average, additional factors may justify higher fees such as:
  - Assistance with participant services
  - Assistance with measuring the success of participant services based on outcomes
  - Provision of industry benchmarking services
  - A service provider that invests in its business, implements or helps implement fiduciary best practices, keeps abreast of industry trends, and does research to give its plan clients an advantage in helping participants achieve retirement security

Rethinking Investment Management Fees in DC Plans

fi360 Webinar

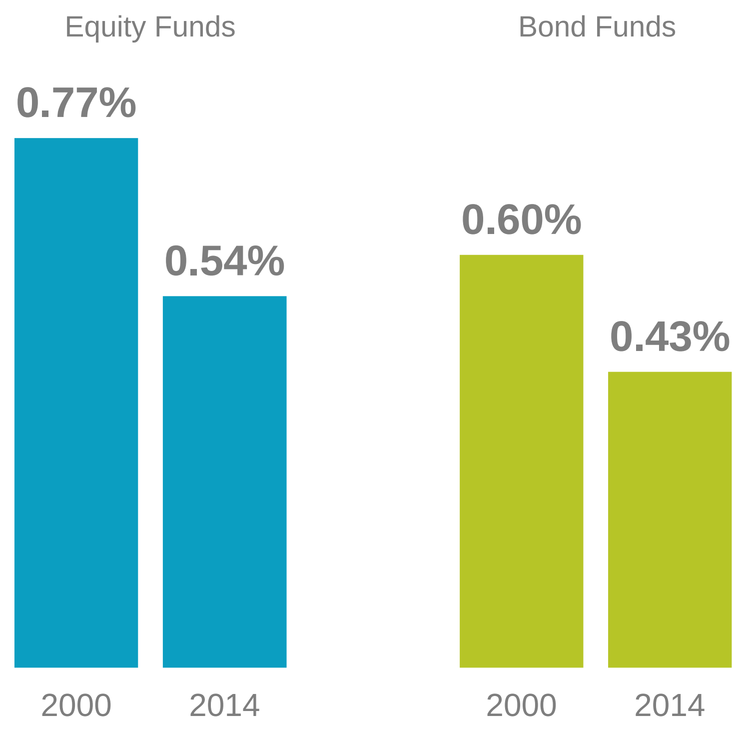
November 12, 2015

Aaron T. Borders, Regional Director and Vice President

Dimensional

401(k) Mutual Fund Expenses Have Been Declining

AVERAGE FUND EXPENSE RATIOS FOR 401(k) INVESTORS (2000 VS. 2014)[1]



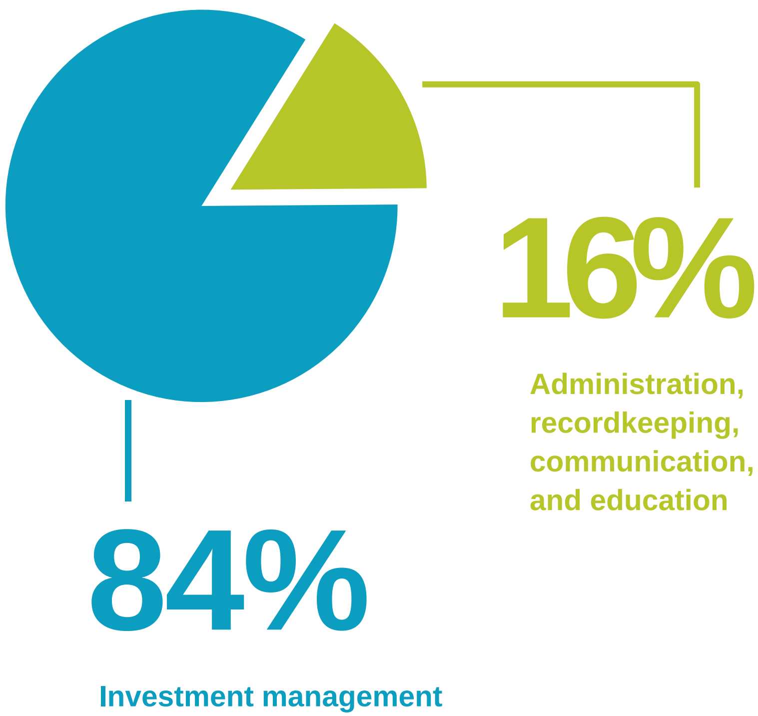
Closing the DB/DC performance gap through declining fund expenses:

- Historically, DB plans have reported higher average returns
- DC plan sponsors are scrutinizing investment management fees—and fund expenses are falling
- Asset allocation and **lower fee structure** have played a role

1. Expense ratios are asset weighted. Sources: Investment Company Institute and Lipper.
An asset-weighted measure assigns greater weight to plans with more assets.
Source: Collins, Sean, Sarah Holden, Elena Barone Chism, and James Duvall, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2014," ICI Research Perspective, Vol. 21, No. 3, August 2015, p. 11. Each year, ICI updates its analysis of the fees paid by 401(k) investors in mutual funds held in their plans. The study combines Lipper fee information with ICI information on 401(k) plan investments in mutual funds at a share class level.

A Focus on Fees

"ALL-IN" FEE CALCULATION



Should plan sponsors always choose the lowest fee option?

No. Fees alone should not determine the investment universe. The evaluation process should also consider:

- Criteria for selecting and monitoring investment options
- Number of appropriate options for participant population
- Participant demographics
- Participant communication and education

Source: Deloitte/ICI, Defined Contribution/401(k) Fee Study, Spring 2009.

Rethinking the Process

RETHINKING THE DEVELOPMENT PROCESS

The fiduciary role and plan design should influence a sponsor's investment selection and structure.

1 Fiduciary Duty

2 Plan Design

3 Investments
Selection and structure

"Fees in absence of value are meaningless."

—Tom Kmak, CEO and Co-Founder
Fiduciary Benchmarks

Can sponsors reduce fees <u>and</u> offer appropriate investment options?

Yes. Plan sponsors may be able to do both by following an enhanced process that considers strategies that:

- Increase diversification
- Offer a transparent investment process
- Simplify participant decision making
- Ease fiduciary oversight
- Keep investment costs low

Tom Kmak occasionally speaks at events sponsored by Dimensional Fund Advisors LP and receives honoraria and/or compensation for this service.

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COMMUNICATING VALUE TO PLAN SPONSOR CLIENTS

Questions

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