Determining reasonableness of retirement plan fees

Fees paid for retirement plan investments and services have always been an important consideration for ERISA fiduciaries. However, in recent years these fees have come under increased scrutiny because of litigation, Department of Labor (DOL) regulations, and congressional hearings.

Today plan sponsors and service providers are gearing up to comply with the DOL’s fee disclosure regulation under section 408(b)(2) of ERISA. This rule requires covered service providers to identify all plan services and disclose all direct and indirect compensation received in connection with the plan.

While plan sponsors undoubtedly will benefit from receiving more comprehensive and more uniform disclosures, many sponsors wonder what it all means for them. Specifically, they ask what they should do with the fee information once they have it. Most sponsors understand they have a fiduciary duty to ensure that plan fees are reasonable, but they repeatedly ask how to determine reasonableness.

This commentary walks plan sponsors through their fiduciary duties and discusses a variety of steps and tools they can use to determine the reasonableness of their plans’ fees.*

* The terms “plan fiduciary” and “plan sponsor” are used interchangeably throughout this commentary. In most cases, a plan sponsor will designate an individual or group (e.g., a corporate benefits committee) as the plan’s named fiduciary subject to the duties and responsible for making the decisions described herein.
ERISA’s fiduciary standard

Choosing a plan service provider and using plan assets to pay provider fees are fiduciary acts subject to ERISA’s fiduciary duty rules. These rules require plan sponsors to act prudently and solely in the interest of plan participants and beneficiaries. In addition, these rules, along with ERISA’s prohibited transaction rules, require that fees paid for plan services must be reasonable.

Prudence. The prudence standard requires plan fiduciaries to follow a prudent process. The law places great emphasis on how fiduciaries reach their decisions, rather than on the results of those decisions viewed in hindsight. Procedural prudence dictates that a plan sponsor consider all relevant information and then make a reasonable decision in light of such information.

Reasonableness. Whether a plan’s fees are reasonable depends upon the facts and circumstances relevant to that plan. The plan sponsor must obtain and consider the relevant information and then make a determination supported by that information. There can be no absolute statements about what is reasonable. For this reason, the DOL and courts generally defer to plan sponsors who follow a prudent process and who can demonstrate the rationale for their decisions. Indeed, the vast majority of fee lawsuits brought in recent years have been decided in favor of plan sponsors.

Despite all the recent attention on fees, the requirement to ensure the reasonableness of plan fees is nothing new. As a result, over the years plan sponsors and service providers have worked together to develop widely recognized tools and methodologies for analyzing plan fees. These range from the most used—periodic reviews of fee disclosure reports—to the most comprehensive and costly—requests for proposal (RFPs). There is no one-size-fits-all approach, and each of the tools and methodologies has pros and cons that should be considered depending upon a plan’s unique facts and circumstances.

Start with a deliberative process

At the outset, plan sponsors must take steps to understand the sources, amounts, and nature (e.g., asset-based or per-capita) of recordkeeping and investment management fees paid by the plan, as well as the related services performed for such fees. After all, how can the plan sponsor determine reasonableness without a comprehensive understanding of the plan’s services and fees?

Under the DOL’s fee disclosure regulation, plan fiduciaries should be sure they receive service and fee information in writing from each covered service provider on or before April 1, 2012, and on an ad hoc basis thereafter as any changes occur. The plan sponsor should diligently review the information contained in the disclosure.

Consider a wide range of relevant factors.

Although the deliberative process will naturally focus on cost as an indicator of reasonableness, ERISA does not require that a plan fiduciary select the provider or investment with the lowest fees. Other factors may be considered such as the plan sponsor’s own positive or negative experiences with the service provider, experiences with other service providers, and the service provider’s marketplace reputation (including industry survey results). Relevant additional considerations include the scope of the requisite plan services, the service provider’s commitment to technology and to sustaining the business, and depth of available services, to name a few. Perhaps as important as any of these factors, the plan sponsor should consider plan participants’ needs and whether those needs can best be met by the service provider. A determination of reasonableness can and should be based upon much more than cost.

Know what’s in and what’s out. The DOL fee disclosure regulation requires service providers to identify the services for which they reasonably expect to receive compensation. In evaluating fees, the sponsor should determine whether all of the plan’s necessary and anticipated services are...
covered, or whether additional charges will be incurred on an “a la carte” or “pay-as-you-go” basis. Exclusion of services may have a substantial impact on the plan sponsor’s determination as to fee reasonableness. Moreover, failure to understand which services are excluded from a quoted fee may cause the plan to incur additional, unexpected expenses.

Look at all-in fees. The DOL’s plan sponsor fee disclosure regulation requires separate disclosure of recordkeeping and investment management fees. This means that bundled service providers like Vanguard must disclose to plan sponsors that component of any affiliated fund expense ratio attributed to recordkeeping (the rule requires an estimated calculation, not a precise accounting).

This “unbundling” of fees provides plan sponsors with a better understanding of the costs for various plan services. However, some in the industry have implied that prudence requires plan sponsors to completely unbundle recordkeeping and investment management decisions. Under this theory, the plan sponsor would attempt to secure the lowest possible price for recordkeeping services without consideration of investments and then engage in a separate process to identify the most prudent investment choices. As noted above, however, ERISA’s fiduciary rules require reasonable fees under all the relevant facts and circumstances, not necessarily the lowest fees considered in light of a subset of facts and circumstances.

In Vanguard’s view, plan sponsors attempting to determine reasonableness may appropriately focus on the all-in fees that encompass both recordkeeping and investment management costs. Complete segregation of the bidding process ignores the fact that a bundled service package may result in aggregate fees lower than—or at least comparable to—separately priced services. Plan sponsors should not unduly emphasize one driver of fees over another if the net effect is higher all-in costs for the plan.

Duty to ask. To the extent the plan sponsor does not understand the contents of any fee disclosure, service description, or cost structure, the plan sponsor should ask the service provider for additional information. Moreover, at least one court case has recently suggested that sponsors should ask whether lower-cost mutual fund share classes are available for the plan. To the extent the plan is eligible for lower-cost share classes, the plan sponsor should consider the cost allocation associated with a share class change in the plan (i.e., consider any corresponding increase in per-participant recordkeeping fees) and determine whether such a change is consistent with the best interests of participants and beneficiaries. The duty to ask does not compel the plan sponsor to actually make a change, and the law does not currently favor one fee structure over any other; rather, when the plan is eligible for more than one share class, the plan sponsor should have a reasonable basis for whichever share class is chosen.

Paper the record. For many plan sponsors, full and thorough consideration of the factors described above should satisfy the procedural prudence obligations of ERISA’s fiduciary rules. To complete the prudent process, the plan sponsor should build a record by documenting (in meeting minutes or otherwise) its review of the detailed service provider disclosure and any other noncost factors considered in determining reasonableness. Prudence likely dictates that the plan sponsor review fees and services on at least an annual basis.
Benchmarking tools and consultants can help

Some plan sponsors may decide that prudence requires consideration of information beyond the plan’s individual circumstances. For these plan sponsors, benchmarking tools and consultants may prove valuable.

**Benchmarking.** Plan sponsors widely use benchmarking to supplement fee disclosure reports, particularly with respect to investment fees. Common investment alternatives can be compared against one another based upon readily available data such as asset class and market segment, investment management fees and/or expense ratios, redemption and other fees, management style and tenure, risk level, volatility, time period dependency, and historical performance.

Fee benchmarking may also provide valuable insights with respect to recordkeeping services. Various third-party studies, surveys, and fiduciary benchmarking services exist to help plan sponsors put into context the information contained in their service providers’ fee disclosure reports. Some of these are publicly available, such as the “Defined Contribution/401(k) Fee Study” conducted by Deloitte Consulting for the Investment Company Institute, while others may be purchased. These studies, surveys, and data services can enable plan sponsors, in a cost-effective way, to compare their plans’ fees with the marketplace.

**Consultants.** Consultants give plan sponsors a third-party perspective on both quality and costs. The best consultants have strong knowledge of the retirement plan market and a keen understanding of fee structures and savings drivers. A consultant may help the plan sponsor evaluate fee reasonableness through comparison with survey results, the fees of the consultant’s other clients, or recent bids submitted by various service providers.

As with any other plan service provider, plan sponsors should make sure they fully understand the fees charged by a consultant. To the extent the consultant’s fees will be paid from plan assets, the decision to hire and pay the consultant is fiduciary in nature and thus must satisfy the prudence and reasonableness requirements discussed above.

Plan sponsors should also ensure that they understand all the sources of the consultant’s compensation. Any of the consultant’s indirect compensation from any other provider for placement of services or investments should be fully disclosed and reviewed for appropriateness.

**Look for meaningful comparisons.** While comparative data can serve as a good resource, plan sponsors should be sure they understand the data’s relevance to their plans. Particularly for analyses of recordkeeping service fees, such noncustomized information may have limited usefulness because it rarely yields “apples-to-apples” comparisons.

Plan sponsors should not always expect their plans’ fees to align with seemingly comparable plans or benchmarks because of wide variability in plan investments, complexity, participant needs, and service utilization. A plan’s costs might diverge—in some cases significantly up or down—compared with a seemingly similar plan or benchmark because of variables such as focus on active or passive investment management, number of payrolls, variety of contribution sources, loan and withdrawal rules and use, complexity of match calculations, participant education needs, participant use of online resources or other unique participant assistance, or operational processing needs. Understanding the plan’s context as it relates to the information in benchmarking or survey data may prove challenging for plan sponsors. A consultant may be able to place the relevant data in an appropriate context.

Comparative tools may have other limitations. For instance, survey data may be insufficiently broad because it relates only to the plans that chose to respond to the survey. Sometimes data can be outdated if the survey or study is not revised regularly. Moreover, there has been limited success so far in aggregating publicly available data. As the industry becomes more accustomed to the electronic filing of plan records and reports such as Form 5500, additional studies and surveys may be produced.
Obtaining plan-specific comparisons

Some plan sponsors may seek additional data specific to their particular plans. These sponsors may request additional information from current or competitive service providers. Others will “go out to bid,” by issuing full-blown RFPs for plan services.

Request for information (RFI). An RFI is generally a business process used to gather written responses to specific questions. A well-constructed RFI will be very specific and narrowly focused on the desired information. Depending upon the plan sponsor’s objectives, the RFI may be sent solely to an incumbent provider, or it may be used to broadly sound out the capabilities and costs of multiple providers.

An RFI will likely result in costs that may be paid from plan assets, particularly if a consultant must be hired to draft the request and analyze the responses; this cost may be mitigated where plan sponsors can use their own procurement resources. The total cost of an RFI is generally much lower than the cost of an RFP (discussed below).

While an RFI can yield meaningful and helpful information, it will not always serve as a final pricing quote because of its limited nature. The responses should be considered preliminary as the service providers may lack the facts to provide a fully comparative quote. For example, other than the incumbent, responding providers will not necessarily understand the plan’s complexity, data condition, and fund lineup unless all of this information is provided, which is typically not the case with an RFI.

To RFP or not to RFP? An RFP seeks much more extensive and detailed information from responding providers, usually resulting in submission of competitive bids. As a result, the RFP may permit the closest “apples-to-apples” comparison of service providers.

As with the other possible steps a plan sponsor can take, analysis of an RFP should not cause a plan sponsor to focus exclusively on costs. Even when an RFP has been solicited, the legal standard remains fee reasonableness, and there is no obligation to choose the proposal that outlines the lowest costs. All the facts and circumstances relevant to the plan (e.g., participant needs, sponsor services, provider reputation, quality of investments and services) should be factored into the ultimate determination of reasonableness. As part of their consideration of lower-cost bids, plan sponsors should also weigh the costs of switching service providers, which can be substantial.

While the RFP may be the most comprehensive tool to benchmark plan fees and services, it also is the most expensive and time consuming. To the extent plan assets are used to pay consultant fees for soliciting the RFP and for compiling and analyzing the results, the hiring and payment decisions are subject to the fiduciary prudence and reasonableness standards. It is possible the costs may outweigh the benefits and plan sponsors often conclude that an RFP is not the optimal approach when they are satisfied with their current provider’s fees, services, relationship, quality, value, and performance.

Neither ERISA nor any DOL regulation specifically requires use of an RFP to determine reasonableness. An RFP should be undertaken when it will reveal additional relevant information that cannot be discerned through the tools and methodologies discussed above. A plan sponsor may find that additional information is required and an RFP may be necessary because of significant plan changes such as a corporate transaction (e.g., a large-scale merger or acquisition) or a material change in a plan’s benefits or features. Moreover, if a number of years have passed since the last RFP, some sponsors will conduct a new RFP to ensure that they have an accurate understanding of the current state of the marketplace. In any case, plan sponsors should evaluate the return on their investment in the RFP process—balancing benefits against time, effort, and cost—to be sure that going out to bid aligns with their goals and objectives.
Cost drivers within plan sponsor control

Many plan sponsors look to their current and prospective service providers as the only source of cost savings. However, plan sponsors seeking to drive down costs may find success by focusing on two courses of action: simplifying the plan’s investment lineup and reducing the plan’s operational complexity.

Managing investment costs. Vanguard has long been an advocate of the benefits of indexing. More recently, Vanguard has called plan sponsors’ attention to the benefits of a tiered investment strategy built around a passively managed target-date fund tier and an index tier (See Vanguard’s 2010 commentary, Building blocks of a well-balanced portfolio). One of the most obvious benefits of these tiers is the availability of well-diversified, low-cost investment options for participants. Thanks to the lower investment management fees of these funds compared with actively managed funds, plan sponsors may derive significant cost savings within the plan by introducing and mapping plan assets to low-cost index funds, either as target-date options or as standalone investment choices.

Managing recordkeeping costs. Reducing complexity and increasing efficiency should be a continuous goal of both plan sponsors and service providers. Plan sponsors may derive substantial cost savings by reducing plan complexity.

Examples of recordkeeping or administrative cost drivers that may be controlled include the timing and variety of payroll cycles, multiple benefit structures or vesting schedules in the same plan, and benefit formulas that require special testing. It is important for plan sponsors to be realistic about the impact of these key drivers of cost. The more customized and complex a plan is, the more fiduciaries should expect to pay in recordkeeping fees.

Final thoughts

The duty to pay only reasonable fees for plan services has been part of ERISA since its passage in 1974. Fiduciaries have regularly focused on their plan fees even before the recent surge in interest driven by congressional oversight, regulatory action by the DOL, and litigation. For years, plan sponsors have used the tools described in this commentary both to satisfy the best interests of their plan participants and beneficiaries and to protect themselves from potential enforcement actions or litigation.

Similarly, Vanguard for years has helped plan sponsors understand their plan fees through disclosures like the annual All-In Fee Report distributed to our full-service recordkeeping clients. Vanguard historically has helped plan sponsors meet their fiduciary duties by providing clear, comprehensive, and understandable fee disclosures, recognizing the impact that costs can have on retirement savings. All of Vanguard’s fee disclosures, including the All-In Fee Report, will be enhanced and updated as necessary by the time the DOL’s service provider fee disclosure regulation finally takes effect in 2012.

A disciplined and diligent approach to reviewing and negotiating fees will help plan sponsors promote the best possible outcomes for plan participants. The marketplace for retirement plan services is mature and pricing is highly competitive. No impediment should exist that keeps a plan sponsor from securing adequate information to determine the reasonableness of fees, and thus to secure plan services for a reasonable cost.

Vanguard Strategic Retirement Consulting (SRC) is a valuable resource that can help both defined contribution and defined benefit plan sponsors optimize their plan design, develop fiduciary best practices, and achieve regulatory compliance. The strategies developed by SRC consultants are grounded in expert analysis of broad-based data and are informed by Vanguard’s highly respected research teams, including the Vanguard Center for Retirement Research.
For more information about Vanguard funds, visit vanguard.com or call 800-523-1036 to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

All investing is subject to risk.

Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in a target-date fund is not guaranteed at any time, including on or after the target date.

Diversification does not ensure a profit or protect against a loss in a declining market.