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10 Popular Myths Regarding the DOL's New Fee Disclosure Rules

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Portico Wealth Advisors is a Registered Investment Advisor and leading Bay Area retirement plan consultant helping sponsors assess the true cost and quality of their plans.

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The retirement plan marketplace is in the midst of significant change. One area undergoing a major overhaul is the disclosure of retirement plan costs.

Recognizing the corrosive effect that excessive charges have on long-term participant investment returns, the Department of Labor (DOL) recently introduced its long-awaited fee disclosure regulations: 408(b)2 and 404(a)5.

Defined contribution plans, e.g. 401(k)s, 403(b)s, etc., have replaced traditional pension plans as the primary savings vehicle for US retirees[1]. The new DOL rules are intended to increase transparency in this historically opaque marketplace and assist both plan sponsors and participants to better understand the true cost of their plans.

Fee disclosure has also increased the administrative burden on plan sponsors, who now must not only understand the underlying structure of their plans, but must also evaluate their often convoluted disclosure documents as well.

What do the new DOL regulations mean for your company and its employees? What information are you required to collect and analyze? And perhaps most importantly, what is fact versus fiction as it pertains to fee disclosure?

From the faulty notion of the "free plan" to an in-depth examination of how retirement plan expenses get paid, this paper tackles 10 of the most prevalent myths surrounding fee disclosure in the retirement plan marketplace today.

A synopsis of the rules surrounding 408(b)2 and 404(a)5, along with their associated deadlines, is also included in the Appendix.

1 My Retirement Plan Is "Free"

This myth is one of the oldest in the retirement plan industry. In fact, the new fee disclosure rules were created specifically to dispel it. Unfortunately, the mythical "free plan" lives on.

To understand why a sponsor might believe their plan is free, one needs to understand retirement plan cash flows *(Figure 1).*

"All-In" cost is the total cost associated with providing a retirement plan, including any explicit charges for plan-level services as well as the underlying fees of a plan's mutual funds. Asset-based charges, in particular internal fund operating expenses, have historically been the largest component of "all-in" cost… and the most opaque.

On average, fund operating expenses make up 90% of the total cost of providing a plan[2], giving rise to the following implications relating to fee disclosure:

- **Participants, not sponsors, are paying the bulk of the fees associated with providing their retirement plans**
- **In order to understand the true "all-in" cost of their retirement plans, sponsors must examine the operating expenses of their mutual funds**

Internal fund expenses are debited from participant balances daily, and without ever being itemized. Thus, only the participants themselves can pay the internal fund expenses. And given that the bulk of "all-in" cost is buried in the mutual fund expenses, it is the participants that bear the bulk of the cost of providing their own plans.

Some might argue that this arrangement is eminently fair. After all, a retirement plan predominantly benefits the participants, so why shouldn't they pay the majority of the cost to provide it?

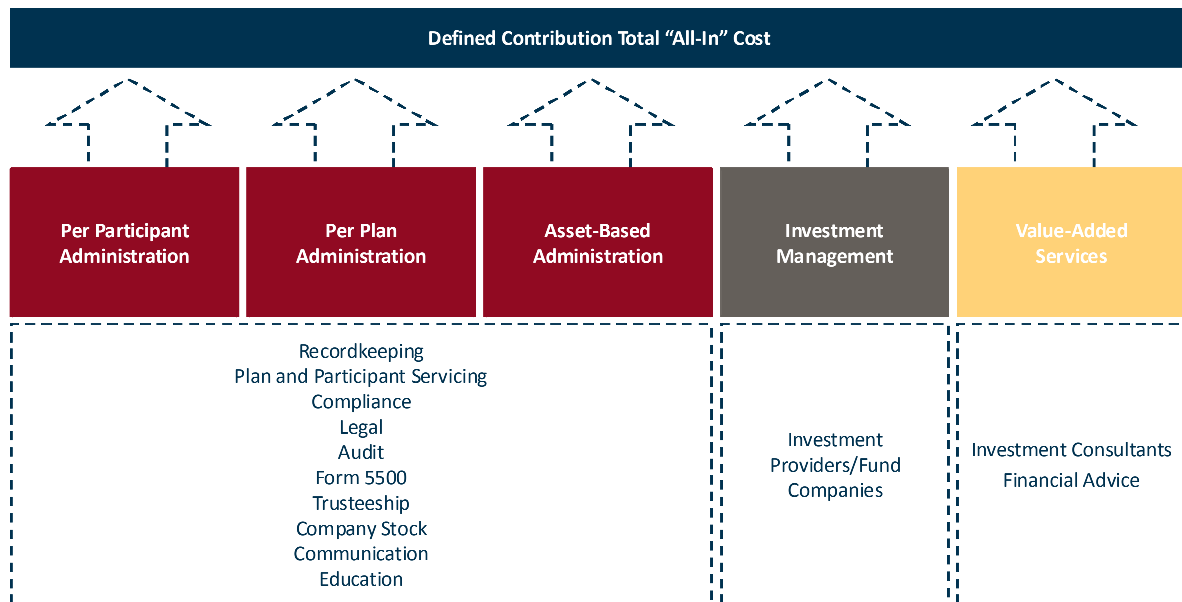
It's important to recognize that although participants pay the bulk of the costs associated with their plans, they are not the ones making the buying decision. The plan sponsors are. This fact may create conflicts of interest, as sponsors attempt to minimize company out-of-pocket costs, instead of minimizing their plans' "all-in" costs.

Hiding charges in the underlying funds can also lead sponsors to have a very poor understanding of the true cost of their plans, ala the mythical "free plan."

The truth is that no retirement plan is free. The costs may simply be less obvious. The new fee disclosure rules require that plan sponsors understand the costs associated with providing their retirement plans, regardless of whether those fees are explicit charges or paid through the mutual funds.

You must look at your fund expenses and understand how they compare with other, similar funds in order to fulfill your fiduciary duty to your participants.

Figure 1



Source: Deloitte/ICI Study 2011

2 My Provider Is a Fiduciary

Fiduciary is a technical ERISA term. However, the layperson's definition is to always place the interests of a plan's participants above all else.

Companies that sponsor retirement plans are clearly fiduciaries under ERISA law, as are any of the individuals who provide and/or regularly interface with the plan. Titles that are usually associated with fiduciary duty (and the associated liability) include:

- **CEO/President**
- **CFO**
- **HR Director**
- **Operations/Office Manager**
- **HR Generalist**

ERISA requires these individuals to make retirement plan decisions that are in the best interest of their participants. Failure to do so can lead to penalties and criminal charges, both for the company as well as the individuals themselves.

Given that most CEOs and HR Directors are not retirement plan experts, they often look to their plan providers for assistance. In doing so, however, sponsors must be clear whether or not their provider is a fiduciary, i.e. acting in their best interest.

408(b)2 disclosures must include a statement regarding the fiduciary status of the provider: fiduciary or not. If a provider is not acting as a fiduciary, it means that they are not sharing any of the associated liability for providing the plan with the sponsor.

Practically, working with a non-fiduciary means that plan sponsors are solely responsible for understanding all of their plans' fees. Non-fiduciary vendors are not obligated to hold participants' interests above their own.

Similarly, a sponsor that is working with a non-fiduciary is implicitly assuming 100% of the liability for the selection, monitoring, and maintenance of their plan's fund menu. That sponsor is also endorsing any education efforts/materials provided to participants.

As a final note, non-fiduciary providers are precluded from providing advice and specific fund recommendations to participants under ERISA.

Take a look at the Fiduciary Status section of your 408(b)2 disclosure. If you are working with a fiduciary provider, it will explicitly state so. Phrases like "fiduciary support" and "experience with fiduciary responsibilities" mean that your provider is not acting as a fiduciary to your plan.

3 I Must Select the Lowest Cost Provider

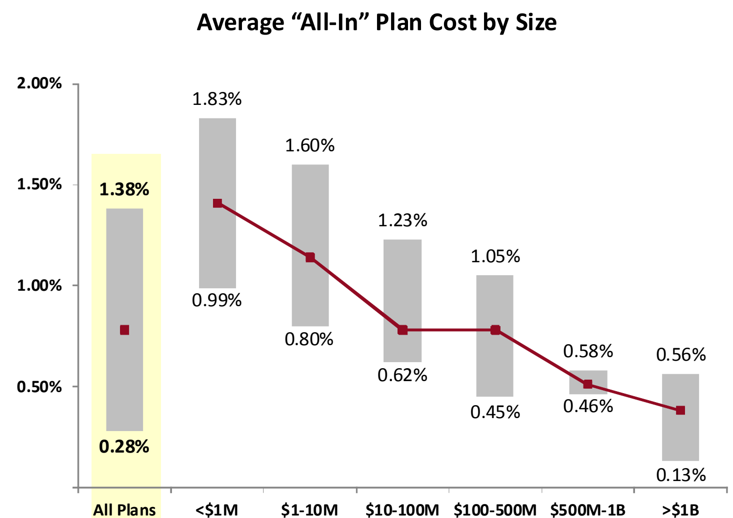
One of the more common misconceptions surrounding fee disclosures is that they require plan sponsors to seek out the least expensive plan. That is not the case.

Instead, sponsors are required to answer the following 2 questions:

- **What are my participants paying for their retirement plan?**
- **Are those fees "reasonable" in light of the services they are receiving?**

The DOL's message vis-à-vis fee disclosure is that sponsors should search for relative value in the retirement plan marketplace.

This fiduciary duty is not new. Plan sponsors have always been required to systematically and continually test the marketplace to determine if more attractive terms are available for their participants.



Source: Deloitte/ICI Study 2011

The new 408(b)2 fee disclosures are simply a tool to help sponsors answer the first question. 404(a)5 participant disclosures act as a compliment to the 408(b)2 notices, as well as to potentially spur sponsors toward compliance.

The onus lies with the plan sponsor to answer the latter question, i.e. are the fees my participants are paying reasonable? In order to make that value judgment, sponsors must have a full understanding of the services being offered by their current provider. These include fiduciary services for the sponsor as well as education/advice services for the participants.

If a prospective provider is offering a more robust set of services than the incumbent, at an equal or lesser cost, plan sponsors are required to switch providers.

The DOL does not require you to select the cheapest plan, but rather the plan that delivers the most value to your participants.

4 Fee Disclosures Will Succinctly Outline My "All-In" Cost

By now, sponsors should have already received their 408(b)2 disclosures (due July 1st, 2012) and be in the process of reviewing them.

As is the case with many regulations, the execution often fails to mirror the intent. In this way, 408(b)2 appears to be similar. The presumed intent of fee disclosure is to provide a plan sponsor with a concise and consolidated reckoning of all of the costs associated with their plan as well as a list of the services they are receiving.

In reality, 408(b)2 disclosures look quite different. Many of them are 10-15 pages long. They are chalked full of pictures and equally colorful descriptions of the services being provided to the plan.

For example, every 408(b)2 disclosure must contain a section called "Fiduciary Status," in which a provider must declare whether or not their services are being provided in a fiduciary capacity. This declaration should not be any longer than a sentence or two; either they are a fiduciary to the plan or they aren't.

Instead, many providers have chosen to spend multiple paragraphs describing their fiduciary-like services, without ever asserting their fiduciary status. Even worse, some providers have omitted that portion of the disclosure completely.

Providers are not necessarily offering more transparency when it comes to disclosure of their fees either. The DOL permits providers to reference contracts and other service agreements in the 408(b)2, in lieu of including all the relevant fee data in one document. As a result, many disclosures read "See Service Agreement," when it comes to detailing certain plan-level costs. Fund fees, on the other hand, are a required element of all 408(b)2 disclosures, and are being uniformly included.

To the extent that a sponsor has multiple providers, e.g. a distinct recordkeeper, administrator, investment advisor, etc., each of these entities is required to provide a separate disclosure. Thus, to answer the questions of cost and relative value posed by the DOL, a sponsor may have to combine several 408(b)2 disclosures in order to fully understand their plan's "all-in" cost.

You should have a process in place for collecting and evaluating the requisite disclosures for your plan. If you don't, you are neglecting your fiduciary duty to your participants.

5 My Provider Will Handle All of My Disclosures for Me

Many sponsors are under the impression that their provider will be handling all of their disclosure duties. That may or may not be the case.

As previously noted, all plan vendors should have already provided their requisite 408(b)2 disclosures.

If you have not received a disclosure from every provider that is expected to bill your plan at least $1,000 in 2012, you need to request that disclosure immediately. If you do not receive it by September 30th, you must fire that provider as well as report them to the DOL. Failure to do so is a "prohibited transaction" as defined by ERISA, and may result in the revocation of your plan's tax-deferred status.

When it comes to 404(a)5 participant disclosures, most providers are offering to assist sponsors. However, the responsibility for the dissemination of those disclosures technically remains with the sponsor. So to the extent that the disclosures are either not distributed or distributed incorrectly, the plan sponsor is liable.

The Department of Labor does offer one exemption: If a sponsor reasonably, and in good faith, relies upon information provided by a service provider, the sponsor is not liable for the completeness/accuracy of information then provided to participants.

It is imperative that sponsors ensure that their participants receive the required disclosures prior to August 30th. It is also a best practice to fully understand the information contained in these disclosures in order to avoid scrutiny from both participants and regulators.

You should request a copy of your 404(a)5 disclosure now, and fully review it, before it is distributed to your participants.

6 My Plan Is Too Small for Institutional-Class Shares

Another pervasive myth surrounding retirement plans and their fees is the idea that larger plans have access to a host of higher quality, lower cost investment options as compared to smaller plans.

The truth is that small to mid-sized plans ($1-25MM) have every opportunity to use the lowest cost, institutional-class mutual funds in their fund menus. These same plans can also access the entire universe of Exchange Traded Funds (ETFs) as well as the bulk of Collective Investment Funds (CIFs), both of which may lead to even lower "all-in" cost.

The key to accessing these investments is having the right plan structure. There are ~7,600 distinct mutual funds in the marketplace, with over 22,000 different share classes of those funds available. An "open-architecture" plan allows plan sponsors to select from that entire universe of funds *(Figure 2)*, including all institutional-class funds, as well as the entire group of ETFs and CIFs.

Figure 2

Various "Closed Architecture" Providers

Provider	# of Funds on Platform(s)
Fidelity	1,500 to 4,000
ADP	100 to 2,800
Hartford	100 to 900
John Hancock	100 to 300
ING	300 to 1,200
Nationwide	500 to 1,000
Principal	100 to 3,000
Entire Marketplace	**> 22,000**

By contrast, most sponsors are using some form of "closed-architecture" solution. Closed plans only offer sponsors access to a subset of the entire mutual fund marketplace. These platforms tend to limit sponsors to higher cost funds that are willing to share revenue with the provider. Given that institutional-class funds do not share revenue, using a closed-architecture platform severely limits a sponsor's access to them. For more on revenue sharing and various share classes, see #7.

If you don't have access to institutional-class funds, you are likely using a "closed-architecture" solution. Moving to an "open-architecture" platform will afford your participants access to higher quality, lower cost investments.

7 Different Classes of the Same Fund Invest in Different Things

Mutual funds are available to the public in various share classes. For example, the extremely popular PIMCO Total Return Fund is offered in classes A-D as well as I (which stands for institutional).

The composition of each class of a given mutual fund, like PIMCO Total Return, is identical. The only difference among them is the method or sales channel by which they are distributed, and in turn, their fees.

In the retirement plan industry, a practice called revenue sharing is pervasive. Revenue sharing is the use of some of the operating expenses paid to a mutual fund to offset the recordkeeping and administrative charges associated with a plan. Revenue sharing dollars can also be used to pay the broker who sold and/or services the plan.

"A-shares" are typically the most expensive share class of a particular fund. These also tend to share the most revenue with recordkeepers, administrators, and brokers. Historically, this higher revenue share has made them very popular for small to mid-sized plans, because virtually all of the costs of providing the plan can be buried inside the operating expenses of the mutual funds. 92% of plan sponsors use funds with some form of revenue sharing arrangement[3].

By contrast, "I-shares," or institutional-class shares, have no revenue sharing component. No revenue share means that the I-share class of a particular fund will be the least expensive. It also means, however, that a plan offering only I-shares will have to pay for recordkeeping, administrative, and investment consultancy services separately and distinctly from the underlying expenses of its funds.

That's a good thing. Although both the courts and the DOL have opined that revenue sharing in and of itself is not a fiduciary breach, these arrangements can often lead to one.

Recall that one of the questions fiduciaries are required to answer is "Are the fees associated with our plan reasonable?" If a plan's recordkeeping and administrative charges are being paid "behind the scenes" through revenue sharing credits, it's less likely that the fiduciaries of that plan know exactly what their participants are paying for these essential plan-level services. In the recent court case *Tussey v. ABB*, ABB was forced to pay over $35MM in fines for not fully understanding and improperly using revenue sharing credits.

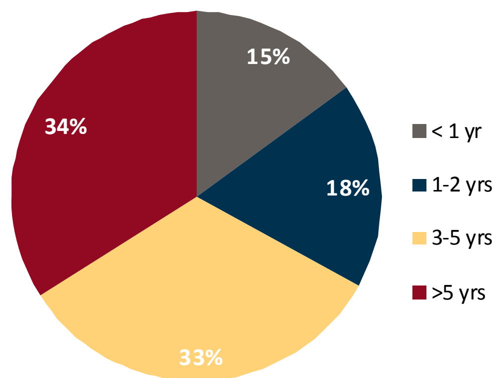
Additionally, plan fees paid through revenue sharing credits may, at any given time, be reasonable. However, given that revenue sharing charges grow with plan assets, what was once a reasonable price to pay for a particular service may no longer be so.

You should avoid revenue sharing arrangements whenever possible. Paying for essential plan-level services with offsets and kickbacks is bound to lead to lower transparency and higher costs for your participants over time.

8 My Provider Benchmarks My Plan for Me

As part of their ongoing fiduciary responsibility, plan sponsors are required by the DOL to have their plans regularly evaluated. A 2-3 year review cycle is customary and sponsors should review both the cost and quality of their plans relative to their respective peer groups. A peer group is comprised of companies/organizations with similar headcount, retirement plan size, and industry focus.

Although the DOL does not offer explicit guidelines on how to conduct a review, it does suggest that it be conducted by an independent 3rd party with access to objective benchmarking data[4].



Source: Deloitte/ICI Study 2011

Many plan sponsors do not engage in this exercise regularly, if at all, begging the question, "How can they assess the reasonability of their plans' fees?"

Others rely on their current platform provider or broker to conduct their reviews. Doing so, presents the opportunity for conflicts of interest, as incumbents may reasonably be expected to skew the results of any benchmarking study to favor their own offering.

As part of the new fee disclosure regulations, sponsors are required to identify and mitigate all conflicts of interest regarding their plans' fees. In order to satisfy this requirement, sponsors should leverage the community of independent retirement consultants to obtain impartial analyses of their plans.

You should benchmark your plan every 2-3 years and that study should be conducted by an independent 3rd party consultant.

9 One Provider Makes My Life Easier

Using a single provider for all plan-level services is known in the industry as bundling. Bundling can bring perceived efficiencies to a plan, and may be cost-effective for plans with less than $1MM in assets. However, bundling is not without its drawbacks.

Specifically, "all-in" cost can be dramatically higher for bundled plans versus unbundled offerings, depending on plan size and demographics (See #7).

Not only are unbundled plans usually less expensive, but they are also modular. With an unbundled plan, a sponsor can replace its investment advisor, recordkeeper, or administrator without having to sever ties with all three.

Additional benefits of unbundling include increased fee transparency and a broader spectrum of investment choices (See #6).

Bundled providers include insurance platforms like ING and MetLife, payroll providers like ADP and Paychex, and certain discount brokerage platforms like Fidelity. Sponsors often utilize these solutions because they are perceived as convenient. However, providers with many different business lines often struggle to excel in each area.

In addition, the DOL has clearly stated that convenience of administration is not an acceptable rationale for selecting or staying with a particular provider.

Unbundling your plan can save your participants money and may lead to better all around service for you as well.

10 A Bigger Provider Is a Better Provider

Sponsors tend to gravitate toward the largest providers in the retirement plan marketplace, like insurance companies and discount brokers. Large providers are often perceived as safer, more reliable choices. But bigger is not necessarily better.

A sponsor should consider more than just size when evaluating their retirement provider. 408(b)2 requires sponsors to determine how much value their participants are receiving from their retirement plan. That means that sponsors must actively seek the best array of services at a given price point.

Local providers, although smaller than many insurance companies and discount brokers, can be a tremendous resource for small to mid-sized plans ($1-25MM).

Plan enhancements that are often uniquely available from smaller, regional providers include:

- **Fiduciary oversight and shared responsibility**
- **Investment Policy Statement creation and maintenance**
- **Investment Committee formation and face-to-face committee meetings**
- **Lower cost, higher quality fund menus, with access to institutional-class shares**
- **Customized employee education and engagement programs**
- **One-on-one participant-level advice**

Receiving more for the same or lesser cost is the definition of enhanced value. To the extent that a plan sponsor can enhance the value of their retirement plan by switching to a local provider, they must do so.

Your provider should be selected on the basis of the value that they can deliver to your participants. If your plan is under $25MM, you can obtain more services and attention for your participants by using a local provider.

Endnotes:

[1]"Private Pension Flows." Board of Governors of the Federal Reserve System: *Flow of Funds Guide 2011.*

[2] 401k Source. *401k Average Book.* Townsend, MD. 12th Edition, 2011.

[3] "Annual 401(k) Benchmarking Study." Deloitte/ISCEBS. December, 2011.

[4]"Meeting Your Fiduciary Responsibility." Department of Labor. July, 2012.

Disclosures:

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Appendix

Comparative Chart of the New Fee Disclosure Regulations

	§408(b)(2)	§404(a)(5)
Description	▸ Provider to Sponsor Disclosure ▸ The exemption that permits plan service providers to be compensated for their services without engaging in a "prohibited transaction" and the associated requirement to disclose that compensation	▸ Sponsor to Participant Disclosure ▸ The requirement to disclose certain plan and investment-related information, including expense and fee information, to participants in participant-directed individual account plans, such as 401(k) plans
Purpose	To assist Sponsors in assessing the reasonableness of the compensation paid for services and any conflicts of interest that may affect a Provider's performance of services.	To give the estimated 72 million participants covered by 401(k)-type retirement plans greater information regarding the expenses and fees associated with their plans in order to help them better manage their retirement savings.
Effective Date	▸ No later than July 1st, 2012 ▸ Sponsors who have not already received their disclosure(s) must request them from their provider immediately ▸ Providers have until Sept. 30th 2012 to comply with Sponsor requests ▸ Sponsors must report Providers to the DOL that do not comply within 30 days of the Sept. request deadline ▸ Sponsors are required to terminate Providers that do not comply	▸ No later than 60 days after the latter of the first day of the first plan year beginning on or after November 1st, 2011, or July 1st, 2012 ▸ For calendar year plans, this means that such initial disclosures must be made by August 30th, 2012 ▸ Sponsors must also deliver quarterly disclosure statements to participants no later than 45 days after the end of each quarter ▸ For calendar year plans, this means that such initial quarterly disclosure statements must be made by November 14th, 2012
Who Must Disclose?	"Covered service providers" who are defined as those entering into a contract or arrangement with a covered plan and reasonably expect to receive $1,000 or more in annual compensation, (direct or indirect) in connection with providing certain plan-level services.	The disclosure obligation falls on the "plan administrator." The plan administrator is the party designated as such in the plan document. Absent any such designation, the Sponsor is the plan administrator.

Source: RidgeWorth Investments 2011

Required Content	▸ Description of services ▸ Statement of fiduciary status (fiduciary or not) for each service ▸ Description of type and manner of all compensation (direct and indirect) ▸ The operating expenses of each investment options ▸ Compensation paid among related parties (commissions & 12b-1 fees) ▸ Cost to sever services	▸ General plan-level information, e.g. trading access, transfer restrictions, etc. ▸ Plan-level fees, e.g. administration, audit, per head count charges, etc. ▸ Individual transaction related fees, e.g. loans, QDROs, brokerage window, etc. ▸ 1, 5, & 10 yr returns of each fund compared with an appropriate benchmark ▸ A chart showing cost per $1K invested for each investment option ▸ All investment-related expenses and any sales charges/loads ▸ Web address for more info
Potential Penalties	If a plan engages in a “prohibited transaction,” the Internal Revenue Code of 1986, as amended, imposes an excise tax of 15% on the amount involved. If not corrected, the excise tax increases to 100%. There can also be other consequences, such as lawsuits against the parties who participated in the prohibited transaction as well as the loss of the plan’s tax-deferred status.	If the Sponsor fails to provide participants with the information the regulation requires, the Sponsor will be deemed to have violated its fiduciary duty under ERISA. In that event, the Sponsor could be held liable for monetary damages to participants for losses they can reasonably be expected to have otherwise avoided had they received the disclosure.
	▸ Evaluate your exposure to the requirements ▸ Evaluate your disclosure obligations ▸ Procure an independent, 3rd party evaluation of your plan ▸ Modify your existing service contracts or implement service contracts ▸ Seek legal advice	▸ Become familiar with the requirements of the regulation ▸ Request a sample copy of your Provider’s disclosure immediately ▸ Prepare to assist plan participants with questions regarding the newly disclosed information

Source: RidgeWorth Investments 2011