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Client Alert

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Is Your Retirement Plan Advisor Overcharging Your Plan?

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Now that the new DOL Fiduciary Rule has forever changed the retirement advice landscape, I must ask… Is your retirement plan advisor overcharging your retirement plan?

The DOL Rule (even though it has been postponed for now) has changed the way most retirement plan advisors are being paid. You are now most likely paying an investment advisory fee (instead of a brokerage commission) and in addition to this fee arrangement being subject to ERISA (and all of its complexities) your new investment advisory fee arrangement is now also subject to the Investment Company Act of 1940 (the "40 Act") as well. What does this advisory fee arrangement mean to both you, as the responsible plan fiduciary ("RPF"), and to your investment advisor?

408(b)(2) and the RPF

Let's begin with your responsibilities as the RPF under ERISA. The new final 408(b)(2) regulations clarify an obligation on the part of the RPF to examine all contractual relationships between its plan and a party in interest to determine both the necessity of the services being paid for with plan assets and the reasonableness of the amount paid for those services with plan assets. It is interesting that ERISA does not define the term "reasonable compensation." It is the responsibility of the RPF who approves a transaction on behalf of the plan and its participants to determine reasonableness. However, DOL regulations § 2550.408c-2(b)(1) do provide some guidance by stating that a determination of whether compensation for the provision of services is reasonable is based on all the relevant facts and circumstances. The RPF, in making its determination of reasonableness, must also consider the fair market value of the goods or services provided to the plan compared to the cost of similar goods or services available in the same geographic location where the goods or services are being made available to the plan.[1]

Investment Company Act of 1940

What are the investment advisor's obligations to ensure that they are receiving only "reasonable compensation" under their investment advisory contract with your plan? There are two court cases that provide guidance into the process of determining the reasonableness of investment advisory fees. Neither of the cases involved an ERISA plan, but the legal principles by which the courts decided the cases are directly applicable to the discussion in this Client Alert. The case of *Gartenberg v. Merrill Lynch Asset*

[1] See *McLaughlin v. Bendersky*, 705 F. Supp 417 (E.D. Ill. 1989); *Marshall v. Snyder*, 572 F.2d 894 (2d Cir. 1978); and *Dole v. Formica*, 1991 WL 317040, 14 Employee Benefits Cas. (BNA) 1397 (N.D. Ohio Sept. 30, 1991).]

Management, Inc.[2] involved an interpretation of section 36(b) of the Investment Company Act of 1940 (the "40 Act"). The court in *Gartenberg* basically disavowed the use of benchmarking in determining the reasonableness of one's fees.[3]

The Supreme Court in *Jones v. Harris Associates, L.P.*[4] *not only* re-affirmed the decision-making factors set forth in *Gartenberg* for determining reasonableness of fees, so as not to violate the fiduciary duty requirement under section 36(b) of the 40 Act; but they also elaborated that the commonly used practice of benchmarking fees for reasonableness is not necessarily determinative when considering whether one has satisfied his or her fiduciary duty.

Clearly, an investment advisor is not able to solely rely on a benchmarking report to justify their fees. When serving as the investment advisor to the plan, one is primarily hired to assist the RPF in the selection of investment options to be made available to plan participants. As the RPF you must ask yourself how much is this advice truly worth to your plan and its participants and are you ready to defend the investment advisory fees you are currently paying?

Prohibited Transaction Penalties

What happens if it is determined that a party in interest is deemed to have received more than "reasonable compensation" from plan assets? If an investment advisory fee contract is deemed not to be "reasonable" for whatever reason, then the resulting prohibited transaction will potentially have consequences for both the RPF and the investment advisor.

If there is a fiduciary prohibited transaction under ERISA, then certain ERISA sections apply that detail the liability of a fiduciary for a prohibited transaction. ERISA § 409(a) provides that a fiduciary is personally liable to restore to the plan any losses resulting from a prohibited transaction. ERISA § 501 sets out criminal penalties for a willful violation of Title I of ERISA – up to $100,000 in fines and up to 10 years in prison. ERISA § 502(a) allows participants and the Employee Benefits Security Administration (or "EBSA") to file lawsuits against the fiduciary in order to enjoin proscribed conduct and/or provide for equitable relief. ERISA § 502(l) provides for a civil penalty of 20 percent of the "applicable recovery amount" from the fiduciary. This civil penalty under § 502(l) is reduced by both the administrative civil penalty of ERISA § 502(i) and any excise taxes paid pursuant to IRS Code § 4975. ERISA § 502(i) imposes an "administrative civil penalty" for violations by plans that are not subject to IRS Code § 4975, including welfare plans or health plans funded through a VEBA trust. This administrative civil penalty is five percent of the amount involved in the transaction, rising to 100 percent if the prohibited transaction is not corrected within 90 days after a final order is issued by the EBSA.

Additionally, any party who commits a prohibited transaction that is not exempt under a statutory, regulatory, or class exemption is subject to a financial penalty under IRS Code § 4975. IRS Code § 4975(a) imposes an initial tax on each prohibited

[2] 694 F.2d 923 (1982)

[3] 694 F.2d 923, at 929.

[4] 559 U.S. 335 (2010)

transaction. The rate of tax is equal to 15 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. In any case in which an initial tax is imposed on a prohibited transaction and the transaction is not corrected within the taxable period, § 4975(b) imposes an additional tax equal to 100 percent of the amount involved. The excise taxes imposed by subsections 4975(a) and 4975(b) are paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such).

The Future of Retirement Plan Advice

Under an investment advisory agreement advisers are typically compensated for their services on a percentage of the assets under management (or "AUM") expressed in basis points. Often, investment fiduciaries will then seek to "validate" for the RPF what the plan is paying using a benchmark report which is a comparison of the amount being paid to advisers on similarly situated plans for similar services. Although fee arrangements based on AUM and benchmarking reports are commonplace and generally accepted by the retirement plan industry today; as fee awareness continues to increase and as soon as plaintiff's bar recognizes that larger plans are paying significantly higher fees for essentially the same services that smaller plans receive for less, this plan pricing model based on AUM might begin to change.

Rather than basing its determination of reasonableness on a comparison of basis points using a benchmarking report, the RPF could alternatively demand that the investment adviser providing advisory services to the plan be compensated under a flat fee arrangement based on the expected number of hours that are required to deliver the contracted services. A flat fee arrangement might not only result in lower investment advisory fees today, but it might also help the RPF avoid future headaches.

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