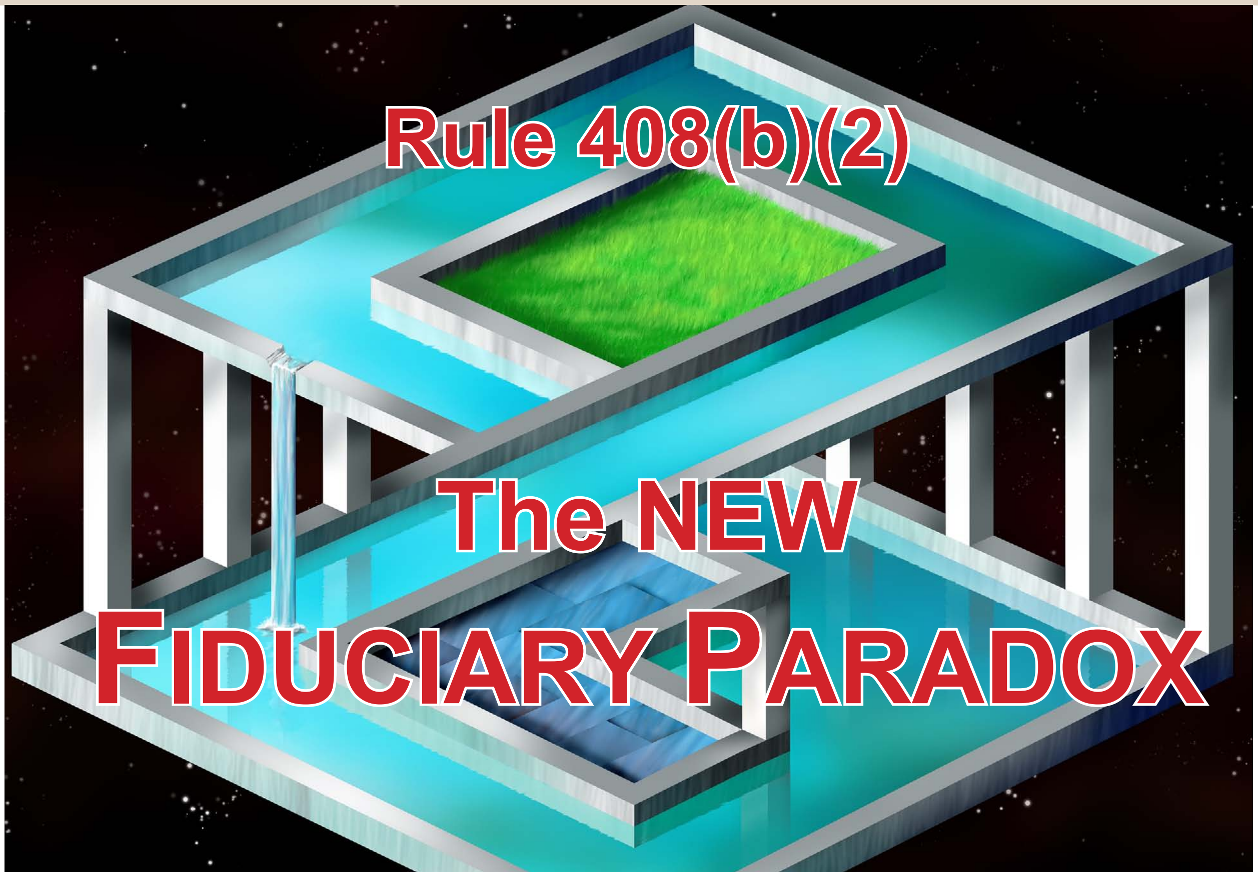

By Mark D. Mensack

Eighteen months ago, after many stalls and starts, the 401k Industry was bracing for the amended Rule 408(b)(2) to take effect. Many believed that the new Fee Disclosure Rules, 408(b)(2) & 404(a)(5), would provide a panacea for eliminating hidden or hard-to-find 401(k) fees. However, as noted by the Employee Benefit Research Institute, "many haven't noticed 401(k) disclosures, most haven't made changes."[1]

In a nutshell, what are these new rules?

First, it's important to understand that Rule 408(b)(2) is not new. What is new, is the amendment to Rule 408(b)(2). Plan sponsors have always had the fiduciary duty to: understand all fees being paid by their plan; identify all compensation received by their service providers; and to ensure that those fees and compensation were reasonable relative to the services being provided. However, what Rule 408(b)(2) did not require was for service providers to disclose all of their fees and compensation the plan sponsor required in order to comply with Rule 408(b)(2).

The "fiduciary paradox" occurred when a plan sponsor attempted to fulfill the requirements of 408(b)(2), while their 401(k) service provider was under no legal obligation to disclose any or all

1 http://www.ebri.org/pdf/FF.239.FeeDisc.25July13.pdf

of the fees and indirect compensation they received. Theoretically, the requirements of 408(b)(2) eliminate the fiduciary paradox.

Indirect compensation, sometimes known as "revenue sharing," is compensation paid by one service provider to another service provider of the same plan. In some cases, like the one described below, the service provider might use opaque or incomprehensible language within a contract or proposal, and thereby claim they made adequate disclosure. But in other cases, the service provider might refuse to make any disclosure at all. For example, a response I once received was: "That is proprietary information. We have no obligation or desire to share it with anyone, including you."

The Department of Labor (DOL) intended the amended Rule 408(b)(2) and Rule 404(a)(5) to complement each other, with a goal of having service providers disclose all fees and compensation to both plan sponsors and plan participants. Among other requirements, 408(b)(2) requires "Covered Service Providers," or CSPs, to disclose all plan-level fees as well as all compensation received relative to the plan. The rule also requires plan sponsors to evaluate the reasonableness of those fees relative to the services provided, and to take action should those fees not be reasonable.

You're Taking Money from MY Account?

Rule 404(a)(5) was intended to shed even more light on 401(k) fees by requiring that plan sponsors provide quarterly and annual fee disclosures to all participants such that all participants understand how much of their 401(k) money will derive from their own accounts to pay these fees and compensation.

A 2011 AARP study found that 71% of the 72 million Americans currently invested in a 401(k) plan don't know that they are paying <u>any</u> 401(k) fees.[2] This is largely due to the fact that so many 401(k) products bury fees deep within fine print or obscure them in complex formulas or percentages. Rule 404(a)(5) requires that participant disclosures be made in "dollars and cents that can be compared to their mortgage, rent, car payments or what they spend on vacation."[3]

Now imagine an employee's reaction if a plan turns out to be what Steve Woolley describes in a Forbes article as a "Retirement Plan from Hell."[4] Woolley states that within the contract for a particular 401(k) product the service provider can "skim off up to 5% of assets before the remains go to work for savers." He also notes that "'trailer' commissions of up to 1.4% of assets annually for as long as the plan exists and 'asset charges' of up to 4%" can be imposed. While every service provider is rightly entitled to charge a fee for services it legitimately provides, there is a line across which fees become unreasonable. The Department of Labor notes that a 1% difference in fees over the average American's 35-year working career could reduce that person's retirement nest egg by as much as 28%.[5] This sort of pilfering ought to get the attention of even the least investment savvy employee.

What are the odds that you have this sort of plan? One of the service provider Wooley describes boasts that it is "One of the largest full-service providers of 401(k) plans across all plan sizes among life insurance companies, mutual

2 http://assets.aarp.org/rgcenter/econ/401(k)-fees-awareness-11.pdf
3 http://401(k)feedisclosure.dalbar.com/upload/AGameChanger.pdf
4 http://www.forbes.com/forbes/2009/0713/group-annuity-aig-retirement-plans-from-hell.html
5 http://www.dol.gov/ebsa/publications/401(k)_employee.html

fund companies and banks," providing "Service to more than 44,000 plans and almost 1.7 million participants."[6]

Unfortunately, a 2013 Retirement Confidence Survey found that "about half (53 percent) of defined contribution plan participants" were aware of these new fee disclosures. Moreover, despite the fee disclosures, only "7 percent of all plan participants" made any changes to their investments.[7]

The Unintended Consequence

Simply put, with 408(b)(2), the Department of Labor was trying to force plan sponsors to engage in the fiduciary process and identify unreasonable fees and compensation. In the event that plan sponsors failed to engage, the expectation was that 404(a)(5) would cause employees to complain thus putting pressure on plan sponsors focus on fees.

Based upon the reasonable assumption that fee transparency will allow competitive market forces to drive 401(k) prices down, the Department of Labor has stated: "Over the ten-year period 2012-2021, the Department estimates that the present value of the benefits provided by the final rule [408(b)(2)] will be approximately $14.9 billion…"[8]

While theoretically, the amended Rule 408(b)(2) eliminated the fiduciary paradox, in reality it created an entirely new fiduciary paradox. Although common sense dictates that the DOL, or some state or federal agency, would be responsible to ensure that service providers comply with 408(b)(2), this is actually not the case. Under the new rule, it's the plan sponsor's responsibility to ensure that its CSP complies with 408(b)(2)! Paradoxically, the hen must ask the fox if the chicks are safe.

The new fiduciary paradox lies in the fact that 408(b)(2) requires plan sponsors to ensure that the experts upon which they so often rely to comply with 401(k) requirements, are in fact complying with the new requirements of 408(b)(2). Particularly in the under $100 million market, plan sponsors rely heavily on the expertise, or purported expertise, of their CSPs in order to understand and fulfill their fiduciary responsibilities as a plan sponsor. According to Jeff Mamorsky, one of the original authors of ERISA, the "burden of having to reasonably believe that service providers disclosed the requisite information is of great concern." [emphasis added][9]

I suggest "purported" expertise because while most CSPs perform non-fiduciary tasks and clearly indicate that they are not fiduciaries, some do mislead plan sponsors into a false sense of fiduciary security. Scott Simon, author of Morningstar's Fiduciary Focus Column and winner of the 2012 "Tamar Frankel Fiduciary of the Year Award," describes these CSPs as "phantom fiduciaries."[10]

Phantom fiduciaries talk like a fiduciary and even walk like a fiduciary, but in the fine print of their contract they eviscerate any true fiduciary responsibility. Simon notes, "They get to throw around the word "fiduciary" — without being on the hook for any real fiduciary responsibility (and therefore liability) to plan fiduciaries."[11] Whether intentionally or not, phantom fidu-

6 http://www.johnhancock.com/products/401(k).html
7 http://www.ebri.org/pdf/FF.239.FeeDisc.25July13.pdf
8 http://www.dol.gov/ebsa/pdf/frparticipantfeerule.pdf
9 http://www.cfomagazine.com/article.cfm/14639870/1/c_2984347?f=archives
10 http://advisor.morningstar.com/articles/printfriendly.asp?s=&docId=4432&print=yes
11 Ibid.

ciaries are pervasive. A 2010 survey found that among investors queried, 76% mistakenly believed that financial advisors are held to a fiduciary standard.[12] As someone who has spent fourteen years as a non-fiduciary financial advisor, I want to make it clear that I am not disparaging any individual financial advisors. Individual advisors don't create contracts, marketing materials, or 408(b)(2) disclosures; it is the firms that train—and sell products through—individual financial advisors, that do so. For an example of a common marketing gimmick used by phantom fiduciaries, and offered by the same service provider referenced in Woolley's article, see the discussion of fiduciary warranties in Caveat Emptor for 401(k) Plan Sponsors.[13]

You Can't Be Serious?

Mary Rosen, Associate Regional Director of the DOL's Employee Benefit Security Administration, in response to the question, "Can't a plan sponsor just rely on the CSP's disclosures?" replied that "The whole idea is to go through a prudent process and make sure that everything is reasonable." She concluded her response with, "So I guess a short answer to the question is no, a plan sponsor cannot rely on service providers."[14]

Not only are plan sponsors responsible for ensuring CSPs have disclosed all required fee information, but we're already seeing a game of "catch me if you can" among some CSPs. Dalbar, Inc., the nation's leading financial services market research firm, has commented, "Regulations permit disclosures that are a patchwork, requiring plan sponsors and participants to do a scavenger hunt without the clues to put the pieces together."[15]

Dalbar Founder and President, Louis S. Harvey describes three types of 408(b)(2) disclosures, which I label as spirit of the law, letter of the law, and business as usual or needle in the haystack.

The "spirit of the law" type is like a baton: "Based on an understanding of what plan sponsors are required to do, the service provider presents the required disclosure in an easily understood format that can be used directly to fulfill the plan sponsor's obligations under both 408(b)(2) and 404(a)(5)."[16]

The "letter of the law" type won't help you win any races because it only "consolidates existing language and tables from various sources into a single document, thus requiring the plan sponsor to navigate the legal and technical language to assess reasonableness."[17]

The "business as usual" or "needle in the haystack" type "does not present the relevant information in one place but instead list a number of references, prospectuses, websites, plan documents, etc., where the plan sponsor can search for answers."[18]

Seriously, How Bad Can It Be?

Craig Freedman, Managing Director of the Retirement Readiness Institute in Boca Raton, Florida has conducted dozens of 408(b)(2) fee assessments and comments "many vendors are going to go down kicking and screaming before

12 http://www.fpanet.org/docs/assets/3FE57198-1D09-67A1-ACB5B3E363E33CB2/091510FiduciarysurveynewsreleaseFINAL4.pdf
13 http://www.wealthcarecapital.com/ruminations/wcwjournal/112013/WCW-November-2013.pdf
14 http://www.dalbar.com/Portals/dalbar/Cache/Erisa/408b2PlanSponsorSolutionsPartD.pdf

15 Quoted from the Dalbar Fee Disclosure Evaluation and Certification Course
16 Personal conversation with Lou Harvey, September 2, 2012
17 Ibid.
18 Ibid.

succumbing to full transparency."[19]

Freedman's rather strong opinion certainly seems accurate given the findings of a study conducted by Dalbar. What follows is an excerpt from a Morgan Stanley/Nationwide disclosure which ranked second to last in the survey.[20] This paragraph appeared under the heading, "Payments from other service providers." In other words, compensation received by the CSP:

"In 2011, when viewed in relation to total (name of firm withheld) client assets of in excess of $1.6 trillion, the payment made by each such service provider… equaled an amount of not more than 31/10,000 of one basis point (otherwise expressed, 31/1,000,000 of one percent). We do not believe that such payments were made in connection with retirement plan business specifically, and were certainly not made in connection with any particular retirement plan, but, for perspective, the amount of retirement plan assets included in the total (name of firm withheld) client asset number set forth above is approximately $112 billion."[21]

Keeping in mind that the plan sponsor is supposed to depend upon this information to make a judgment call that might potentially incur serious repercussions, what level of confidence should one have in a disclosure stating: "We do not believe that such payments were made in connection with retirement plan business specifically." [emphasis added] This statement creates confusion and begs the question of why it was included in a retirement plan fee disclosure if the service provider does not believe it has anything to do with retirement plan business.

Putting that concern aside, the first challenge with this disclosure is finding a 13-digit calculator to do the math. The second challenge, for me at least, was knowing how to convert "31/1,000,000 of 1%" into a decimal. Since it appears to be such a miniscule number, some might not even bother to find out, but as a decimal it becomes 0.00000031. After borrowing a statistical calculator I determined that $1,600,000,000,000 x 0.00000031 = $496,000. I am not suggesting that this compensation is reasonable or unreasonable; however, I am reminded of the words of Chief Joseph of the Nez Perce tribe who said, "It doesn't require many words to speak the truth."

Saving the Worst for Last

If a CSP is kicking and screaming there are a limited number of ways for the plan sponsor to win the game:

If the CSP fails to provide any disclosure, provides incomplete disclosure, or if additional information is needed to determine compliance with 408(b)(2), the plan sponsor must demand it from the CSP.

If the CSP fails to provide this information within 90 days of the request, the plan sponsor must report the CSP to the Department of Labor. According to nationally recognized ERISA attorney Fred Reish, plan sponsors must also "fire their advisors if they fail to provide information regarding fees and information about their 401(k) plan within 90 days of a written request." [22]

If a plan sponsor fails to evaluate the disclosures, fails to identify unreasonable compensation in a

19 Personal conversation with Craig Freedman, January 31, 2013
20 http://www.thinkadvisor.com/2012/12/20/401k-fee-transparency-best-worst-providers?utm_source=compliance10413&utm_medium=enewsletter&utm_campaign=compliance&page_all=1
21 This excerpt is from page 7 of a national wire house 408(b)(2) disclosure provided to plan sponsors utilizing a specific insurance company's 401(k) product.

22 http://www.riabiz.com/a/11293644/dol-tells-employers-when-they-must-fire-advisors-to-401(k)-plans

disclosure, or fails to take the required actions in the scenarios above, the plan sponsor will be liable for having participated in a prohibited transaction — for which the penalties and fines can be significant, and for which the plan sponsor can be held personally liable.[23]

While it might appear that many plan sponsors will be caught in this new fiduciary paradox, there is, and always has been, one ace-in-the-hole available to every plan sponsor — a prudent process. As stringent as ERISA can be, the courts have typically protected fiduciaries so long as they adhered to a well-documented, prudent process in making decisions. Even 408(b)(2) provides an exemption for a plan sponsor in the event that he or she was not aware of any failure by a CSP and reasonably believed that proper disclosures were made. It is unlikely that a court would accept a "reasonable belief" argument without documentation of the prudent process the plan sponsor used in reaching reasonable belief.

While some plan sponsors might find all of this tedious and overwhelming, the following ought to provide motivation not to ignore 408(b)(2). Charles Humphrey, Employee Benefits & ERISA Counsel for Fiduciary Plan Governance, LLC. explains that "the potential downsides of a DOL finding of failure are quite significant including personal liability for losses to the plan and prohibited transaction excise taxes."[24]

Moreover, while plan sponsors are prohibited from relying on their service providers to fulfill their responsibilities under 408(b)(2), ERISA *not only allows*, but suggests that "Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert."[25] While a plan sponsor must be cautious of "phantom fiduciaries" who claim to be qualified, independent experts, there are truly qualified, independent experts who work with plan sponsors to ensure they are compliant with their fiduciary responsibilities including both Rules 408(b)(2) and 404(a)(5).[26]

Conclusion

While the new fee disclosure rules are a step in the right direction, placing the onus of enforcement on plan sponsors just causes a new paradox. Although it might be reasonable for an inexperienced plan sponsor to engage an independent expert, now that inexperienced plan sponsor must identify a second expert to ensure the first expert is expertly performing their responsibilities. In other words, despite the panacea of 408(b)(2), plan sponsors and their employees acting in a fiduciary capacity, the touchstone is still CAVEAT EMPTOR!

23 http://www.law.cornell.edu/uscode/text/29/1109
24 http://www.fiduciaryplangovernance.com/the-dol-plan-investigation-408b2-style-why-not-prepare-for-the-investigation-before-you-get-that-nasty-notice-letter/
25 http://www.dol.gov/ebsa/regs/aos/ao2002-14a.html
26 For example: http://www.fiduciaryplangovernance.com/prudent-suite/

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