The Qualified Plan Industry at a Glance:

Trends, Direction, and the Road Ahead

Contents

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The Qualified Plan Industry at a Glance: Trends, Direction, and the Road Ahead

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Overview

This article will discuss the basics of the qualified plan service industry with an emphasis on the strategy employed by firms that provide services to plan sponsors and their participants. Let's start with the terminology:

Defined Contribution Plans – Retirement savings/investment plans offered by public and private companies, including government agencies. Virtually all plans allow the participant to make their own investment decisions based on the plan's menu. Although frequently lumped under the singular description of 401(k) in the popular press, the basic plan types are:

- Profit Sharing
- Money Purchase
- Employee Stock Ownership
- 401(k)

Defined Benefit Plans – "Pension" plans that are managed by the company (or whomever they hire to manage the assets), and that provide the participant an income guarantee at retirement based on years of service and salary.

Plan Sponsor - The company, government group, or entity offering a retirement plan.

Plan Participants - Employees of the plan sponsor who are eligible and elect to participate (invest money) in the retirement plan.

The Five Services Provided to Plan Sponsors

Plan sponsors and participants require five key services to actively maintain and manage a retirement plan. Those services are:

1. Recordkeeping Administration – The heart and soul of the services provided to the plan sponsor, recordkeeping represents over 80% of the work related to a plan. A record keeper provides, at minimum, plan administration and compliance services, including updating participant account balances and handling all participant and plan sponsor transactions.

2. Directed Trustee Services – The firm that performs the buying and selling of the plan assets on behalf of the participants is called the directed trustee. The directed trustee is responsible for investing monies in an accurate and timely manner. The reason they are called 'directed' is they take all direction from the recordkeeping

service provider and are not responsible for any investment decisions on behalf of the plan or participant. The directed trustee holds the assets on behalf of the plan sponsor--in aggregate, not at the participant level. (Note: Do not confuse the Directed Trustee with the "plan trustee." The plan trustee refers to a person or people at the plan sponsor company, or people hired by the company, who act as a fiduciary on behalf of the plan. In simpler terms, the plan trustees are the people who are legally responsible for the plan.)

3. Participant Communications – All of the information that a participant needs regarding his or her defined contribution plan falls into this service category. Standard communications include: retirement planning education, ongoing deferral and investment options, onsite presentations and other internet reading and paper reading.

4. Investments – Each defined contribution plan typically offers a menu of investments that the participants can select from to invest their assets. Most plans offer 8-20 mutual funds to choose from, and some plans offer a brokerage solution. Solid investments are the driving force to the success of the participants, because the participants are limited to the plan's investment menu. If the investment options offered do not meet prudent standards, the plan sponsor can fire, or even sue its recordkeeping service provider, investment advisor, and /or consultant for not performing their duties appropriately. Investment options and their rates of returns are often seen by participants as one of the most important component of a plan (the company contribution is the most important).

5. Compliance – ERISA law mandates that all DC plans be test annually to maintain a "qualified" status. In addition to these tests, plans must be compliant with many other state and federal laws, and all plan sponsors must file an annual Form 5500 with the IRS.

These services can be provided to the company/plan sponsor by one firm (bundled) or a multiple firms (unbundled). Both service models have their advantages and disadvantages. Most plan sponsors hire an investment advisor/broker or consultant to select the best service approach and service providers.

Other Industry Terms

Below are few more terms that describe types of companies and services they offer:

Third Party Administrator (TPA) – TPAs typically perform compliance work on retirement plans (testing and government filing). However, many people in the industry use the term TPA differently. Some TPAs also provide participant communication and investment services—in addition the firms that provide recordkeeping services (see next description) often call themselves TPAs (so as not to confuse their clients) thus they are really a "Recordkeeping Service Provider" though they call themselves a TPA. The term TPA is often misunderstood. Additionally, the acronym "TPA" is also used to describe third party administrators of health care plans. The term can be confusing to plan sponsors.

Recordkeeping Service Providers – Recordkeeping service providers offer the functions of a TPA and they provide other administration work such as updating account balances daily and processing most plan related transactions. When a participant goes online or goes to the internet to see their balances or perform a transaction, they are seeing the work of the recordkeeping service provider. Many of these firms provide investment sales or management, communications, and directed trustee services dependent on their strategy.

Outsourcing - A term again that is used loosely and is often misunderstood in the marketplace. Within the industry, outsourced means the plan sponsor has hired a recordkeeping service provider to handle all participant inquiries and transactions, including the approval of distributions, loans, and withdrawals, but this outsourcing firm typically does not provide legal advice. The key differentiation between a standard recordkeeping service model and an outsourced service model, is the recordkeeping service provider is approving all distributions and loans.

Total Benefits Outsourcing – Outsourcing in which the service provider handles all defined contribution, defined benefit, and health & welfare services for the plan sponsor and its participants; but, does not provide legal advice or claims processing for health and dental claims (although some firms do include this). The participant goes to one site or service provider for all benefit transactions and inquiries.

Daily Valuation – Daily valuation describes how frequently a participant's account balance is updated to reflect the total value of his or her investment. Plans that utilize daily valuation (a vast majority) have their accounts updated each day the market is open.

Balance Forward – (In my opinion, the most ridiculous term ever invented.) This refers to all plans that are not updated daily, whereby participant accounts are updated monthly, quarterly, or annually. I refer to these plans as traditional, as *balance forward* implies that all other plans are *balance backward* (which many of us would like when the markets are down). Traditional processed plans are on their last legs due to upgrades in technology and ease of use for the plan sponsor and service providers. ESOP plans and one fund profit sharing plans (almost extinct now) are generally updated in a traditional environment.

Who Is in the Retirement Plan Services Business?

The answer is almost every financial service provider, most with the goal of garnering assets (earning commissions or fees from the assets) under management. Each recordkeeping service provider has its own target market in relation to plan size, complexity, region, and or partnerships. Following is a list of providers by type with service generalizations/service strategies explained in subsequent sections:

- Mutual Fund companies – Mutual fund companies either offer a full service bundled provider approach (offering all services related to the administration of the plan), with an emphasis on their investment funds. Or they attempt to win placement of their funds on investment menus with open architecture or on other service provider platforms.

- Banks – Banks generally offer a full service approach, with an emphasis on their investment funds.
- Administration and Consulting Firms (Open Architecture Firms) – These firms generally offer an unbundled recordkeeping approach and provide recordkeeping administration and compliance services. Many of these firms only offer recordkeeping administration services and have exclusive arrangements with select investment advisors and brokers. Each major city has at least 3-5 of these firms.

- Third Party Administrators (TPAs) – TPAs provide plan documents, compliance and government reporting services to the plan sponsor. TPAs usually work with investment advisors and/or an insurance platform to provide recordkeeping administration.

- Brokerage and Investment Advisory Firms – These firms provide investment fund selection/monitoring and participant communications to plan sponsors in the small and middle market (under 500 participants). They typically have arrangements with recordkeeping providers—*this way the brokerage or investment advisory firm can offer a complete solution to the plan sponsor.* Brokers typically get paid via fund commissions, while investment advisors charge a fee for service based on the amount of assets under management.

- Insurance Firms – Insurance firms offer a full service bundled approach or a TPA Model approach, leveraging their own proprietary investment funds to make up a bulk of the investment menu.

- Accounting Firms – Some accounting firms and CPAs (depending on the size and strategy of the firm) provide TPA services or full service solutions. They also provide employee benefit auditing services.

- Payroll Providers – Payroll providers are recent entrants to the recordkeeping administration service line (full service or TPA model). Payrolls firms have leveraged their client base software to enter the field. Payroll firms that do not service retirement plans, still play a key role in the day-to-day process of recordkeeping, as they track participant deductions or contributions and provide them to the client for delivery to their recordkeeping service provider.

- Recordkeeping Software Providers – These are firms that create software and/or systems for the recordkeeping service providers, TPAs, and trust departments.

Some of these software makers also provide recordkeeping administration services to plan sponsors.

- Attorneys – Some law firms, such as those that specialize in employee benefits and ERISA law, often create custom documents, provide compliance and testing services, and act much like a TPA. They also "clean up" plans that are not in compliance, and handle bankrupt, orphaned or abandoned plans.

- Plan Document Providers – Plan document providers create mass produced plan documents or templates of plan documents. Attorneys, TPAs and recordkeeping service providers buy these documents to use in establishing and administering plans. Some of the these firms have a division that functions as a TPA.

- Communication Firms – Communication firms provide newsletters, retirement plan education, statements or other communication materials and technology to recordkeeping service providers or directly to plan sponsors.

General Service Models

Two general models exist for servicing retirement plans.

Closed Architecture Service Providers – Also referred to as "bundled providers," these firms provide one-stop-shopping for all the five necessary services mentioned above, with an emphasis on their own investment package as their core service and profit generator. Typically these are banks, mutual fund companies, and insurance companies. These firms clear trades internally, so they do not need an outside directed trustee, which becomes critical in pricing and serving of the plan.

Open Architecture Service Providers – Also referred to as "unbundled providers," an open architecture firm generally provides one or two of the five necessary services mentioned above. Unbundled providers traditionally place an emphasis on their recordkeeping administration, compliance, and consulting. Unbundled service providers tout their ability to quarterback the entire process and emphasize their flexibility in plan design and unlimited investment selections. The small plan marketplace (serving companies with fewer than 500 employees) is generally served by the unbundled providers.

Both types of service providers--open architecture (unbundled) and closed architecture (bundled)--are starting to look similar especially from an investment menu perspective. Closed architecture firms may still require a certain amount of funds or assets in their proprietary funds.

Recordkeeping Service Provider Models

Plan sponsors secure a recordkeeping service provider by one of four methods. Or to say it in another way, recordkeeping service providers work in multiple arrangement. Here are some of the most common arrangements:

1. Direct Model – where the plan sponsor retains a recordkeeping service provider directly. This is the best way for plan sponsors to control and manage service expectations and maintain a long relationship. Plan sponsors often hire consultants to help them find a record keeping service provider.

2. Preferred Provider Model – where a plan sponsor retains a recordkeeping service provider through an investment advisor or broker, who owns the relationship with the recordkeeping service provider, yet that provider works directly with the plan sponsor. This approach is often used to eliminate any advisor responsibility related to the recordkeeping service. It is important that the service provider be committed to serving the plan participant, plan sponsor, and investment advisor, in that order of priority.

3. Back-office or Service Bureau Model – where a recordkeeping service provider acts as the back office recordkeeping administrator (recordkeeping and compliance services) for their client/partner (mutual fund company, broker/dealer, bank, insurance company, and/or wire house). Generally the back office recordkeeping administrator has no direct contact with the plan sponsor. This model is not as prevalent today due to efficiency and accountability issues. In this model, the service provider performing the recordkeeping administration work is not the primary point of contact with the plan sponsor and participants.

   TPA Model – where a plan sponsor retains a recordkeeper through an investment advisor or broker, whereby one service provider (usually insurance firms and some mutual fund companies) performs the day-to-day recordkeeping administration, and a second provider such as a TPA performs all compliance work including testing, vesting calculations, required government filings, and potentially the calculation of all distributions and loans. This model is prevalent in the small plan marketplace. Even for TPA Models that are 100% efficient, the total cost is not as low as the Direct Model (recordkeeping administrator direct with the client), and for better or for worse, the TPA Model requires that:
   - All providers be on the same page operationally
   - The annual reconciliation process is manual, although the downloads from the recordkeeping service provider to the TPA are electronic
   - The plan sponsor has multiple relationships, and often the TPA tries to act as the lead party organizing all inflow and outflow of transactions (for

example, acting as a middleperson for the payroll input process and handling distribution requests)

The power of this relationship is twofold: One, the TPA acts as an auditor of the day-to-day recordkeeping financials; and two, the compliance role is segregated from the recordkeeping service provider, which allows each firm to work in its area of strength.

Trustees

The term 'trustee' is another often misunderstood term. Below are listed three types of trustees along with an explanation of the function they perform.

<u>Discretionary Trustee</u> – A discretionary trustee is a bank or trust company that takes full fiduciary responsibility for the investments offered to the plan, mainly from a performance perspective but can include how the investments are communicated to the plan participants. Discretionary trustee are nearly extinct today due to our litigious society, but you can still find them at a hefty price. If you hire a discretionary trustee, look at your contract closely.

<u>Directed Trustee</u> – A directed trustee is typically a bank or trust company that serves as a custodian of the plan assets and performs all monetary transactions related to the plan assets. The direct trustee is crucial to the success of the open architecture platforms (bundled service providers have this function internally). Most directed trustees today are state chartered. Liability is limited to errors related to accurate and timely trades. The reason they are called 'directed trustees' is they take all direction from the recordkeeping service provider and are not responsible for any investment decisions that affect the plan or participant.

The optimal directed trustee partner provides many services, ideally at 100% quality and accuracy levels, and competitive pricing. Those services are:

- Same Day/Late Day capabilities with a large mutual fund universe (platforms such as NSCC allow the trustee to trade across multiple fund families using that days closing price). From a participant perspective, same day/late day capability means that the participant's transfer request can be fulfilled at that day's market close if they put in their request before market close with their recordkeeping service provider.
- Tracking and collecting revenue sharing data. (Recordkeeping service providers have difficulty keeping up with the latest maximum revenue sharing available through sub-TA's, platform fees, 12b-1's, dealers concessions, shareholder service fees, and marketing fees.)
- Timely and accurate check cutting, complete with state and national reporting through the 1099R process.
- On demand reporting in print and digital formats (both for transactions and held positions).

- A seamless online brokerage option (commonly known as individually directed accounts (IDAs) or self directed brokerage account (SDBAs)).
- Comprehensive and reliable online reporting.

Plan Trustee – People at the plan sponsor company, or people hired by the company, who act as a fiduciary on behalf of the plan. The people designated as “Plan Trustees” carry the most liability for the legal aspects of the plan. Companies that think they have outsourced the “Plan Trustee” function should review their contracts closely. Typically, the directed trustee indemnifies itself for virtually all plan issues. Most legal issues that arise in a plan are ultimately the responsibility of the plan trustee.

Plan Sponsor Trends

DWC Consultants has conducted numerous interviews with plan sponsors within the past year. Plan sponsors continue to emphasize quality of service and fast and accurate turnaround of compliance tests and reporting. Based on our interviews we have determined that plans sponsors want:

- The plan administration and recordkeeping process to be easy and simple for them and the plan participants.
- The plan administrator or another party to take on the fiduciary responsibility of their plans (or at least a co-fiduciary status).
- Customized participate communication campaigns that emphasize one on one meetings with the participants.
- No surprises related to services.
- Low out of pocket costs.
- More health plan options at lower costs (in other words the 401(k) plan may not be the plan sponsors top priority in 2007).
- Integrated benefit administration. (Companies that are focused on ease of use for their employees want one internet site where their employees can review their health and retirements benefits and process transactions. The large plan marketplace has already migrated to this integrated solution. Integrated systems are expensive to implement, as health care plans and retirement plans are different from company to company, and the system must be setup up to communicate with a number of providers. When the price is right, the middle and small plan marketplace will have access to total benefit outsourcing. This will require all defined contribution service providers to either provide total outsourcing or be an integrator with other systems.)

The bottom line is plan sponsors want ease of use and no surprises related to their administration, and most important they want to reduce litigation risk. Of course they want premium service at low cost out-of-pocket costs, which of course can only be accomplished by leveraging the investment portion of the revenue equation.

In the last three years, plan sponsors have not changed service providers as fast as the early 1990's when 100% turnover in 3 years was prevalent. Plan sponsors are staying with their service providers longer and the better firms have retention rates averaging in excess of six years. Based on our surveys last year, plan sponsors changed providers for two main reasons, 1) quality/accuracy of service (as in, errors recognized by the participants or the plan sponsor) and, 2) quality of compliance and consulting offerings.

Trendy Plan Designs

Below are some plan types that are currently in demand.

Cash Balance Plans

This is a type of defined benefit plan that provides for annual contributions of either a percentage of pay or a set dollar amount.

Cash balance plans provide for a guaranteed rate of interest which is usually tied to a set index (such as the 1-year Treasury rate) to minimize volatility. As in a cross-tested profit sharing plan, the employees can be divided into groups that receive varying levels of contributions. The minimum non-highly compensated employee allocation typically ranges from 1.5% to 2.5% of pay and usually requires a slight increase in the non-highly compensated employee contribution to the profit sharing plan.

Due to recent legislation and the latest IBM ruling, it is a good possibility that well funded defined benefit plans will transition to cash balance plans which act like DB plans, but lack the costs and funding issues that DB plans typically have.

The cash balance plan is desirable for employers without a current defined benefit plan wanting to contribute additional amounts (in excess of the annual defined contribution limits) on behalf of one or more highly compensated employees.

Solo DB Plans

DB Boomer plans are hot because they allow business owners to put away far more each year as compared to a defined contribution plans. Solo 401(k)'s, 412(i)'s and the like are here to stay.

Nonqualified Plans

Non qualified plans continue to be popular for companies of all sizes. They are virtually unregulated, the assets in them are not secure, but highly compensated employees can defer far more money into these plans than into qualified plans.

And as a side note: although stock options may be a popular press item, a majority of companies do not offer stock option plans.

Trendy Plan Features

Below are some plan features that are currently in demand.

Automatic Enrollment

Plans offer this feature for the following reasons:

- If you wait for participants to complete a form or go online to enroll, their procrastination may prevent them from ever enrolling
- Greater participation leads to better compliance testing results
- Gets participants saving for retirement

Automatic enrollment may one day become standard operating procedure.

Expanding Investment Menus

Investment menus have been expanding because:

- Current technology makes it easy to offer a variety of investment options
- Investment advisors and plan sponsors have a tendency to keep underperforming funds on the menu. They do this for two reasons: 1) if they take these funds off the menu, the action itself implies that they made a poor decision in putting the fund on the menu to begin with, and this poor decision is sometimes construed as a litigation risk; and 2) it's easy to just leave the fund on the menu and simple add more funds.

Experts often disagree as to the optimum size menu and whether to sell out of a mutual fund due to recent sub par performance. Participants simply want ease of use. Hence, asset allocation and lifestyle funds have been the most common addition to fund menus recently.

Typically, the more investment choices on the menu, the more the participant gets confused. A quick primer on the primary investment offered within retirement plans follows:

> **Mutual Funds** are the most prevalent of the options selected by defined contribution sponsors. The Securities and Exchange Commission (SEC) directly regulates these funds. Investment management fees are taken out at the daily net asset value (NAV) at the same rate for every dollar invested. In the late 1980s, mutual funds were the cutting edge trend, as participants could track their investments in the newspaper. Unfortunately for the participant, the trend in the mutual fund industry is to have multiple classes for each fund, with the class used for the plan dependent on sales commissions or the service provider selected. Class A is generally the best, as there are no front end or back end loads, and the investment expense ratio is typically the lowest. Multiple class shares make tracking difficult. With tracking issues and investment fees high in a lot of mutual funds, separately managed funds and CIF's (see below) are becoming popular again (for all of the right reasons; i.e., lower investment expense ratios). Watch

out for Class B or C shares, as these typically have higher investment fees and/or loads (front/back).

Collective Investment Funds (CIFs) are typically offered by banks and insurance companies, and are similar to mutual funds except the Office of the Comptroller of the Currency (OCC) regulates them, instead of the SEC. CIF's have been the vehicle of choice since the inception of the funds in the late 1980's because they offer flexible Fee Arrangements (lower asset based fees for clients) and are less expensive to operate. The key benefit of CIFs is that the fees are variable (and can be graduated) and they are available on daily trading platforms so they can coexist with mutual funds. The beauty of this graduated fee schedule is that asset power can lower the overall investment expense charged to the plan. A majority of Stable Value Funds (previously referred to as GIC Funds) are CIFs.

Separately Managed Funds have investment managers who manage a fund for a plan exclusively or invest in a pool with other plans (similar to CIFs). The advantage is lower investment advisory fees and a manager who places minimum investments (by plan) thus eliminating the retail issues involved with investing (turnover and chasing rankings). For plans that are direct, no assets are shared with other institutions or retail clients. Separately managed accounts also allow for performance-based investment fees. With today's technology, the fees can be taken out of the recordkeeping value daily at the manager or recordkeeping level. The majority of separate account managers have a minimum of dollars they will manage, ranging from $1 to $20 million based on the type of fund and/or manager. With today's difficulties in tracking mutual funds, and the advent of the Internet enabling participants to check their accounts and to research investments, separately managed funds will become more popular.

Lifestyle or Asset Allocation Funds (Objective Based Funds) are finally catching on as a supplement to the traditional mutual fund approach. Companies generally offer three asset classes: conservative, moderate, and aggressive. Some managers use a fund of funds (multiple mutual funds within each category); others manage these in a non-mutual fund environment such as CIFs or separately managed accounts. These funds are popular for participants who do not have time to understand the markets, but can fill out a simple questionnaire in order to find out which risk category fits their lifestyle. The good questionnaires not only ask about the participant's risk, but also focus on the participant's net wealth and age. Bottom line: These are great funds for defined contribution plans, as they can reduce the anxiety risk factor for many participants who are uncomfortable with investing. Drawback: The 'fund of funds' approach has two layers of fees: the underlying mutual fund expense, plus the investment expense for managing the fund.

Individually Directed Accounts (IDAs) allow participants to buy and sell in any mutual fund or security available in the retail market, or in simple terms, these are brokerage accounts. They are also known as self-directed accounts (SDAs) and personal choice accounts (PCAs). Plans offering IDAs generally limit these to one brokerage firm, and all transactions by the participant are made directly with the online brokerage firm. In the past, service providers did not have an integrated process to allow for IDAs; therefore, the recordkeeper and/or the trustee charged annual fees ranging from $50 to $300 a year for the account. These fees do not include commissions on stock transactions or transaction fees for some mutual funds. Today, IDAs are rapidly becoming an integrated solution for plan sponsors. If implemented correctly, the brokerage account is integrated directly with the directed trustee and/or recordkeeping system.

Company Stock – The menu option that offers company stock to participants. Some companies pay all or a portion of their company match or profit sharing in company stock.

Service Provider Trends

Service providers want to provide plan sponsors with ease of use and bells and whistles at a price that allows the service provider to be profitable and competitive. The latest trends among service provider offerings are as follows:

Elimination of Paper Participant Statements
Historically paper statements have been quarterly. Research shows the cost of producing the statements (let alone the risk for error) far exceeds the value as the information is outdated by the time it is received and a majority do not review their statement. In addition, with the improvements in technology, participants have access to participant statements and account information online, on demand.

Voice Response Systems
Telephone voice response systems that offer participants a way to check balances, change investment options, and request loans are being phased out by service providers. Most service providers are now offering full inquiry and transaction support via the internet and statistics support the decline of voice response usage.

Customer Service Call Centers
Some firms have transitioned to a 100% Call Center option supported by 24/7 internet. This is done to provide a higher level of service and support as participants enjoy talking to a person as compared to trying to get an answer via the internet or voice response system.

Software
A majority of recordkeeping service providers and TPAs use software from the top 4 or 5 software providers. Top tier administration software is more expensive than basic software or modified MS Excel or other in-house solutions. More service providers are moving toward top tier software because it provides:

- More efficient work flow

- Extensive level of detail and customization in regards to the plan documents, designs and reports
- Solutions for online participant and sponsor internet access.
- Solutions for small and large call centers, which ultimately leads to more satisfied customers.

Many service providers have moved to top tier software, because ultimately it allows them to serve their clients more effectively and efficiently and for a lower price**.**

Walk in Service Centers
Allows participants to walk in to a financial center and receive on demand retirement modeling and asset allocation decisions. This model failed in the past, because the walk in centers did not have the participant plan information readily available nor was the staff trained appropriately in defined contribution plans.

Most service providers would like to offer their clients much of the latest technology and full service offerings. However, hardware, software and other service upgrades are expensive and time consuming investments which must be choosen wisely.

Investment Advisors/Brokers Trends

Plan sponsors hire investment advisors and brokers to provide prudent investments to the plan participants. Another key service many investment advisors and brokers perform outside of investment selection is participant communications. In review, there are two ways investment advisors and brokers get paid:

<u>Fee-for-service</u> – Investment advisors charge a fee based on all assets under management. That is on top of any mutual fund investment expenses or CIF expense. The average asset based fee ranges from 50 – 225 basis points, based on the size of the plan and complexity of the relationship. Most fee for service advisors offset any mutual fund commissions against their fee or the recordkeeping fee. In the insurance/TPA Model, the fee for service can be imbedded in a group annuity fee so the fee is built into the net asset value (NAV).

<u>Commission</u> -- Brokers earn a fee paid to them by the investment fund into which the broker places plan assets. A typical commission is 1 percent on all new assets, and 25 basis points on recurring assets.

Historically, the commission approach was by far the most popular approach. However in the last ten years, the fee-for-service has become popular because fee-for-service advisors:

- Select funds based on actual performance without regard to commission rates
- Keep total plan costs low
- Often declare themselves co-fiduciaries

The only downside to this approach is that these fees are charged to the participant's accounts, and thus the participants will see the fees hit their accounts via mutual funds being sold to pay the fees. Well constructed and delivered communication can virtually eliminate the participant backlash.

In the TPA/Insurance Model the insurance company builds the investment advisory fee into the fund fee (typically their own proprietary fund) or by adding a sub-annuity wrap on top of the underlying mutual fund expense. The participants do not see a fee through sold shares. Their overall investment expense may be higher, but the participant only sees the fund returns.

Commissions vs Flat Fees

To date, a majority of investment advisors, brokers, and TPAs (defined as firms that provide compliance service only) have embraced the insurance/TPA platform models that bury fees within the NAV or a higher R share class. This method is typically perceived as low out-of-pocket cost. However, beginning in 2008, plan providers will be forced to declare these fees. The argument that participants don't see the fee and therefore it is easier to sell, may fall by the wayside because of new legislation called the Pension Protection Act of 2007.

The Impact of the Pension Protection Act of 2006

(This section is co-authored with Adam Pozek of Swerdlin & Company)

The 2007 calendar year offers our industry new challenges and opportunities. On August 17th, 2006 the Pension Protection Act (PPA) of 2006 was signed into law. The PPA of 2006 is the latest attempt by the government to strengthen the defined benefit and contribution system. The 900 page Act contains several changes to ERISA fiduciary responsibility laws, as well as changes to the "prohibited transaction provisions" of ERISA. Both changes will impact the management of pension plan assets.

The PPA of 2006 raises a hot issue: who is a fiduciary? Prior to the passage of this act many service providers, advisors and consultants were highly clear and specific in their contracts which stated that they were not fiduciaries. Yet the plan sponsors in many cases thought they were!

Historically commission-based advisors were not allowed to render advice to participants, as the participant's investment selections impact the advisors compensation. Additionally, plan sponsors have historically been held liable as fiduciaries for any advice given to participants and the subsequent results of that advice.

The Pension Protection Act of 2006 ("PPA") changes the playing the field. Effective January 1, 2007, both fee and commission-based advisors meeting certain requirements will be able to offer investment advice to participants in 401(k) and other defined contribution plans.

A covered advisor (one registered with the appropriate securities and insurance bodies as well as banks and similar financial institutions) must enter into a formal agreement with a plan sponsor to provide advice to that sponsor's participants. The agreement must require the advisor to comply with the appropriate legal requirements and *must acknowledge the advisor's status as a plan fiduciary*.

In addition, the advisor must provide a notice to the participants at least once per year that includes the following information:

- Acknowledgment of advisor's status as a plan fiduciary
- All compensation to be paid to the advisor or any related party
- Any material affiliation between the advisor and the plan's investment options
- Role of any related party in developing the advice or offering plan investments
- All services provided by the advisor in connection with the advice
- How participant information will be used or disclosed
- Ability of participants to seek other independent advice
- Past performance and rates of return for all investment options in the plan

Upon satisfying these requirements, fee-based advisors, e.g. those whose compensation is not impacted by the participants' actual investment choices, can offer advice to the plan participants. Those whose compensation is affected by participant elections, i.e. commission-based advisors, can offer computer-generated advice.

The computer model must meet several additional requirements. The model must:

- Be based on generally accepted investment theory including historical returns of different asset classes over time
- Use relevant information about the participant
- Use objective criteria to build asset allocation models
- Not be biased towards investment options offered by the advisor or an affiliated party
- Take into account all plan options without inappropriate weighting towards options offered by the advisor or any affiliated party

The model must be certified by an independent investment expert and re-certified any time there is a material change. The advisor is not permitted to offer any advice other than that generated by the model. A participant must make an affirmative election to implement any of the advice provided.

Both fee-based and computer-generate advice programs must be audited each year by an independent expert to ensure compliance with all the rules outlines above. The auditor must provide a written report to the plan sponsor detailing the results.

Plan sponsors implementing a so-called "eligible investment advice program" must abide by the normal prudence requirement in selecting an advice-provider; however, sponsors are not required to monitor the specific advice given to participants. And, importantly, **plan sponsors enjoy a waiver of fiduciary liability with regard to such a program.**

As long as the advisors' compensation is reasonable in light of the services provided, they are entitled to an exemption from the prohibited transaction rules with regard to the advice as well as any transactions that result.

What does this mean for the retirement plan services industry? The true answer lies in how the Pension Protection Act laws ultimately become interpreted and implemented. But let's take a look at what will mostly happen.

Looking Ahead

In the coming years some things will stay the same. For example, service providers of all sizes will be successful each with their own unique value proposition. And some things will change, most notably in 2008, service providers will have to report (on the Form 5500) **all** revenues earned from a plan sponsor's plan. All means everything! Plan sponsors historically have looked at out-of-pocket expenses and now with all revenues being publicly disclosed the end result may be:

- Increased litigation from participants when they learn the actual revenues their service providers are receiving
- More plan sponsors migrating to open architecture firms with a history of full disclosure
- Brokers and advisors "adjusting" their fees commensurate with their services, that is, those that provide the 'fiduciary protection' can charge a premium.
- Substantial litigation to determine the actual meaning of the PPA of 2006.

The actual effects of the PPA of 2006 will be difficult to determine until they play themselves out in the coming years.

In the technology area, service providers may begin to offer:

- Easy to use mobile phone solutions
- Text message statements
- Walk in service centers
- One site solutions for all employee benefits

And lastly in the investment area, baby boomers may focus on purchasing annuities with their defined contribution balances.

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