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Benchmarking as a Part of a Prudent Process

By Fred Reish

It is commonly accepted that 401(k) fiduciaries must prudently select and monitor both investments and service providers. It is also understood that, in order to fulfill their selection and monitoring responsibilities, 401(k) fiduciaries must engage in a prudent process. However, in my experience, many plan fiduciaries and advisers do not understand the specific requirements for a prudent process. This article focuses on those requirements.

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Basically stated, there are several steps to a prudent process, which are:

1. Identify the particular issue to be considered. In some cases, it is obvious. For example, fiduciaries must decide which asset classes should be used by the plan and which mutual funds should be selected to represent those asset classes. However, in other cases, the fiduciaries, like the committee members, have the flexibility to decide whether or not to address an issue, for example, should the plan offer participant-level investment advice or investment management?
2. Determine the information that is *relevant* to making an informed decision about that issue. Keep in mind that all of these steps are subject to the prudent man rule, which measures fiduciaries by the standard of a hypothetical knowledgeable person. Thus, fiduciaries need to identify the information that a knowledgeable person would need in order to make a prudent decision.
3. Gather and evaluate the information. The output of a prudent process is an informed and reasoned decision. As a result, the fiduciaries should start by gathering the appropriate information. Then, they need to analyze the information to make a decision that is a reasonable result of the evaluation of the information.
4. Implement the decision.
5. At reasonable intervals thereafter, monitor the decision.

When evaluating the relevant data, the fiduciaries should compare it to comparable information from the marketplace. In other words, fiduciaries have to "benchmark" the investments and services in order to evaluate their quality, cost, effectiveness and other attributes. This requirement applies to all fiduciary decisions, regardless of whether they are about recordkeepers, investments, investment advice, participation, and so on. In other words, benchmarking is an inherent part of a prudent process—and fiduciaries must engage in a prudent process for every decision they make.

Here is what the DOL says about the process for selecting a service provider (which applies to all fiduciary decisions): "...the responsible plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualification of the service provider, the quality of the work product, and the reasonableness of fees charged in light of the services provided."

The DOL goes on to say: "What constitutes an appropriate method of selecting a service provider, however, will depend on the particular facts and circumstances. Soliciting bids among service providers at the outset is a means by which the fiduciary can obtain the necessary information relevant to the decision-making process."

In this case, the DOL is saying that, by soliciting bids, the fiduciary can obtain information about the individual provider... and can also obtain comparative, or benchmarking, information about other providers of these services.

The DOL continues: "Whether such a process is appropriate in subsequent years may depend, among other things, upon...the fiduciary's knowledge of prevailing rates for the services...Regardless of the method used, however, the fiduciary must be able to demonstrate compliance with ERISA's fiduciary standards."

In other words, regardless of how the fiduciary obtains the comparative information, the fiduciary must be able to demonstrate that he engaged in a process to evaluate both micro information (related to a single service provider) and macro information (comparative data from the industry).

The point of this article is that, in order to engage in a prudent process, fiduciaries must do more than analyze a particular service provider or a particular investment. Instead, they must also compare that information to comparable data about other similar plans, services or investments.

While 401(k) advisers commonly benchmark investments and sometimes benchmark plan costs, my experience is that they often do not use benchmarking data for other fiduciary decisions, such as the services that are offered by a plan (like in investment education, enrollment meetings, investment advice and management, and so on). However, as more and more 401(k) advisers are positioning themselves as consultants for successful plans, they will need to become more proactive in assisting plan sponsors benchmark the other services and features of plans.

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