Fiduciary Benchmarking of Retirement Plan Fees:
A Q&A with Tom Kmak and David Witz





Tom Kmak
CEO
Fiduciary Benchmarking



David Witz, AIF
Managing Director
Fiduciary Risk Assessment



Larry Goldbrum
General Counsel
The SPARK Institute

With the recent introduction of retirement plan fee disclosure regulations, coupled with litigation related to plan fees, there has been significant interest in benchmarking of fees. Larry Goldbrum, General Counsel of The SPARK Institute, recently interviewed Tom Kmak of Fiduciary Benchmarks and David Witz of Fiduciary Risk Assessment and PlanTools, to discuss the trend.

Goldbrum: *There has been a lot of discussion recently about fiduciary benchmarking of plan fees. Please describe what that entails.*

Kmak: I think fiduciary benchmarking entails three important steps. The first is making sure you compare similar plans or what in the industry is quite often called making an apples-to-apples comparison. Once you have a similar group of plans by a number of various factors, you then need to understand the fees you are paying for these plans. So there's a dissection of the fee elements in the equation. Finally, it's making sure you understand what you're getting for what you're paying – a value component that has to be juxtaposed to those fees. It's not about low fees. It's about reasonable fees.

Witz: I would totally agree with what Tom has laid out. I think the issues he has identified are right on target. When you look at the obligation to benchmark fees, you've got to compare fees charged for services rendered for a plan to other plans of similar size by assets and by the number of participants. Benchmarking services rendered by fees charged is important to determine if you are comparing the same or different services. It's subjective in terms of whether or not those services are better delivered by one party versus another. Fee benchmarking doesn't do a very good job of determining some of the subjective issues, but it is a great quantitative measure to help the plan sponsor make and document a solid decision about whether or not the fees are reasonable for the services rendered.

Fiduciary Benchmarks

Fiduciary Benchmarks is recognized as one of the industry's leading services for benchmarking retirement plans. Started in 2007 by several industry experts, the company's client list includes 400 of the industry's most respected advisors, the most well known and largest broker-dealers, prestigious investment only organizations and respected record keepers. The company provides independent, comprehensive and informative benchmarking services that are delivered through these industry experts. For more information about Fiduciary Benchmarks, visit www.fiduciarybenchmarks.com.

Fiduciary Risk Assessment LLC (FRA) and PlanTools, LLC.

FRA provides consulting and expert witness services. PlanTools provides technology solutions for service providers including standards-based risk management performance reports, expense analysis and benchmarking, 408(b)(2) and Schedule C reporting and customizable web-based fiduciary compliance solutions with dashboards, document lockbox and resource library. For more information, visit www.fraplantools.com.

Goldbrum: *Why is it important for plan sponsors, service providers and financial advisors in the retirement market to understand this trend?*

Witz: Plan sponsors, service providers and financial advisors acting in a fiduciary role have an obligation to understand the requirements of providing services for reasonable fees. Therefore, any market developments that provide cost-effective and accurate solutions that assist a fiduciary in documenting and determining if fees are reasonable for services rendered is something of paramount importance. In fact, ERISA standards hold fiduciaries accountable for what they know or what they should have known. So while trends are always worth evaluating, a trend that deals with a fiduciary's obligation is particularly important to evaluate and understand. I think it will become more difficult if not impossible in the future for fiduciaries to claim they acted prudently and in the best interest of participants without the documentation to support that they engaged in benchmarking.

Kmak: There's no doubt a legal component to it, but I also think it's just a good business practice. Anybody that runs a business is constantly measuring and trying to understand how they compare to other similar services. In effect, a plan can be viewed like a mini-business – it provides services for fees. And it's also good if the participants wind up saving more, investing better and having bigger account balances at the end of the rainbow. So, there are more than just legal reasons – it just makes good business sense.

Goldbrum: *Is this something all plans should be doing or is it really applicable and affordable only for larger plans?*

Kmak: I think traditionally, it really wasn't affordable for a plan that had $5-6 million in assets. Today, with tools like Fiduciary Benchmarks' as well as David Witz' tools, I think all plans can afford to do this and that's a good thing for our industry. In fact, the DOL was specifically concerned in its 408(b)(2) regulation that they want all plans to be able to figure out whether their fees are reasonable, not just larger plans. Of course, the law doesn't differentiate between small and large plans.

Witz: To Tom's point, ERISA is non-discriminatory. It doesn't matter how big or small your plan is, either by assets or by participant count. If you're an ERISA-qualified retirement plan, you have to operate by the same rules as everyone else that offers an ERISA-qualified plan. So if all plans are subject to the same fiduciary standards, then all plans have an obligation to determine if fees are reasonable regardless of plan size. As far as affordability is concerned, efficiencies in current technology permit service providers to subscribe to cost effective benchmarking solutions so the cost to buy access to a benchmarking solution or service is not a deal-breaker for any size plan. While a small plan may not be able to afford to retain some advisors that perform benchmarking, it doesn't mean they can't afford all advisors. There are advisors focused on certain market segments and those that specialize in delivering services to small plans can do it cost effectively using PlanTools, for example. There's no reason, including cost, for any plan not to have benchmarking studies performed at least annually if not quarterly.

Goldbrum: *What impact do you think the new DOL fee disclosure rules, the DOL's proposed fiduciary definition rules and the SEC's proposed 12b-1 fee rules may have on fiduciary benchmarking?*

Witz: The short answer is they're all accelerators. In other words, they will all act as a catalyst to accelerate the use of fee benchmarking. In fact, with the introduction of all three issues in 2010, I think it's fair to say we're going to close 2010 with a bang on the issue of expense analysis. The concept of a free plan came under aggressive attack back at the beginning of this decade and that was followed by a barrage of lawsuits filed against mega-plan sponsors. On the heels of a litigation frenzy that appears to be moving toward small plans, the legislative wheels were set in motion. At the same time, the halls of the DOL and the SEC were buzzing with activity directed at passing new regulations dealing with fees. The result is more disclosure obligations before, during and after the engagement and the likelihood that all advisors will be held to a fiduciary standard where they may not have been in the past. As a result, benchmarking has experienced a true boost in attention and interest that shows no signs of waning.

Kmak: A short follow-up on David's already correct comments. No doubt they're going to accelerate and encourage fiduciary benchmarking and that's great. As we view this issue from the highest 50,000-foot level, there was a concern around transparency and that led to a number of disclosures. Those disclosures have been not just about fees, but service and fiduciary status as well. What I think is so interesting is that we wanted transparency so we're going to now have disclosure, but since we know the industry is not at commodity status, we also have to look at the value being rendered. In fact, the preamble in the 408(b)2 regulation several times makes the point that the intent of the regulation is fee reasonableness. So, they can't mandate reasonableness, but they can try to get at reasonableness through disclosure. So, it's going to accelerate. It's going to be good for our industry.

Goldbrum: *Do you believe that any of these regulatory changes and proposals will encourage sponsors to pay fees directly?*

Kmak: With the thousands of reports we've generated and

(Continued on page 6)

A Q&A with Tom Kmak and David Witz

(Continued from page 5)

are going to generate, we really have not seen that. It's a tough economy. Expenses can and, in many cases, should be paid from the plan. But I think the changes will ensure that plan sponsors understand what they are paying and what they are getting for what they are paying. It hasn't been our experience that we've seen a shift to plan sponsors paying fees directly. It's been more an examination of what you're paying for what you're getting.

Witz: It's a fascinating question because we are in a very difficult economy, so plan sponsors aren't necessarily looking for ways to increase their costs. That said, many plan sponsors have experienced expensive defense litigation to protect themselves over claims of prohibited transactions, unreasonable fees and fiduciary breaches. For a conservative plan sponsor that is risk averse, paying fees directly from the general account and not from plan assets is probably the most practical way to avoid a claim of unreasonable fees or a failure to disclose fees. Since advisors using PlanTools are disclosing fees in more detail, sponsors now have an understanding of what they are paying and can make an informed decision about whether they want to pay fees directly or deduct fees from plan assets. I don't know to what extent it will change the way fees are paid in the future, but if I'm a plan sponsor and I don't want to risk being sued over unreasonable fees or risk facing a claim that I failed to meet the 408(b)(2) exemption by failing to collect the required disclosure information on a timely basis, I will pay fees directly.

Goldbrum: *Do you think fee analysis and benchmarking will cause plan sponsors to rethink how they pay and allocate fees?*

Witz: There's no question that transparency and benchmarking of fees will affect how fees are paid in the future. In particular with the issuance of the 404(a)(5) participant disclosure rules that are effective at the end of 2011, many plan sponsors will need to consult with their service providers and develop a communications strategy to address fee disclosure to participants. This in turn will cause plan sponsors to evaluate if they want to continue allocating fees in the future as they have in the past. I think we may find that 408(b)(2) and 404(a)(5) are the impetus for how fees will be allocated to plan participants in the future as sponsors become more familiar with what fees are assessed to each participant for services rendered. For example, if one participant is paying more than another for the same services with the same account balance but with a different investment mix, the plan sponsor and service provider may want to collaborate on the wording to address this discrepancy or change the way fees are being allocated. While benchmarking is going to start the conversation about the appropriateness of existing fee allocations, participant disclosure might have a bigger impact on the actual allocation of fees.

Kmak: I agree. I think it will lead to what are known as levelized methods, as opposed to straight asset-based fees. For example, today you can have an S&P 500 fund that is literally not helping to defray any cost of administration and an international fund that might be contributing as much as 45 basis points. If you think about it, the administration doesn't really work that way. I think you'll see certain providers moving toward a component where if the fee for the entire plan for administration should be 25 basis points, the S&P 500 fund that's not paying anything will have a surcharge added to it of 25 basis points. The international fund that has 45 basis points has a rebate back to those participants of 20 basis points. Of course, the mechanics aren't simple and there are serious issues that need to be thought through, but I think benchmarking will cause people to ask serious questions about how those fees are assessed and paid by sponsors/participants.

Witz: I agree. The argument made in many of the cases litigated includes a claim that there's been a discriminatory allocation of fees to participants without any disclosure. This claim is tied to the different amounts of revenue-sharing paid from one fund to another. Maybe what will happen is we'll see all the plans moving toward an institutional share class of funds that don't pay any revenue-sharing. That way, the fees can be allocated proportionally to everybody on a basis that's clean. Of course, only time will tell if that approach will be universally accepted and applied.

Goldbrum: *As a follow up to that, do you think fee analysis and benchmarking will have a significant impact on the make-up of investment platforms?*

Kmak: I don't know that it will necessarily mean that people will remove a large value fund or put in an international fixed-income fund. The asset allocation decisions will still be primary, and the fees should be secondary to the decision. I think how those fees help defray other expenses will impact it. Also, as the metrics become richer in the industry, we'll be able to do regression analysis and research regarding how success measures are impacted by platform make-up. Looking at this from a slightly different angle than the fee component, the Hecker vs. Deere & Co. decision may result in more plan sponsors being more amenable to offering a brokerage account for their plan because of some of the protection that was afforded by that ruling. It might not be just a fee issue. So, I think there will be ties to participant success measures, as well as other possible litigation issues.

Witz: Regarding fee analysis and benchmarking, I do believe it's going to impact the investment menu. I feel this way because almost 100% of the people using our fee benchmarking solution are what I consider to be more sophisticated advisors. Their approach in using fee

benchmarking is not only to take care of their existing clients, but also to use it as a marketing tool to help educate prospective clients on how to position their portfolios for better outcomes. As these more sophisticated advisors educate their prospective clients, you can't ignore the fact that they are more likely going to end up with a better investment platform with lower overall expenses and better performance as well. Benchmarking is the impetus that helps them get down that path. Long-term, it should affect the make-up of the investment menu.

Goldbrum: *Is the RFP process a more reliable methodology for analyzing and benchmarking fees?*

Witz: Fee analysis and benchmarking won't replace the need to obtain an RFP, but it will empower the advisor, the service provider and the plan sponsor to negotiate a better arrangement or, for that matter, validate whether or not the existing offering or the offering that is being considered is reasonable. The benefit of benchmarking is the ability to draw from a much larger universe so you can determine if fees are reasonable for services promised versus an RFP process which involves a handful of vendors that may or may not be aggressively pursuing the business at that specific time, or may not feel confident about their ability to secure the engagement. I don't see benchmarking replacing RFPs, but I also don't see RFPs as a solution that can be utilized without benchmarking. I would look at them working hand-in-hand in many respects but with a heavier and more consistent emphasis on benchmarking.

Kmak: When you RFP a plan, that plan gets sent to vendors A, B, C, D and E. And as David just said, A, B and C might be lukewarm about pursuing it. And E may be completely focused on landing it. You get five fee quotes, but what you really don't see is that plan may have ridiculously poor success measures. That plan may require much higher services than others, such as more payrolls or more employee distributions. None of that comes through in an RFP. In a benchmarking process, you compare that plan to dozens or hundreds of plans that are similar. You'll be able to see what the fees, services, support and success measures look like. I think you get a more holistic picture with a benchmarking proposal than you do with an RFP where the focus is on one individual plan and the price for that plan.

Goldbrum: *Do you foresee any changes in fee analysis and benchmarking as a result of recent fee-related litigation?*

Kmak: We absolutely do. There is a very prominent ERISA attorney who said, because of the Caterpillar suit, she believed there were several things that were going to be required for fiduciaries. Specifically, they should monitor their fees, monitor them on an ongoing basis and have real documentation that can be put in a file. Probably the most important one is to make sure they have an independent, third-party opinion. You can't have the fox in the henhouse telling you their fees are reasonable. For those service providers trying to do that today, I think they are delaying the inevitable. It has to be an independent, third-party opinion in order for it to have more weight.

Witz: Fee benchmarking has always been a prudent and appropriate method to secure pertinent information. In the past, we just haven't had the technology available to pull the data together and make it available on a reasonable basis to small plans like we do today. Benchmarking also provides the necessary documentation to support compliance with fiduciary obligations. I think litigation is the accountability factor. ERISA was designed to give participants ready access to the federal courts to help them enforce their benefit rights. I believe we are where we are today due in large part to fee litigation which has caused the industry to adopt more stringent disclosure rules and benchmarking is the most appropriate methodology to meet those requirements.

Goldbrum: *Any final thoughts?*

Witz: I don't believe there is room for a single benchmarking solution in our industry. At the same time, benchmarking must be more universal. Using a closed sampling around a specific vendor's book of business is inherently misleading and conflicted. Benchmarking must be applied through a universal system that covers a broader, larger range of plan types, industries, geographic areas and service providers. With the technology advancements that are now available, benchmarking eliminates any reason to rely on surveys. Surveys are passé and represent an antiquated resource for decision making. On the other hand, benchmarking a plan based on 5500 Form data is unreliable and misleading. At best, 5500 data can be used for prospecting but the information is too inconsistent and inaccurate to be used to make decisions regarding fee reasonableness. Finally, as with any professional engagement, it is extremely important to have the right system as well as a qualified advisor to collect, analyze and populate the data. A professional advisor or consultant is key to obtaining a useful benchmarking report from which a plan sponsor can make an informed prudent decision.

Kmak: I have just one final thought. It's a pithy quote, but I think it sums up the situation perfectly: "Let's not lose sight of the forest for the fees." There is no doubt that fees have to be reasonable. The law requires it. It's good business practice. It helps participants retire better. But the success metrics around a provider that can get people to save more, invest better and roll over more can absolutely dwarf a differential in fees. So, while our firm welcomes the focus on fee benchmarking, let's not lose sight of the forest for the fees. Concentrating on the value side is what's important: good, timely, accurate record keeping, protecting plan sponsors as fiduciaries and really helping participants retire. Those three key value metrics are the things that should determine the fee for a plan. ■