APPLYING THE TEST OF PRUDENCE TO FEE BENCHMARKING AND COMPETITIVE BIDDING

(Benchmarking is no substitute for an RFP Process)

For those responsible for the investment and management of institutional assets, particularly assets subject to ERISA, much has occurred over the last decade to focus attention on fees paid to service providers and the extent and quality of the services provided in exchange. The major influences have been litigation and regulation.

According to Groom Law, during the last decade, more than 75 lawsuits were commenced alleging claims of excessive fees with regards to defined contribution plans, including those of nonprofit universities[1]. They also report that such litigation continues to rise[2].

Regulation has also placed more focus upon fees and services. First, Department of Labor (DOL) regulations were issued under ERISA §408b-2, effective July 1, 2012[3], requiring service providers to disclose to retirement plan clients their services, fiduciary status and compensation, direct and indirect. The purpose was to enable a plan sponsor to make an informed and reasoned decision that each service provider contract or arrangement was "reasonable", lest the arrangement would constitute an ERISA prohibited transaction.

A second regulation issued by the DOL under ERISA §404a-5, effective August 30, 2012[4], requires plan sponsors to disclose to defined contribution plan participants detailed information about the fees they are charged, and the investments made available under the plan.

Some of the new focus may also be attributable to the 2015 US Supreme Court decision in *Tibble v. Edison* [5] which reminded us that the duty of prudence requires plan fiduciaries to monitor investments (including their fees), separate and apart from the duty of prudence when first selecting investments. What else appears to be dawning on plan sponsors and their advisors is that this decision may effectively extend the ERISA 6-year statute of limitations for breaches of fiduciary duty that go undetected and without corrective measures for lack of monitoring, after an initial imprudent decision is first made. For example, if a retirement plan is incurring excessive fees and the fiduciaries who meet, shall we say, every quarter, fail to monitor that cost, the statute of limitation conceivably resets every quarter, when the fiduciaries have an opportunity to perform monitoring and to take corrective action and yet fail to do so. Such circumstances clearly expand litigation risk and, maybe, fiduciary risk, for every plan sponsor who does not perform adequate monitoring of its fees and services.

[1] See: https://www.groom.com/resources/excessive-fee-litigation/

[2] "Plan Sponsor Fee Litigation Cases on the Rise", Plan Sponsor Council of America, Defined Contributions Insights, Fall 2017

[3] 29 CFR Part 2550 408b-2

[4] 29 CFR Part 2550 404a-5

[5] *Tibble v. Edison, Int'l* 135 S. Ct. 1823, 191 L. Ed. 2d 795 (2015)

As a response to these influences, many plan sponsors rely on "benchmarking" tools to evaluate whether the fees they are paying and the services they are receiving are inline with those of others in the market place.

BENCHMARKING BACKGROUND & MERITS

Benchmarking tools can provide a lot of information. Typically, benchmarking reports will compare a plan's fees and expenses to those of other plans whose information is incorporated in the benchmarking provider's database. This will typically consist of data provided by other plan sponsors and their service providers, such as recordkeepers, and benchmarking thus provides a basis for comparison of recordkeeping/TPA fees, investment advisor/consultant fees, and investment management fees. In addition, it may afford a comparison of plan design, plan complexity, consultant services usage, and of participant success measures, such as participation rates and percentage use of a company match. As a further feature, the benchmark data may be segmented to match certain plan demographics, typically by reference to the volume of plan assets and the number of participants.

Accordingly, benchmark tools can conveniently provide data that is important to plan fiduciaries in evaluating whether plan fees and services are consistent with the experience of the market place.

BENCHMARKING LIMITATIONS

But does periodic benchmarking of the nature just described satisfy a plan fiduciary's duty to monitor? Does benchmarking allow you to determine whether investment-related fees, compensation and expenses are fair and reasonable for the services provided?[6]

To answer those questions, one must consider the weaknesses of benchmarking. The primary weakness is that benchmarking data represents pooled experience, the accuracy and completeness of which goes unverified. Further, there is no assurance that the pooled experience represents prudent rather than imprudent conduct, i.e. whether plans represented by the data have themselves independently established that investment-related fees, compensation and expenses are fair and reasonable. Beyond that, most service provider arrangements are customizable in relation to such matters as the number of meetings to be held each year, whether meetings will be in person and whether service personnel who will attend are junior or senior representatives. Benchmarking does not reflect the impact of such choices on cost. Further, a plan in Wichita, Kansas, where recordkeeping costs may be lower than in other markets, such as New York City, does not know to what extent benchmarking data is impacted by the regionality of data sources.

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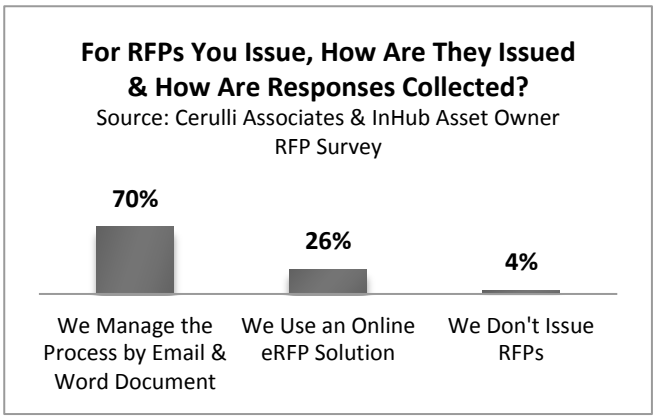
A PRUDENT RFP

In face of these weaknesses, the only way to reliably test what is "reasonable" for a plan and a service, whether it be investment advisory, recordkeeping and administration, trusteeship and custody, is to determine and compare what competing providers would charge. In other words, conducting competitive bidding, using an RFP process for example, is the only prudent way to investigate and evaluate the reasonableness and

[6] See Practice 4.4, Prudent Practices *for* Investment Stewards, © 2006-2013 fi360 Inc.



fairness of what a plan should pay for any given service. In terms of convenience, an RFP process has historically been a time consuming and manual process. Today, online RFP tools, including downloadable templates and checklists, and even the online management of the entire RFP process, tend towards matching the convenience of benchmarking. According to the 2017 Cerulli Associates and InHub (theinhub.com) Institutional RFP Survey, 26% of RFPs issued by Institutional Asset Owners are done via an online RFP technology (see Table above), which is up significantly from just 5 years ago. The efficiency represented by such technology should therefore encourage more use as a means of conducting prudent competitive bidding.

CONCLUSION: BENCHMARKING VS. RFPS None of the foregoing is intended to suggest that benchmarking is imprudent. It has its place among the tools available to plan sponsors in monitoring investment-related fees, compensation and expenses. Furthermore, it is unnecessary to conduct competitive bidding each year and, so, benchmarking can fill the gap. But, benchmarking is not a substitute for an RFP process which prudent plan fiduciaries will conduct every three to four years, depending on the facts and circumstances.

The Supreme Court in *Tibble v. Edison* reminded us that:

> *"In determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts."*

This brings to mind the words of Justice Benjamin Cardozo of the New York Court of Appeals who wrote:

> *"Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. . . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."* (*Meinhard v. Salmon*, 164 N.E. 545–546 (1928)).

It is no stretch to suggest that benchmarking represents a "*level of conduct …trodden by the crowd*". In fact, that's exactly what it is. While providing useful, comparative information which can inform prudent decision-making, the limitations of benchmarking tools suggest that such tools cannot be relied upon independently to satisfy a fiduciary standard of care in monitoring investment-related fees, compensation and expenses, and in determining whether such are fair and reasonable for the services provided. Thus, benchmarking may not be relied upon as a substitute for a prudent competitive bidding process[7].

[7] For further reading, see "Selecting Service Providers, Competitive bidding & RFPs Importance in a Fiduciary Investment Process," Roger L. Levy, May 18, 2015.