Avoiding Pitfalls of New DOL Disclosure Regs

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Lou Harvey

is the founder and president of **Dalbar**, a consultancy and research firm that tracks customer service in the mutual fund industry.

Starting on July 16, 2011, the definition of a reasonable 401(k) plan will no longer mean that a plan has to compare favorably on the basis of all-in costs. Under the final 408(b)(2) regulation, service providers will be required to disclose detailed information about the compensation that they receive from each plan sponsor. The regulation follows concerns that retirement plans, particularly those with scarce resources, have had difficulty getting information on what constitutes reasonable compensation to recordkeepers, mutual funds or financial advisors. That information is seen as key to helping plan sponsors understand whether they are paying an appropriate price for rendered services, and thus acting in their plan participants' best interest. The regulation will compel plan sponsors to weigh a service provider's value against three main variables: service, fiduciary status and associated fees. The Department of Labor (DOL) has defined these three elements as a basic requirement to meeting Erisa regulations (the DOL can scrutinize a plan sponsor's record on selecting vendors on those factors when compared to other plan sponsors). Plan sponsors will then be required to determine if the service provider is performing adequately in terms of providing necessary services, charging reasonable fees, and acting as a fiduciary… and failing to do so could lead to disqualification of the plan!

While the direct liability is to the plan and its fiduciaries, mutual fund companies are also involved to the extent that they provide services including investment management, recordkeeping, administration and advice. In redefining what is reasonable, the DOL has created pitfalls that reach beyond the visible changes to systems and the addition of more paperwork required to report these details to each and every plan. By requiring that plan sponsors consider all three of these elements, disparities that are not discernible today will become evident. Three such pitfalls can be anticipated, and investment firms can benefit by having a plan in place to respond to them.

Trap 1: Necessity for Service

In evaluating each service, the plan sponsor will be expected to establish the need for that service, how it benefits participants, and whether or not the provider must be a fiduciary. It will also need to examine whether the fee charged is comparable to others in the industry. The evaluation will require new benchmarks that compare plan costs for each category of service. These new benchmarks and the review by plan sponsors will raise questions that threaten current business arrangements.

Diligent plan sponsors will certainly question the payment for services that do not have an obvious benefit. Among the most likely to be questioned could be 12b-1 fees for distribution services. When buried in the pages of the prospectus of each fund in a plan's lineup, distribution services remain unnoticed, but an explicit disclosure is likely to raise serious questions. The effect will be for the plan sponsor to change the share class to avoid the expense.

The best defense against this eventuality is to ensure that plan sponsor clients understand the specific services being provided. Attempting to explain prospectus language is futile. Instead, providers receiving 12b-1 fees should review the specific services being provided to each plan sponsor. Providers should then make sure that the disclosure document explains how each fee serves the needs of both the plan sponsor and participants.

Trap 2: Allocation of Recordkeeping Fees

Another likely area of concern will be recordkeeping fees. Bundled providers are faced with a dilemma of comparability. If the recordkeeping fees are minimized by including only very basic services and excluding costs such as relationship managers and client service, the costs in other areas such as investment management will appear inflated. The seemingly inflated cost will cause some plan sponsors to seek an unbundled alternative. On the other hand, if recordkeeping costs are in fact inflated, some plan sponsors will consider switching recordkeepers.

Recordkeepers and bundled providers are best served by reaching a consensus on what will be included and excluded from recordkeeping costs. It would be folly to expect such a definition from the regulators. Industry participants can independently decide on standards for recordkeeping that prevent costly disruption in 2011.

Trap 3: Disclosure of Non-Fiduciary Status

A third area of concern is non-fiduciary advisory services. Non-fiduciaries who walk the thin line between education and advice may have difficulty explaining why their disclosure describes the service as non-fiduciary education. Surveys show that many plan sponsors believe, wrongly, that they are receiving fiduciary services. These plan sponsors will be surprised to discover that the expert they rely on for investment advice has not been acting in a fiduciary capacity. This discovery can lead plan sponsors to seek investment advisors that do act in a fiduciary capacity. This disclosure has the potential to disqualify thousands of registered representatives who are unable to act as fiduciaries.

This third pitfall can be avoided by resolving the fiduciary status of advisors who expect to make investment recommendations. Advisors need to be trained and registered as fiduciaries and approved by their broker-dealer in advance of the disclosure date. The issue here is not the regulatory definition or requirement but what plan sponsors expect. In view of these expectations, it is detrimental to business if a plan sponsor can only rely on the advisor's plea to "trust me!"

These three possible pitfalls can be avoided by taking action in advance of the July 2011 deadline. There is not much time to address them, so action on these important issues needs to occur sooner rather than later.