The Black Box of 401(k) Expenses

By Kerry Pechter *Tue, Jun 19, 2012*

The experts--Louis Harvey of Dalbar, Mike Alfred of Brightscope, David Witz of PlanTools, Phil Chiricotti of CFDD, Jonathan Leidy, CFP, and Tussey v. ABB attorney Jerry Schlichter--talk about what the 401(k) fee disclosure rules will mean.

In an ideal world, perhaps, every 401(k) plan sponsor would choose low-cost funds, participants would pay a flat fee for recordkeeping, advisory costs would be prominent and fiduciaries in shining armor would slay the dragon of revenue-sharing for once and for all.

In other words, the black box of retirement plan fees would open wide and the sunlight of disclosure would disinfect all of its darkest, dankest corners.

The 401(k) fee disclosure regulations, 408(b)(2) and 404(a)(5), which the Pension Protection Act of 2006 created, which the Obama administration fine-tuned and which will finally take effect on July 1, won't achieve that ideal. The flaws of the 401(k) part of the defined contribution system—composed of some 400,000 plans ranging in size from a single person to tens of thousands—aren't so easily corrected.

But the new regulations are bringing—and have already brought—significant improvement, a number of 401(k) experts told *RIJ* in recent weeks. Here's what knowledgeable observers are saying about what the new regulation aims to do, what it has already accomplished, and how it might fall short of its ambitions.

Targeting the outliers

The Department Labor aims to make the 401(k) system operate more efficiently and transparently and to ensure that there's less fee attrition so that plan participants reach retirement with larger nest eggs that produce more lifetime income.

To get there, the DoL is requiring fees to be more visible—to recordkeepers and fund providers, to consultants and plan sponsor advisors, to plan sponsors and participants and to the DoL—and insisting that fiduciaries do their jobs and protect participants' interests.

It's generally agreed that high fees are mainly a problem at small plans. The average annual all-in expense ratio for the 72 million 401(k) participants is 1.30% a year. But the GAO recently found that small plans spend an average of 1.33% of plan assets on recordkeeping and administration alone, while large plans average only 0.15%.

With regard to total annual spending on 401(k) plans, the DoL's goal is fairly modest. According to a report from Dalbar, the present value of the savings DoL hopes to achieve over 10 years is just $14.9 billion—in a

$3 trillion industry where direct fees from participants alone amount to about $40 billion a year.

"The philosophy is to identify the egregious outliers," said Louis Harvey (below, right), president and CEO of Dalbar, which published a report last February called, "404(a)(5) A Game Changer?" Nowhere have I seen [the DoL] focus on overall lowering of revenue for everybody.

"The DoL could never have said, 'We're going to lower the average participant expense ratio to 1.2% from 1.3%.' Imagine the ruckus that would cause. But there are participants out there who are paying 300 basis points a year. So, strategically, the government is targeting the outliers and saying that these are the 'excessive' fees that we're going to recapture."

Revenue sharing will survive

Much of the opacity of the 401(k) fee structure arises from revenue-sharing relationships between fund companies and other service providers, but the new fee disclosure regulations aren't eliminating revenue-sharing, and probably won't get eliminate 100% of the opacity that goes with it.

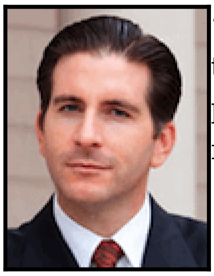
Anybody who's familiar with how fees work in annuities can easily understand how revenue sharing works in 401(k) plans. For instance, if a commissioned broker sells an A share variable annuity to a client, the client has to pay the broker a direct, up-front and very palpable commission.

But when same broker sells a B share variable annuity, the insurance company pays the commission to the broker. The client might feel like he paid no intermediary fee, but the insurer earns the commission back by adding about 100 basis points to the annual so-called mortality and expense risk charge that the client is charge each year.

Revenue sharing in 401(k) plans works in a similar way. A plan sponsor or the plan sponsor advisor can choose from several classes of the same mutual fund, each with a different expense ratio. "R1" shares are the most expensive, and "R6" funds—the equivalent of no-load, no 12b-1 fee funds—are the cheapest. (See example of R1 to R6 shares of an American Fund.)

The difference is that much of the asset-based fee of the R1 share–collected from the participant's account by the fund company–may be paid to the plan providers—the broker who sold the plan, consultants to the plan sponsor, the recordkeeper, or a third-party administrator—as compensation for their services.

"Why would anyone select an R1 fund (or R2-R5, for that matter) over an R6? The short answer: to bury fees. Those that sell American Funds R1 shares can use the healthy 12b-1 fee [the fees that mutual fund providers are allowed to deduct from the fund for marketing purposes] as an offsetting credit towards plan-level expenses," wrote Jonathan Leidy, CFP, in *Fiduciary News* last March.



"Since fund fees are deducted daily, prior to fund pricing, participants never actually see the 12b-1 fees being debited. In this way, plan sponsors can offer participants a retirement plan that appears low or even 'no cost.' Of course, invisible is not that same as free. But many sponsors prefer this more opaque billing methodology," Leidy (at left) ventured.

There's nothing illegal about revenue sharing. It's a legitimate way to charge the plan participants for the cost of the plan. But it makes costs much less conspicuous and therefore less prone to monitoring. It leads many sponsors to believe the plan is free and leads most participants to believe that their 401(k) plan is a "benefit."

Revenue sharing can be especially inconspicuous if the fund company and the recordkeeping company are the same company. Other problems may arise. The incoming revenue from the fund company might be applied to various service providers in non-transparent ways. When the shared revenue exceeds the recordkeeping and administrative expenses, there might not be a transparent mechanism for rebating the excess back to the plan or to the participants.

Ultimately, it would be as difficult to ban revenue sharing in 401(k) funds as it would be to require all variable annuity contracts to be no-surrender charge contracts. It is revenue sharing that allows commission-based brokers to sell 401(k) plans to companies. Currently, different kinds of intermediaries are paid in different ways to sell plans—just as different kinds of advisors and brokers sell deferred annuities–and to ban revenue sharing would be favor one type of 401(k) intermediary over another.

Opacity may remain

The 404(a)(5) disclosure rule may not shed light on all of this. Although the rule requires that the participants' quarterly statements carry a "dollars and cents" expression of the costs that they pay, RIJ was told that plan providers can still merely reveal the "cost per thousand" that the participant pays while putting recordkeeping charges in a separate document that the typical participant won't bother reading.

"I still think there's a lot of opacity going on in those disclosures," Leidy told *RIJ* in an interview. "I've seen some disclosures, even in the part that the participant sees, that say, 'Refer to the recordkeeping agreement.' That's not in the spirit of consolidated fee disclosure."

"The way they've written the rule, you can dodge a bullet by using an investment fund that has a heavy expense ratio to cover services," said David Witz (right), managing director at PlanTools LLC and Fiduciary Risk Assessment LLC in Charlotte. "Most people will not be inclined to multiply the cost-per-thousand by their account value. Most people don't know how to calculate a tip in a restaurant. There's a lot of speculation about why this loophole was not closed."

“Frankly, there are some companies that are planning to make their quarterly disclosures in such a way that you have to be Sherlock Holmes [to figure out what you’re ultimately paying],” said Louis Harvey of Dalbar.

“But if your account is charged directly [for administration or recordkeeping, for instance], then the charge must appear in dollars and cents in your disclosure,” he added. “If those charges come out of your investment fees, that fact has to be disclosed. It is questionable whether or not that disclosure will be in dollars and cents. Good guys will show you the dollars and cents. Those who are less forthcoming must still document the fact that the [recordkeeping fees] are being paid by a mutual fund, but they could theoretically write, ‘See prospectus for details.’”

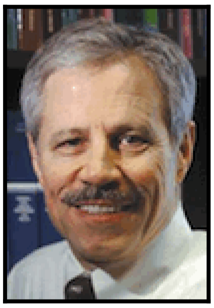
Ironically, the most forthright providers may not be rewarded for transparency, Witz told RIJ. “The [plan sponsor] advisors who are using open architecture with [low-cost] institutional funds are potentially the victims of the unfair assessment that their fees are too high. If I’m the guy who’s fully disclosed, it might look like I’m charging more when I’m just disclosing more.”

“If you are a plan broker [who is] paid through 12b-1 fees, the participant will never see that,” Mike Alfred (below, left), co-founder and CEO of Brightscope, which benchmarks and publishes 401(k) plan fees, told *RIJ*. “It will look as if the broker is providing a free service. If you’re an RIA [registered investment advisor] the fee will show up. That’s an issue that we’ve heard more people talking about.

“The other issue is transaction [i.e., fund trading] costs,” he added. “We believe that transaction costs are a real cost and should be disclosed. But there’s no industry standard for that. The fund industry wants those costs to be baked into fund returns and not be visible. So fee disclosure isn’t perfect.”

The disclosure rules will not do away with the practice of charging a variable, asset-based fee for a relatively fixed expense like plan recordkeeping. “Recordkeeping is a commodity service. The account value has nothing to do with the cost of recordkeeping. You should get a flat rate. Maybe it’s $40 per person per year,” said Jerry Schlichter (below, right), the St. Louis attorney who on March 31 won a $35.2 million class action lawsuit, Ronald Tussey versus ABB Inc., where a federal judge held that a plan sponsor was liable for selecting an expensive fund share with no justification.

Another unresolved grey area in the disclosure landscape concerns non-monetary compensation. In a recent broadcast letter, ERISA expert Fred Reish wrote, “Of particular concern is the requirement that the disclosures include both monetary and non-monetary compensation.



For example, where a mutual fund family or insurance company subsidizes broker-dealer or RIA conferences for plan sponsors or advisers, there is at least an issue of whether those subsidies should be disclosed to the plan sponsor clients of those RIAs or broker-dealers. Another example is where a mutual fund complex or insurance company pays for advisers to attend conferences.”

David Witz described the sorts of pay-to-play arrangements that may or may not be disclosed as a form of compensation to plan intermediaries. “Broker-dealers receive gobs of money from mutual fund companies and vendors to attend conferences,” Witz told *RIJ*.

“I’ve had a broker-dealer say to me, ‘I’d love to make you preferred provider. Can you give us a discount?’ I said, ‘My price to use my [401(k) fee evaluation] system is $2000 per advisor, but I just did a proposal for 2,000 advisors at $400 per person.’” But Witz had to pay to play. “‘We cannot guarantee any sales,’” the broker-dealer said, “’and if you don’t pay $75,000 to come to conference, then you’re not a preferred provider.’”

Watershed moment

There are those who believe that much of the reform that 408(b)(2) and 404(a)(5) are meant to accomplish has already happened. In anticipation of stepped-up regulation and enforcement, many companies have already taken steps to comply with the letter and spirit of the rules. That’s heartening to people like Mike Alfred, whose company, Brightscope, has itself been a force for fee disclosure and lower costs.

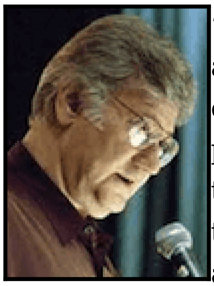
“When you talk to people at Schwab, in private calls, they’ll admit that they invented Index Advantage because they know that the world is changing,” Alfred told *RIJ*. And when a company like Schwab does it, others follow. [Fee disclosure] is transformative because of a domino effect from the top, rather than some rebellion from below. When we look back 10 or 15 years from now, we’ll recognize that this was a watershed moment.

“In any competitive industry, when there’s more data available, the market becomes more efficient and cheaper,” he added. “The enforcement issue is interesting, but I don’t think enforcement is the reason this is happening. When asset managers or recordkeepers know that their fees will fees will be displayed, they’ll roll out products that are better. What some people don’t consider is the impact of lawsuits.”

“The compensation will be more visible. The gravy train of excess fees will come to an end,” agrees Dalbar’s Harvey.

But Phil Chiricotti, the president of Center for Due Diligence, an association for plan sponsor advisors, chafes at suggestions that the 401(k) system is fundamentally flawed. He's not embracing a *mea culpa* moment.

"The whole disclosure bandwagon is insane," Chiricotti (right) told *RIJ* in a recent email. Collectively, 401(k) plan fees are not too high now and they have never been too high. These plans are by far the most cost effective way for the average person to save. They are the most successful savings vehicle in history. They are not a failure.



"All this drivel in the media—much of it fed by ill-informed Marxists and Socialists in the academic world—is enough to make one gag," he wrote. "Coverage, participation, contributions and asset growth are all irrefutably a win for 401(k) plans. If some participants decide not to save, or some companies don't offer plans, that is not the fault of the supplemental savings vehicle. The mainstream media has really been incompetent with their reporting on this. The retirement plans industry is so margin-poor that many vendors are nothing more than the walking dead."

Election wild card

The fact that fee disclosure regulations are taking effect on the eve of a presidential election raises the question of how a Republican victory would affect them. A Romney-appointed Secretary of Labor might not be as eager to enforce the regulations and might not push for new funding that would allow the Labor Department to hire the hundreds of examiners needed to enforce the new rules.

"The real question is how much enforcement will come from the Labor Department," Louis Harvey told *RIJ*. "When the Pension Protection Act was passed in 2006, Congress instructed the Department of Labor to move forward with it," said Harvey. "The Obama appointees have been far less tolerant than the Bush appointees had been. The question is, how eagerly will they do it? With a whimper, or with guns blazing?"

What participants will do is anyone's guess. No one knows what will happen if and a person with a $500,000 401(k) balance discovers that he's paying $1,250 a quarter for a service he or she thought was free. Participants with small balances at large plans will likely have little reason to complain. The Labor Department may hope that participants—like the plaintiffs in Tussey vs. ABB Inc.—will blow the whistle on plans with egregious fees. That may or may not happen.

Ultimately, the success of fee disclosure regulation may depend on the willingness of plan sponsors–especially the tens of thousands of small plan sponsors–to take their fiduciary responsibilities more seriously. Research by Callan shows that a troubling percentage of plan sponsors don't know much about plan fees and don't wish to know.

The worst outcome might be if small employers decide that sponsoring a 401(k) plan is more trouble than it's worth. As Louis Harvey put it, "They may say, 'Why do I need to take on all this fiduciary risk and liability? I'll just tell my employees to go get a Roth IRA.' There's definitely a risk to all of this."