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White Paper

The Age of Fee Reasonableness

by John Hare, AIF®

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Due to 408(b)(2), we are living in a new age of responsibility for determining the "reasonableness" of fees and services in ERISA retirement plans. After the distraction of formatting and distributing the 404(a)(5) disclosures to employees, it is now time to turn our attention back to the required evaluation of reasonableness of services and fees. In the final regulations alone, the Department of Labor used the word "reasonable" 41 times specifically referring to fees, compensation, contracts and arrangements. But what is "reasonable"?

To pursue a better understanding of "reasonable", we will approach the concept from several angles:

- 1) Provide a working definition of Reasonable for fee disclosure
- 2) Highlight the importance of a prudent review process
- 3) Understand cost and compensation in plan
- 4) Evaluate the services provided to plan
- 5) Justify your choice of provider through benchmarking

And we are going to accomplish all of this with the help of Yogi Berra....

Yogi Berra is famous not only for being a Hall of Fame baseball player, playing in 14 World Series (series, not games), but his fame came also from his plain spoken, and often unintentional, wisdom. Many of the quotes attributed to Yogi are laughable when you first hear them. But "upon further review", there is a thing or two his perspective can teach us regarding fee disclosure.

1) What is reasonable?

*"You've got to be careful if you don't know where you are going 'cause you might not get there!"
- Yogi Berra*

The Department of Labor used the term "reasonable" in various forms 93 total times in the final 408(b)(2) regulations. Of these uses, 41 uses specifically referred to fees, compensation, contracts and arrangements. However, this concept of plan and service "reasonableness" has not been defined. Fiduciaries, providers, participants and, presumably, regulators are left to define this term for themselves and their plan.

Merriam-Webster.com defines the following pertinent terms:

Reason: A sufficient ground of explanation or logical defense;

especially: something (as a principle or law) that supports a conclusion or explains a fact.

Reasonable: Being in accordance with reason; not extreme or excessive; moderate; fair; inexpensive.

Just: Having a basis or conforming to fact and reason; conforming to a standard of correctness.

Justified: To prove or show to be just right and reasonable.

Prudence: The ability to govern and discipline oneself by use of reason; skill and good judgment in use of reason.

That helps, but it doesn't fully sum up a fiduciary's duty under 408(b)(2).

So here is a 408(b)(2) definition, taking elements of the concepts above:

Reasonable (general definition):

Defensible, prudent, moderate, or fair.

Reasonable (as it applies to fiduciary decisions under 408(b)(2):

Prudent arrangement or contract for investments or services with moderate and fair (inexpensive) cost or compensation.

Inexpensive is noted in parentheses as it is the implied default criteria without justified increased value from services.

So now we have a better idea of where we are going. We now need to look at how to get there.

2) What is a prudent process for determining reasonableness?

"When you come to a fork in the road, take it." - Yogi Berra

It is not enough to just know the destination, it is just as important to know how to get there.

Key: Having a process to determine reasonableness is more important than making the "best" selection without a process. The DOL will not just look at your investment line up, give you a Gold Star and leave. They are more concerned with how you got there than where you ended up.

According to Fiduciary Plan Governance, LLC, an independent fiduciary process consulting firm, there are three general parts to a strong and prudent fee disclosure evaluation and management process: preparation, action and response.

Preparation tasks include:

- A) Identification of responsible plan fiduciaries.
- B) Identification of all Covered Service Providers (CSPs) and document disclosures to the plan.
- C) Establishing the internal process for dealing with the disclosures.
- D) Evaluating the business and compensation models of the CSPs.

Action tasks include:

- E) Ensuring the disclosures are accurate and complete.
- F) Performing a full and complete due diligence process including independent benchmarking or request for proposal (RFP).
- G) Taking action on any CSP deficiencies.
- H) Development of proper employee fee disclosure and follow up communication from employee questions.

Response tasks include:

- I) Amending provider contracts or plan documents to conform with any changes made by providers.
- J) Ensuring ongoing disclosure compliance (not once and done).

K) Establishing procedures for monitoring covered service provider fees and service commitments.

Each of these steps needs to be supported by documentation, documentation and more documentation. Fiduciary Plan Governance, LLC, for example, has created protocols and reporting for each step to ensure compliance.

When Yogi Berra was asked by a reporter "What makes a good manager?", he responded: "Good players". In this setting, we can say in response to the question "What makes a good retirement plan?" It is a prudent process.

3) Understand cost and compensation.

When asked if he wanted his pizza cut into four or eight slices, Yogi replied, "Four. I don't think I can eat eight".

One of the front burner items in the 408(b)(2) regulations is determining the cost for each of the services provided. Because of the disclosure of direct and indirect compensation arrangements, a plan that once looked like it had four slices may now look like it has eight. The pie is the same size as it was, it just now has more definition. Sometimes this definition is confused as an increase in cost. Some of the services were previously noted as "free" as part of the overall plan servicing cost. Now these "free" services are required to be given a distinct value. The purpose of this clarity of fees and compensation is the ability to allow the plan to evaluate each service and cost independently. If you see that recordkeeping or participant education services are assigned a larger than reasonable value, these could conceivably be bid (or negotiated) separately. These "unbundled" services are transparent and usually have well defined success measurements and clear costs. However, these specific services are not always able to be efficiently "unplugged" from the overall provider services. "Bundled" service and investment costs need to be considered in their respective parts but also evaluated in total to appropriately determine value to the plan. Based on plan assets, average account balances and number of accounts, some plans which "unbundle" services in pursuit of lowest cost investments could end up with higher overall cost to the plan due to administration and recordkeeping service costs. All pieces of the plan work together.

The Department of Labor, however, is clearly serious about ensuring reasonable compensation in retirement plans. They referenced "reasonableness of compensation" in ten of the 41 direct references. They are always on the lookout for potential self dealing or conflicts of interest by plan sponsors and service providers. Make sure you understand the cost and compensation being charged and paid to your service providers.

4) Evaluate Services

"Never answer an anonymous letter" -Yogi Berra

Price is the only issue in the absence of value.

Part of the requirements of 408(b)(2) is for Covered Service Providers (CSPs) to detail services provided for the plan. Understand that all they are committing to (and all that can be determined as value) are these services noted on the disclosure. If they didn't say it, they don't get credit for doing it as they are not committed to doing this in the future. This may be new territory for bundled plan providers.

Be sure and read the provider's service commitment closely. Is it what the plan understood was being provided? Is there a much lower degree of fiduciary responsibility than expected? Has the plan grown over time in assets or participants to the point that the overall cost of your bundled provider is considered high? These factors could be the incentive needed to evaluate a move to an unbundled program.

If any of the CSPs are providing more services than is noted on the disclosure, ask them to provide this in writing. Unless this is in writing they do not have an obligation to continue providing any service that is not disclosed. Most providers' legal departments limit committed services to ensure they are not promising services they are not delivering. Plan sponsors also have a legal department, it is called the Department of Labor. Your legal department requested all services be provided in writing to allow you to determine reasonableness for your plan. Lean on these regulations that require the plan fiduciaries to take responsibility for taking action related to disclosures. CSPs may have been hoping the game was over after providing the 408(b)(2) disclosure. In reality, the game has just begun.

Service necessity.

Like reasonable, "necessity" is a difficult term to define. It is often in the eye of the beholder. Essentially the thought here is to make sure you are not paying much higher prices for services you do not need. Leather bound enrollment kits and monthly participant education meetings at the beach come to mind as not meeting the necessity test.

Service effectiveness.

A service such as participant education may be deemed necessary and prudent for your plan. However, its execution may not be effective. As an example, a certain major university /

medical center felt that offering seminars for employees given by the multiple investment providers in their plan would be helpful and beneficial. These providers needed to travel to the university quarterly for these meetings, and priced their services to accommodate this requirement. The only problem is that very few employees attended. The university tried various times and locations but still no attendance. This went on for several years. The university felt they were doing what was expected and appropriate in offering education meetings using this format. This was a program that most people would say is necessary and recommended. At this institution, however, the education program was not effective. A completely different form of engagement, such as online, on demand education, might be more utilized and effective in this setting.

5). Benchmarking your plan.

"We're lost, but we're making good time"- Yogi Berra on the way to his Hall of Fame Induction Ceremony

Benchmarking is the process of comparing the cost and services associated with a plan to a large number of similar plans. This is not a bid or agreement for services to be provided to a plan. Benchmarking simply provides comparative data for a plan to consider. It does not mean that you must change providers if their costs are higher. It also does not mean you need to offer or eliminate services "just because everyone else is doing it". However, this process helps a plan know where they stand. It can provide incentive to improve a plan or justification for previous decisions. Another due diligence tool is the Request for Proposal (RFP). An RFP is different from a benchmarking report as it is a bid for services to your plan. This is usually used when a plan has determined that a provider needs to be replaced. The advantage of the RFP approach is that if an acceptable offer is received at an appropriate cost, this service can be implemented. The disadvantage is that these usually are sent to a much smaller number of providers. As not all providers who are sent a RFP respond, the data is more limited when used for comparative purposes.

Even though your organization has always worked with a particular service provider, you still have a responsibility to determine if that choice is still justifiable and defensible today. The plan fiduciaries should ask themselves the question: " Would I select this investment, service model and pricing model again today, if I had to make a new choice"? This is true even if that provider is the dominate provider for a particular industry. Not only have many service providers improved their range and levels of investments and services, many have created more beneficial cost structures. This is partly due to the expected impact of the fee disclosure regulations and partly normal market evolution. Your current provider may be able and willing to improve the investments and services for your plan if they know you have a formal process of evaluation. The covered service provider is not "on the hook" if they disclose higher than average fees with

low or no services as justification, and nothing is done to address this. As non-fiduciaries, they are not required to act in the best interest of plan participants. They are free to charge as much as they wish. The plan fiduciaries (responsible plan fiduciary, committee, Board of Directors, fiduciary advisor, etc.) clearly are responsible and will be held accountable. Benchmarking is an important part of the process to keep them honest and defend your decisions.

Summary

"We made too many wrong mistakes" - Yogi Berra on why the New York Yankees lost the 1960 World Series.

The Department of Labor (DOL) has, with these disclosure regulations, created the ability to much more easily assess how well decisions are being made with retirement plans. They have approached proper decision-making and enhanced cost disclosure from three angles. This triangulated view allows them to efficiently smell prohibited transactions and impose fines. These three views are 1.) Recent enhanced reporting on the 5500s 2.) 408(b)(2) disclosures to plan sponsors and 3.) 404(a)(5) disclosures to plan participants. They no longer need to guess what plans are paying in relationship to the number of participants or assets. They can more easily estimate which plans have a prudent process of evaluation and which does not. These disclosure formats fit with other DOL evaluation initiatives. The fishing for audit targets and penalties by the DOL has never been easier.

It is time for plan sponsors to create a prudent process for evaluation of the fees and services disclosed. A plan should thoroughly review cost and compensation derived by covered service providers. The plan needs to evaluate the necessity and effectiveness of services provided. These factors along with previous considerations of investment performance and employee success measurements are key components of a defensible, prudent retirement plan. This moves the plan solidly toward the goal of "reasonable".

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More information can be found at www.prudentprocess.com.

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Yogi Berra quotes from [The Yogi Book: I Really Didn't Say Everything I Said](#) by Yogi Berra.