On the surface, it may seem like just another onerous, costly government drill: The Department of Labor’s new ERISA (Employee Retirement Income Security Act of 1974) 408(b)(2) disclosure rule. It mandates that 401(k) plan service providers and others furnish plan sponsors with highly detailed transparency disclosures, especially concerning fees—or face enforcement consequences.

But the impact of the new regulations could be market-changing for the entire 401(k) industry.

Though service providers have long been required to disclose fees to participants, many obscured them by burying what employees paid in opaque disclosures. To be sure, many plan sponsors and certainly the majority of participants have been unaware of any “hidden fees.”

The new fee transparency regulation is based largely on a 2007 AARP study of 1,581 participants that found 83% of them unaware of how much they were paying in plan fees and expenses.

The onus of the new rule is chiefly on the extremely competitive service provider space, which for decades has sustained strong price pressure. The fee transparency requirements will only serve to increase that fierce competition.

“The new regulations opened the door for industry leaders to benefit by providing a more compelling case for doing business with them and for laggards to keep their plan sponsor clients in the dark,” So declares an in-depth study conducted by Dalbar, the Boston-based financial services consulting firm, which teamed up with Research to present its findings.

“The leaders that present a value proposition [will] make the firm more attractive to advisors who recommend them and to plan sponsors who select them,” Dalbar notes.

In the extensive study, Top Honors for recordkeepers went to BB&T Retirement and Institutional Services, Great-West Retirement Services, John Hancock Retirement Services, Fidelity Investments and TIAA-CREF Financial Services. The five ranked lowest were First Mercantile, Ascensus, The Guardian Insurance & Annuity Corp., Morgan Stanley (Nationwide) and last, MassMutual.

Fidelity’s disclosure stands out as one of the best in overall presentation by, for instance, using language that a typical plan sponsor would understand. It is apparent that the firm’s approach wasn’t merely to fulfill a paperwork obligation.
“We designed the disclosure to give us a competitive ad- advantage. We’re using it to continue to obtain new business and retain the business we have,” says Krista D’Aloia, vice president-associate general counsel, Fidelity Investments, in Boston. “We tried to make it as intuitive as possible and provide things that aren’t required in order to make it a useful tool.”

The new regulatory regime, which went into effect July 2012, not only mandates transparent disclosures but requires plan sponsors to assess whether or not fees are reasonable for services provided.

Should they be judged unreasonable, plans must notify the provider. If the issue goes unresolved for 90 days, sponsors must then file complaints with the DOL and Internal Revenue Service.

Under the new regulations, enforcement is expected to become aggressive, a big change from the spotty activity of the past. Whistle-blowing is encouraged, and those not complying will be penalized. Sponsors are exempt from “regulatory action,” Dalbar notes, “merely by reporting service provider failures.” That can be conveniently accomplished via an online reporting system.

Based on the technical requirements of 408(b) (2), Dalbar’s Transparency Analysis evaluated and ranked recordkeepers and others according to parameters of: overall usefulness, cost estimates, description of services, fiduciary status and conflicts of interest.

Estimating fees that plans can anticipate paying is of course crucial to sponsors’ assessments. Recordkeepers that expressed estimated costs as an aggregate figure in dollars and showed the bottom line—“the best way to present cost estimates,” Dalbar says—include Principal Financial, TIAA-CREF and Charles Schwab & Co.

The new requirements are intended to protect investors by allowing employers to scrutinize fees on an apples-to-apples basis and help advisors recommend plans. Data drawn from many unconnected areas must be set forth in a single document and sent to the IRS, DOL and Pension Benefit Guaranty Corp., in addition to plan sponsors.

Participants as well as employees eligible to join plans are sent a different disclosure, not as detailed as the plan document but which puts greater focus on investments.

The new regulation could have major impact on advisors, who “must help plan sponsors determine whether or not the fees are reasonable. We hope that when [plans] match up services with fees, they’re not just going to say, ‘Hey, cheaper is better!’, says Sara Richman, vice president-product management, Great-West Retirement Services, which hired Dalbar to verify that its disclosure meets the new rule.

Joe Ready, executive vice president-director of Institutional Retirement and Trust at Wells Fargo, stresses that “assessing reasonableness is a big to-do for plan sponsors and/or the financial advisors that assist in the process.”

While the regs are forecast to result, over time, in a shift of service providers, such changes aren’t likely to occur at the initiation of plan sponsors themselves.

“They see the expanded powers as a burden that detracts from their primary business,” says Louis S. Harvey, Dalbar’s president-CEO. “But advisors will come knocking at the door, and regulators will soon follow. These forces will certainly lead to changing plans because of fees.”

He continues: “Becoming embroiled in a regulatory hassle holds little appeal for a human resources manager, benefits manager or CFO. Only concern over liability will force them to take steps to enforce the DOL regulations.”

So far, “there has not been a mass exodus” from providers, says Kevin Crain, head of institutional retirement and benefits services at Bank of America-Merrill Lynch, based in Hopewell, N.J. “But in two or three years you could see a pickup in activity of plans making provider changes.”

This means that sponsors will be relying more heavily on financial advisors to justify fees, and to compare and choose service providers.

ERISA’s 408(b) (2) has been years in the making. It was prompted partly by class action lawsuits against plan sponsors and service providers brought since 2006. These suits focused largely on revenue sharing. In the new disclosure requirements, revenue sharing is included under “Conflicts of Interest.”

“Revenue sharing is that the expenses of the fund have been subsidizing the administrative costs of the plan,” says Ed O’Connor, managing director-retirement services at Morgan Stanley Wealth Management, in Purchase, N.Y. “Generally, plan sponsors like that because they want to show employees fund performance, not account fees being charged.”

O’Connor adds: “But if the rule leads to no revenue sharing, and fund expenses do not subsidize administrative costs, what we’ll have are account fees, with participants paying directly for things like online series.”

The 401(k) industry grew up based on insurance companies packaging mutual funds with a recordkeeper and a third party administrator, and sold as a lump.
“The firms weren’t trying to be nefarious. Plan sponsors weren’t colluding with service providers on hidden fees. This is just the way these products developed,” says Celia Rafalko, managing principal-CEO of Piedmont Independent Fiduciaries, in Richmond, Va., an investment advisor and asset manager to service providers. “It’s the norm—layers of costs that were not apparent. It was very difficult to parse out where all the money was going, and it continues to be.”

However, adds Rafalko, former chief administrative officer of Wachovia Securities’ financial services group, “as technology improved and options changed, more and more companies have started to develop a focus on full transparency.”

A goal of the new rule, according to Dalbar, is to help plan sponsors “identify situations where service providers have a vested interest in an outcome that may not be in the best interest of plan participants. The best practice has been to disclose potential conflicts of interest clearly … including steps that protect the interest of participants.”

Dalbar singled out disclosures from TIAA-CREF and Merrill Lynch, Pierce, Fenner & Smith as examples of achieving that.

“We leveraged the broader experience of the Bank [of America] with conflict-of-interest rules to guide us in our approach to this issue,” Merrill’s Crain says. “We’re a large financial services firm with a broad array of products, so adherence to conflict rules is a key focus.”

The new rule gives plan sponsors power to hold service providers accountable. But Dalbar points to “major flaws,” among them: “Service providers are permitted to retain incomprehensible disclosure language.”

That surely presents a big stumbling block to meeting the fee disclosure document’s key objective.

Rafalko, in her capacity as consultant, has read disclosures from 30 firms.

“It’s kind of terrifying!” she says. “I understand that companies want to make sure they’re covering all their risk, but they’re doing it in a way that obfuscates the point of the exercise.”

Still, some are doing it the right way. Dalbar gives kudos for services descriptions to BB&T; TIAA-CREF, Great-West and Wells Fargo Institutional Retirement and Trust.

“We educated people on where participants’ dollars are going,” says Great-West’s Richman, based in Denver. “Which entities are taking the money and what that means as dollars is something really new and useful to the plans.”

Wells Fargo’s Ready notes: “The regulation says we have to disclose all the services, roles and fees. We take it a step further and do the math. We boil it down to a one-page summary worksheet with a detailed breakdown of fees and services at both dollar and basis point levels. Then we provide a retirement readiness index.”

BB&T’s disclosure has a unique summary of plan services with a succinct explanation of each plan-option’s benefits for both sponsors and employees. John Hancock opens with a three-page outline of services and a hard-to-miss presentation of costs and compensation. TIAA-CREF uses reader-friendly language and includes an educational introduction.

Other mandated information zeroes in on the critical issue of fiduciary responsibility. But the new government directive concerning that is “cloaked in mystery,” Dalbar says, “since, technically, only fiduciaries are required to make a disclosure.” Therefore, when not stated, plan sponsors have no way of knowing if a service provider is or is not a fiduciary. That information, for example, could have been left out accidentally.

Merrill Lynch’s disclosure, positioned prominently, makes a clear statement of fiduciary responsibility; and Paychex and Morgan Stanley (Nationale) each received perfect scores for the quality of its fiduciary disclosures.

This is a section, though, on which some recordkeepers need to brush up. Wells Fargo, for instance, uses asterisks to indicate fiduciary status but left unmarked services for which the firm does not act as a fiduciary. Dalbar deemed Great-West’s and Fidelity’s disclosures “Obscure” because they “require legal or mathematical analysis or multiple documents,” and MassMutual’s fiduciary status got a poorly rated “Omitted” because no reference was indicated.

With fee comparison now a reality, price compression is certain to accelerate. Crain says the rule makes plan sponsors “educated consumers about what they’re paying for. They can either say, ‘I’m comfortable with it’ or ‘Now that I’ve got this information and have looked at the market, things need to change.’”

“In previous years,” Crain notes, “they didn’t even understand where they were in terms of fee structures. Now plans will challenge service providers to drop fees. They’ll say, ‘Do you want to lose this plan if you don’t drop them?’ The provider may say, ‘I can’t afford to do that,’ and the plan will move.”

Further, today’s bundled fees could be unbundled in due course. “In some cases, that will reduce fees; but in others, it
might actually increase them, depending on the services that are wanted,” Ready notes.

In the months preceding 408(b) (2)’s implementation, smart service providers educated sponsors and others on the new documentation to come. Fidelity talked it up in client meetings and on webcasts. Merrill trained financial advisors, launched webinars and reached out to specific clients. Great-West even produced a video for plans, “Clarity in a Complex World,” explaining that the firm’s fee disclosure goes beyond simply what is required.

Despite the intent, all the work and considerable cost involved in compliance with the new regs, some experts predict that meaningful results will be minimal.

“The rules are certainly needed, and everything they require will be done; but they won’t have much effect,” says Saul Nirenberg, whose eponymous New York City firm advises sponsors on specific plans and how to select advisors. “ERISA will be pleased with itself, service providers will have another layer of protection and individuals will be right where they are now. Uninformed.”

He continues. “The majority of companies are content to turn everything over to their service providers. They don’t want to embark on programs to help employees make the right choices. They defend this non-action by saying they may get sued if things go wrong. But companies need to start taking their employees’ welfare more seriously.”

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