Selecting Vendors for your Defined Contribution Plan

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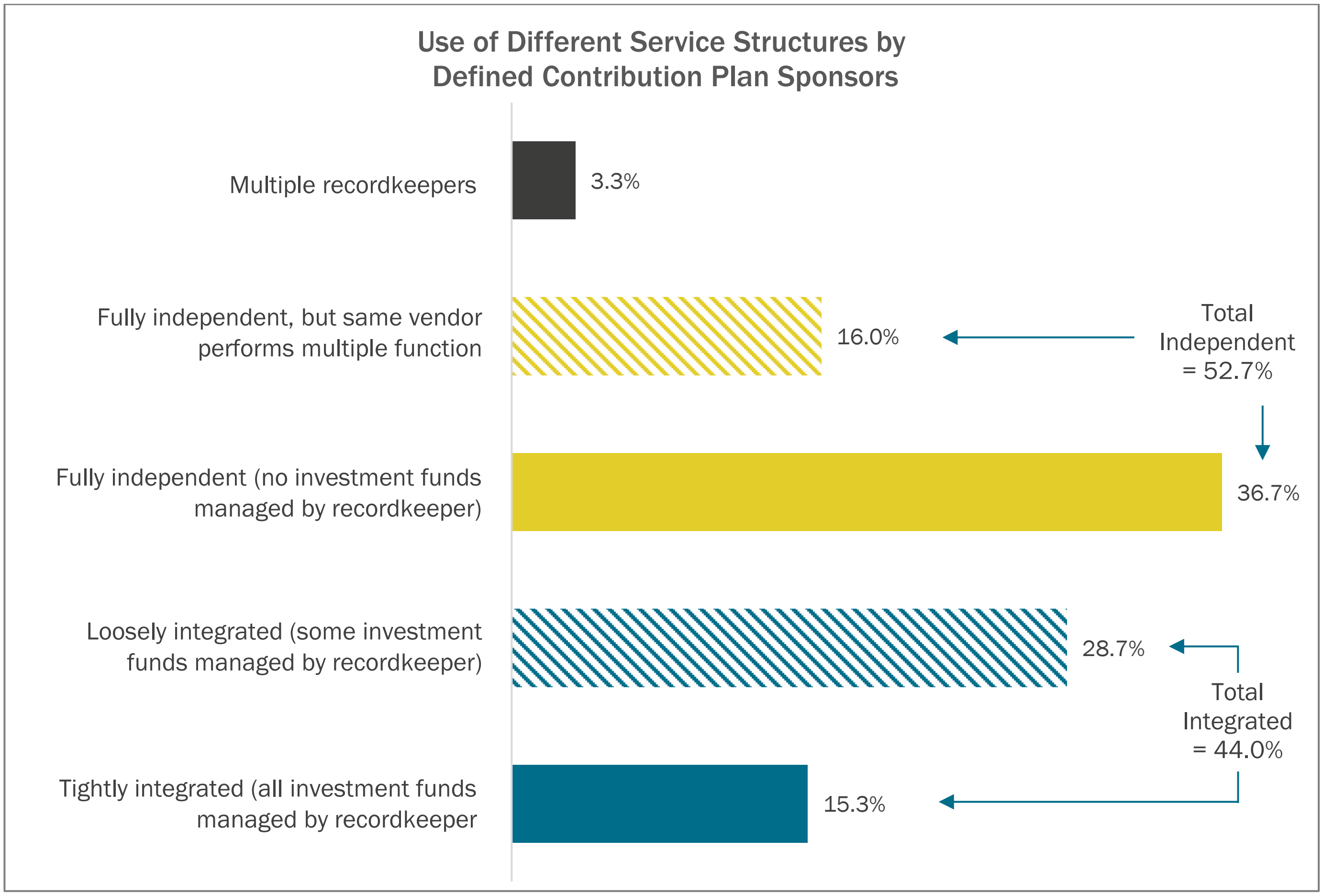
Individuals responsible for their company's qualified retirement plan face numerous difficult decisions when selecting plan service vendors. As technologies change, and as plan sponsors seek to shift additional responsibilities to external vendors, the complexity of the assignment increases. In selecting providers for the plan, each vendor must be assessed in each of several key areas, including:

- Administrative, recordkeeping and trust service capabilities
- Access to a broad range of quality fund options
- Ability to insulate the company and its key executives from fiduciary liability
- Employee communications and investment education capabilities.

Service arrangements are typically offered under three different structures, defined as follows:

1. Integrated: All services and plan funds are coordinated through one vendor; investments may all be from one fund family (tightly integrated) or may include funds from multiple fund families (loosely integrated).
2. Partnership: Services and funds are provided by different vendors under an alliance agreement, with the coordination of trust, investment and recordkeeping services handled by the primary vendor, not the plan sponsor.
3. Independent: Services and funds are provided by unrelated vendors; the plan sponsor plays a role in the coordination of trust, investment and recordkeeping services.



Source: Callan 2018 Defined Contribution Trends Survey

Survey data indicates that all three approaches are used by plan sponsors somewhat frequently. However, over the past decades, the general trend has been away from tightly integrated services, and towards loosely integrated and independent services.

When many companies consider changing plan service providers, the question inevitably becomes: “What vendor should we select to assist with the operation of our plan?” Given the popularity of integrated service arrangements, particularly among mid-sized plans, it is natural that the question is frequently framed in this manner.

However, instead of initially focusing on vendor selection, for a service solution to be truly appropriate for the plan sponsor, we suggest that the service selection question should be parsed into its component elements:

1. What investment structure (or combination of structures) is most appropriate for our workforce?
2. What type of administrative configuration can most effectively deliver the services necessary to support the selected investment structure(s)?
3. Which vendor or vendors should be selected to deliver desired services, such as:
   - Investment management
   - Trusteeship
   - Recordkeeping and administration
   - Employee communications
   - Participant investment education/advice
   - Compliance consulting/plan documentation
   - Investment consulting/plan sponsor investment advice

Many plan sponsors find that an integrated provider's capabilities will support most of their needs in each of these various categories. Other sponsors find that independent arrangements offer more customized capabilities at a total cost comparable to or lower than the comprehensive fee proposed by the integrated providers. By identifying their company's key priorities, and rigorously evaluating each vendor's capabilities to support their unique needs, plan sponsors can ensure that the vendor selection process leads to a robust and lasting plan support solution.

VENDOR SELECTION PROCESS

The Department of Labor's ERISA Advisory Council seems to believe that many plan sponsors adopt a flawed vendor selection process. In their Report of the Working Group on Guidance in Selecting and Monitoring Service Providers, the Advisory Council writes:

> *"Many of the problems with respect to service providers arise because the responsible fiduciary either does not understand his role and responsibility in the selection and monitoring of service providers or exercises poor judgment because he does not have experience or an appropriate source of information concerning legal requirements and industry practices."*

Plan sponsors can ensure that their retirement plan investment and administrative structures are supported by appropriate vendors, and correctly matched to their employee population and service needs, by implementing these seven steps:

1. Review the range of investment and administrative service configurations available for the plan
2. Decide which configuration best meets the employees' ability to manage investments and the sponsor's objectives for liability relief
3. Identify vendors that offer services in the preferred configuration
4. Solicit proposals from service providers, using a structured service and pricing template
5. Evaluate proposals, focusing on how well provider capabilities match employer and plan objectives
6. Select and interview finalists (generally two or three entities) and
7. Notify selected vendor(s) and develop a transition workplan

Steps 1 through 3 will help ensure that providers under consideration offer services appropriate to the needs of the plan sponsor's workforce. For example, a sponsor might be considering a proposal from a provider that specializes in offering self-directed brokerage accounts and a sophisticated investment education program. However, the sponsor may be aware that much of its workforce is overwhelmed by the current range of investment options, and that employees seek a simplified method for making investment decisions. Although the provider's capabilities for supporting brokerage accounts may be impeccable, these qualifications are irrelevant to most of the participants in the plan. Consequently, the provider would be an inappropriate choice for this particular plan sponsor.

Steps 4 through 6 will help the plan sponsor identify a vendor whose capabilities match appropriately to the unique needs of the sponsor's employees. Step 7 is required to appropriately manage the transition to the new vendor.

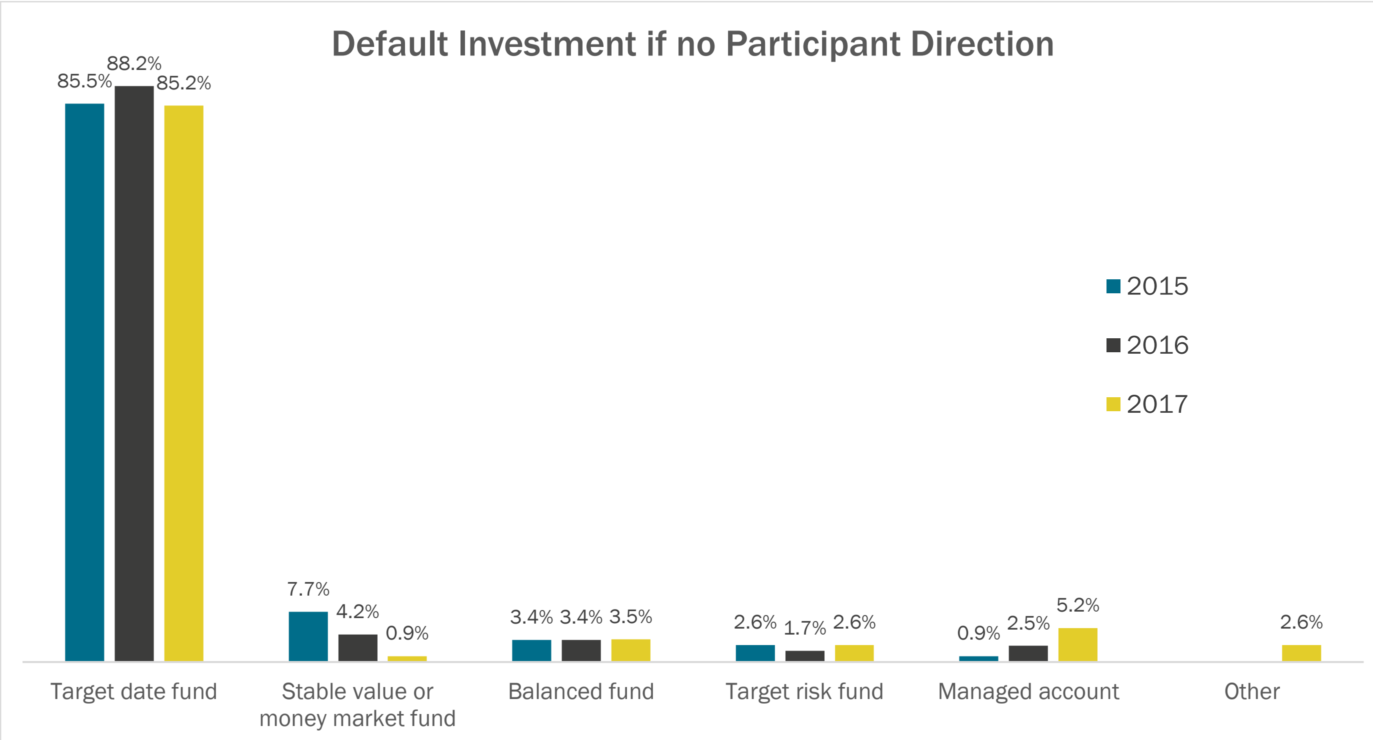
SELECTING INVESTMENT AND SERVICE CONFIGURATIONS

Just as there are three primary administrative service structures (integrated, partnership and independent), there are also three primary investment configurations from which the plan sponsor may select: asset allocation solution, core fund menu, and brokerage window. Each administrative service configuration might include any combination of the three investment structures.

The primary investment structures and administrative service configurations are described below:

INVESTMENT STRUCTURE	PRIMARY CHARACTERISTICS
Allocation Funds/Qualified Default Investment Alternative (Tier 1):	Series of diversified portfolios managed to meet various risk/reward targets. Participants generally choose just one portfolio that is most appropriate for their retirement objectives and/or current economic circumstances. Commonly used investments include Target Date funds, Target Risk funds, and managed accounts. Asset allocation solutions typically serve as the plan's Qualified Default Investment Alternative (QDIA), for participants that don't select their own plan options.
Core Menu (Tier 2):	Selection of investment choices, each choice typically reflecting a relatively narrow investment category or mandate, as designated by the plan sponsor. Usually includes both active and indexed funds. Participants create their own portfolios by combining funds from among the designated menu options. Menu funds are typically selected from unrelated investment providers, and under an integrated arrangement, may include funds managed by the integrated provider.
Brokerage Window (Tier 3):	Permits participants to purchase any legally permissible investment under ERISA through a brokerage account.

Historically, the fund menu approach (Tier 2) was the most popular investment structure. However, over the past decade, both asset allocation solution (Tier 1) and brokerage window (Tier 3) approaches have experienced increasing popularity. Today's plans typically include asset allocation funds, and brokerage windows are offered by a significant minority of plans. Plan sponsors find that their workforces include employees with varying degrees of investment expertise. More sophisticated investors argue that the range of choice available in a typical menu plan restricts their ability to construct truly customized portfolios. Less sophisticated investors may be overwhelmed by the decisions required to select investments from even a moderate range of menu options. Consequently, many plan sponsors are adding brokerage window accounts to menu plans to satisfy the needs of sophisticated investors without excessively complicating the basic menu. According to the NEPC 2017 Defined Contribution Plan & Fee Survey, 54% of the large plans surveyed by New England Pension Consultants offer brokerage windows. Additionally, most plan sponsors believe that some employees need help making basic investment decisions. Vanguard's "How America Saves" survey indicates that in 2016, 45% of Vanguard clients used "automatic enrollment", which, by definition, defaults participants into plan participation without requiring investment selection, thereby requiring a QDIA investment option, up from just 32% in 2012. Other surveys report even greater use of automatic enrollment, for example, the Callan 2018 Defined Contribution Trends reports that 71.4% of plans offered auto enrollment in 2017. Default investments used with automatic enrollment are usually Target Date funds (see chart below, based on data from the 2018 Callan Defined Contribution Trends Survey). Thus, many plans incorporate all three investment approaches.



Source: Callan 2018 Defined Contribution Trends Survey

Some retirement plan consultants refer to these comprehensive arrangements as “three-tier” plans. Tier one refers to asset allocation solutions, generally catering to less sophisticated “do it for me” investors. Tier two refers to the core menu of funds, from which more sophisticated “do it with me” investors construct their own portfolios. Tier three refers to the brokerage windows used by the most experienced “do it myself” investors.

INTEGRATED OR INDEPENDENT?

One of the key decisions that the plan sponsor faces is whether to bundle all plan services with a single integrated provider, or to separately engage specialist providers for each required plan function. As discussed above, most mid and mid-to-large plan sponsors tend to gravitate towards the integrated approach, with the smallest and largest sponsors more likely to use unbundled arrangements. According to the 2015 Deloitte Annual Defined Contribution Benchmarking Survey, “the survey found that the smallest (33%) and largest (34%) organizations were the most likely to have unbundled structures with multiple, unrelated vendors.” This data implies that very large plan sponsors have sufficient resources to coordinate service delivery among multiple providers, while very small plans lack the scale necessary to command the attention of integrated providers, and therefore must engage multiple specialist providers.

FIDUCIARY RESPONSIBILITY FOR VENDOR SELECTION

Vendor selection is a fiduciary responsibility under ERISA. Fiduciaries are responsible for operating the plan solely for the benefit of plan participants and beneficiaries, and can be sued by participants, beneficiaries and the Department of Labor (DOL) for not adequately fulfilling their fiduciary responsibilities.

In selecting vendors for their plans, plan fiduciaries face two primary pitfalls:

- Poor or inadequately documented selection of investment providers
- Lack of appropriate distinction between (1) administrative service pricing and capabilities and (2) investment management pricing and capabilities

Both pitfalls generally stem from the fact that most sponsors focus on selecting a specific provider too early in the process.

Most large integrated providers have competent sales executives who are eager to demonstrate their organization's capabilities. Cross-subsidization of administrative services has developed to the extent that for many vendors in the mid- and large-size plan market, the purported nominal price for recordkeeping and trust services is zero—or, in the case of vendors offering so-called "ERISA accounts" or revenue share recapture arrangements, the purported nominal cost may be negative. With the opportunity to eliminate all out-of-pocket costs, and to take advantage of the latest service package offered by the integrated providers, many sponsors jump immediately from basic fact finding to vendor selection.

Unfortunately, such rapid decision-making may inadvertently omit consideration of some of the most important cost factors. In a pamphlet directed to 401(k) plan participants, the DOL reports: "By far the largest component of 401(k) plan fees and expenses is associated with managing plan investments…You should pay attention to these fees. You pay for them in the form of an indirect charge because they are deducted directly from your investment returns." Data from the 2017 401(k) Averages Book supports the DOL's assertion, finding that investment management fees represent 93.6% of the total operating costs for a typical 401(k) plan with $5 million in assets and 100 participants.

To avoid these pitfalls, we recommend that sponsors implement a less traditional selection approach. Rather than initially focusing on vendor selection, start by focusing on investment structures. What range of investment options would be most appropriate for the unique needs of your workforce? Then investigate administrative capabilities. What services are essential for the effective administration of your plan? What frills would be nice to have, but are not essential? How do various providers match up in offering these services? Then, start comparing fees for administrative services, remembering that an accurate comparison of total plan cost can't be made until investment funds have been selected.

DISTINGUISHING BETWEEN ADMINISTRATIVE AND INVESTMENT CAPABILITIES

Many plan fiduciaries fail to distinguish between a vendor's administrative service pricing and capabilities, and their investment management pricing and capabilities. There are various reasons for this conundrum, including:

- Investment fees are generally paid directly from fund assets, through an implicit reduction in the fund's Net Asset Value (NAV). Administrative fees are generally paid by the plan sponsor, and hence receive greater scrutiny.
- Investment performance and costs are difficult to evaluate, due to varying performance measurement approaches and fee types. Administrative services and fees are generally easier to evaluate objectively.
- Fiduciaries responsible for vendor evaluation will work closely with the selected provider, and will rely on the provider for administrative support for functions such as distributing participant statements, processing benefit payments, etc. If administrative services are deficient, the fiduciary will receive numerous complaints and questions from disgruntled plan participants.

Although these reasons appear legitimate, ERISA makes fiduciaries responsible for ensuring that participants have the opportunity to invest in high-quality funds. Investment results generally have the greatest impact on a participant's ability to retire at a suitable and sustainable standard of living. Poor investment results, coupled with poorly documented investment selection procedures, represent a plaintiff's opportunity for litigation.

THE RFP: ASSESSING VENDOR CAPABILITIES

Once you have completed your review of administrative and investment structures and reached some preliminary decisions regarding appropriate structures for your organization, you are ready to proceed with vendor selection. This is generally best accomplished through a formal Request for Proposal (RFP) process, where a cross section of service providers is asked to respond to a set of questions in a standardized format. The RFP enables the plan sponsor to rate the vendors in a reasonably consistent manner.

In structuring your RFP, you should ask questions that will permit you to gauge a vendor's capabilities in each of the following areas:

Administrative Issues

- Adequacy of the vendor's recordkeeping and administrative systems
- Ability to respond promptly to changing IRS/ DOL rules and regulations
- Capability to permit your company to outsource administrative functions

- Willingness to contain administrative expenses to a reasonable level

Fiduciary Liability Management
- Willingness and ability to accept applicable fiduciary liability
- Ability to comply with applicable Federal regulations
- Capability to assist you in implementing appropriate risk mitigation strategies

Investment Capabilities
- Ability to provide plan participants with suitable investment choices and immediate access to their account information
- Access to a broad range of quality fund options
- Ability to provide performance information to facilitate the initial selection and ongoing monitoring of plan investments

Participant Communications
- Quality of participant statement, and ability to customize statement at plan or participant level
- Availability and qualifications of phone service representatives
- Internet capabilities (information transmittal, account review, online transactions, etc.)
- Other financial planning and modeling tools that may be offered
- Availability, cost and quality of individualized investment advice
- Ability and willingness to conduct participant meetings, webinars, and individual counseling sessions

A SYSTEM FOR EVALUATING RESPONSES

A successful RFP process rates vendors separately in three primary areas:

- Investment offerings, performance, diversification and fee structure
- Service capabilities and responsiveness
- Administrative fees, expenses and pricing structure

EVALUATING INVESTMENT OFFERINGS

As indicated earlier, rating investment products may be the most difficult part of the vendor evaluation process. However, in many respects, investment selection is the most important component of the vendor search. Future fund performance will determine the value of employees' retirement benefits.

Integrated service providers are becoming increasingly flexible in offering investments from other fund families on their standard platform. For example, in 2016, Fidelity, the leading 401(k) provider, offered over 14,000 non-proprietary funds on their platform. Wells Fargo offered 5,800 funds.

The pervasiveness of revenue sharing arrangements on service provider platforms makes fee comparisons increasingly difficult. Many integrated providers require that you select at least some of their proprietary funds, but also permit you to use nonproprietary funds, preferably platform funds that pay revenue share, but potentially including unaffiliated funds, that may pay little or no revenue share to the provider. When requesting fee quotes, ask the vendor to price services assuming no proprietary funds are selected, and no revenue sharing payments are received from platform funds. Quotes can be requested as a fixed per participant fee, as a percentage of plan assets (typically expressed in hundredths of a percent, or "basis points", or both. Requiring quotes to assume no proprietary funds and no revenue share permits you to fairly compare cost proposals between different vendors, and positions you well to make fund selections independently from provider selection. Caution is suggested, however, as in our experience, some service providers may "game" their no proprietary funds quote, assuming that if selected, they will be able to lobby for inclusion of certain funds. In some cases, we've seen prospectively selected vendors request revised pricing arrangements if the sponsor is unwilling to include proprietary funds on the plan menu.

Also be sure to evaluate the range of outside funds offered on the platform. Some programs offer a limited selection of high cost funds; other programs offer a much broader range of choices. Require that proposing vendors disclose all revenue sharing arrangements maintained with outside funds, as well as the implied revenue share paid on proprietary funds.

WILLINGNESS/ABILITY TO SUPPORT ALTERNATE INVESTMENT APPROACHES

In recent years, sponsors have increasingly been migrating away from mutual funds and towards lower cost investment approaches, such as collective investment trusts (CITs). This trend is particularly evident among larger plans. For example, the Callan 2018 Defined Contribution Trends Survey reports that the use of CITs increased from 43.8% in 2011 to 65.0% in 2017, while the use of mutual funds declined from 95.0% to 79.5% over this same period. However, not all plan service providers support the use of CITs. A comprehensive RFP should inquire about the provider's capabilities to support alternate investment approaches such as CITs, as well as the process for adding new investments as they become available in the market. Although mutual funds continue to be the primary investment vehicle for most plans, market share for mutual funds is already eroding, and is likely to fall further over time. A provider's ability to support alternate investment approaches will become more important over time.

MUTUAL FUND FEES

Historically, plan sponsors have paid relatively scant attention to mutual fund fees, because participants pay them through an implicit reduction in investment return. However, the DOL has made it clear that employers have a fiduciary responsibility to "Ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of the services provided." This responsibility certainly extends to mutual fund management fees, since they typically represent the largest component of a plan's operating cost. Suffice it to say that mutual fund fees vary significantly, and include elements such as:

Operating Expenses

All mutual funds incur a variety of expenses including management fees, marketing and distribution costs, etc. These expenses are quantified in the fund's annual operating expense ratio (OER). In general, equity fund OER's range from less than 0.10% to over 3.00% of assets. Fixed income fund OER's generally range from less than 0.10% to over 1.50%. For no-load funds, the largest component of the fund OER is typically the investment management fee, followed by other fund administrative expenses (legal and accounting, fund operations, etc.)

According to the 17th Edition of the 401(k) Averages Book (a 401(k) fee benchmarking resource, published by Pension Data Source, Inc. of Baltimore, Maryland in 2017), investment fees for a 401(k) plan with 1,000 participants and $50 million in assets averaged about 96 basis points (0.97%) per year. But the range of investment expenses for these plans trended between 28 and 121 basis points—a high to low variance of $465 per participant per year!

Loads and Sales Charges

Some funds may be subject to front-end sales charges. Most retirement plans should be exempt from front-end sales charges, so check to see whether your plan is subject to these fees. Additionally, funds may levy 12b-1 fees, generally ranging from 0.15% to 1.00% of assets annually. 12b-1 fees are charges assessed by the fund company to recoup marketing and distribution costs. The 12b-1 fee is part of the fund's OER. Funds with moderate to high 12b-1 fees are frequently found in integrated platforms, because the 12b-1 fee is easily transformed into a revenue sharing payment.

SERVICE CAPABILITIES

Qualified plan service vendors have varying strengths and weaknesses. Responses to your RFP will permit you to assess each vendor's relative strengths. This is generally accomplished through a "point" system (e.g., score one to five points for each vendor's response to each RFP question). To further customize your evaluation, once you have decided which vendor capabilities are most important to your organization, you can develop a point weighting system for grading the responses, with more points allocated to questions addressing capabilities in those areas deemed most crucial for your company. For example, if local service delivery is important for your company, you could allocate additional points to providers close to your company headquarters.

FEES AND EXPENSES

You may also want to develop a separate spreadsheet for comparing fees and expenses applicable to each possible alternative, as vendors will have different fee schedules and costing methodologies. By creating a reasonable and consistent set of assumptions for plan experience (i.e., number of participants, number of benefit payments, loan applications, inter-fund transfers, etc.), and applying the same assumptions to each vendor's fee schedules, you should be able to evaluate each fee schedule in a reasonably equivalent manner. Your spreadsheet should also consider implicit costs, such as any contract or surrender charges.

TOTAL PLAN COST

Once you have summarized each vendor's direct fees and implicit costs, you should also assess each vendor's total plan cost. To calculate total plan cost, you need to add fund operating expenses to direct fees and implicit costs. Fund operating expenses are calculated by multiplying the fund's OER by the total dollars allocated to (or expected to be allocated to) the fund. This calculation will require some estimation, since the sponsor can't know in advance how participants will allocate their individual accounts to the various new options offered through the plan. By assuming that investment allocations will remain reasonably consistent, and by assuming a rational mapping of old funds to new funds, a reasonably accurate calculation can be made.

Total plan cost is typically a large number. For small and mid-sized plans, it generally approximates 1% of plan assets. Additionally, the variance in total plan cost between various providers is also likely to be significant. However, plan sponsors should remember that they are not required to select the lowest cost provider. Rather, fees that the plan and participants pay must be reasonable, given the service that the plan receives.

CONCLUSION

Selecting an appropriate investment and administrative structure for your company's qualified retirement plan is a significant and crucial task. The investment structure you select has a direct impact on the degree of fiduciary liability you retain. Further, your selection of investment and administrative vendors has operational, liability management and employee relations implications. Following the procedures outlined in this article provides an essential framework for:

- Demonstrating procedural prudence in the selection process;
- Ensuring that your investment structure, administrative configuration and service vendors are appropriate for your employee population; and
- Avoiding the "sales claims" trap that leads to frequent turnover among plan service providers.

There is no single formula for determining the preferred structure for a company's retirement program. Rather, final selection should be based on the sponsor's objectives and the wishes of the participant group. Indeed, multiple different investment structures may be offered within a single plan so that participants have more choice. Whatever the selected path to compliance, managing fiduciary liability management demands complete, written documentation of the decision-making process and of the objective criteria used for all evaluations (both initial and ongoing) of products, vendors, and service providers.

Investing in mutual funds is subject to risk and loss of principal. There is no assurance or certainty that any investment strategy will be successful in meeting its objectives.

The target date of a target date fund may be a useful starting point in selecting a fund, but investors should not rely solely on the date when choosing a fund or deciding to remain invested in one. Investors should consider funds' asset allocation over the whole life of the fund. Often target date funds invest in other mutual fund and fees may be charged by both the target date fund and the underlying mutual funds.

Asset allocation, which is driven by complex mathematical models, should not be confused with the much simpler concept of diversification. No investment strategy can ensure a profit or protect against loss.