Best Practices, Hot Topics and Trends for Recordkeepers

Mark Klein, Richard Grotto & Kara Ardis
Issues Raised by the Conflict of Interest Rule

• Advisors
  • Rumors of Demise Exaggerated?
    • Tools to support fiduciary role
  • Increased Demand for Independent Fiduciaries (3)(21) and/or 3(38)
  • Advisor Compliance

• Will Assets Stay in Plan
  • Roll In vs Roll Over

• Continued Recordkeeper Consolidation
  • Reduction in Use of Proprietary Funds
  • Data is King

• New Tools
  • Bubble Wrap?
Rumors of Demise Exaggerated?

• Many have predicted the demise of the dabbler (aka 2 Plan Tony)
  • Dabbler advisors (under 50% of revenue from retirement plans) and non-producers (less than 15% of revenue from retirement plans) are the groups that some see migrating away from DC plans due to the additional work needed to comply with the new rule.

• It may be unrealistic to expect a full-scale exodus of dabblers and non-producers from the DC market, though, as retirement specialists comprise only 6.6% of all advisor practices.
Increased Demand for Independent Fiduciaries (3)(21) and/or 3(38)

- Increased interest in fiduciary outsourcing services as the Conflict of Interest Rule has shined a light on the role of an ERISA 3(21) investment advice fiduciary.
  - This creates opportunity for outsourced fiduciary service providers to partner with advisors who are either not allowed to act as a fiduciary per their broker/dealer (B/D) or do not have the appetite to assume this higher standard of responsibility.

- The use of third-party investment advice fiduciaries means the role of the non-fiduciary advisor must evolve from being primarily focused on investment selection to helping plans increase participant engagement and creating better retirement outcomes for employees.
Advisors Compliance Burden

• Compliance with the new Conflict of Interest Rule will be easier for those advisors who already act in a fiduciary capacity, these advisors will not be immune to the changes this new regulation introduces.

• Some of the activities they perform for plan sponsors may require the Best Interest Contract Exemption (BICE) and/or new and additional documentation of their activities.
  • This will be particularly true for advisors who use a B/D for taking over commission-priced plans before transitioning them to a RIA fee model.
  • Simply by taking the plan over, the advisor may be receiving commissions, such as 12b-1 fees, and the B/D may be receiving revenue sharing, which fall under variable compensation and will require a prohibited transaction exemption (PTE), such as the BICE, under the new rule.
Will Assets Stay In Plan?

• Of course, implication of the Conflict of Interest Rule is that the recommendation to roll over assets from a DC plan to an individual retirement account (IRA) is now considered a fiduciary act, requiring documentation as to why the recommendation is in the client’s best interest.

• Given that DC plan participants generally have access to institutional pricing that they would not receive in an IRA, the rollover transaction can be difficult to validate.
  • In smaller plans, higher investment costs and admin fees may make it easier to show best interests.

• In order to accommodate more participant assets staying in-plan, recordkeepers would need to make progress in terms of available distribution options for retired/separated participants and retirement income products.
  • Many have expressed expectations that flows from DC plans to IRAs will be slowed as a result of the Conflict of Interest Rule.
Roll In vs Rollover

• One tool by which recordkeepers can potentially mitigate leakage from the employer-sponsored retirement savings market is through greater encouragement of plan-to-plan rollovers.

• Many recordkeepers have initiatives in place to encourage DC plan-to-plan rollovers. The effectiveness of these initiatives must be questioned, however, in light of the continued low participant use of plan-to-plan rollovers.

• In sum, data does not suggest an upcoming wave of support from recordkeepers in encouraging plan-to-plan rollovers.
Roll In vs Rollover

• The degree to which individual retirement account (IRA) flows have already been impacted by the pending rule is unclear.

• According to Cerulli, IRA providers were more likely to report increased flows in advance of the rule’s original effective date.

• However, some of that activity can be attributed to firms’ increasing focus on IRA business and having it flow through more structured formats that allowed firms to track the business more closely.

• Other firms attribute increased IRA business to normal business and a general pickup in business.

• While there were other firms reporting a slowdown, Cerulli believes most of the changes so far are more structural in nature, such as pricing changes.
Continued Recordkeeper Consolidation

• Increased competition is evident in the recordkeeping industry as consolidation has taken hold with an increasing number of providers looking to add size and scale to their business to counter declining margins.

• It is well established The industry has experienced considerable consolidation, driven by intense fee compression and competition.

• Most believe that recordkeeper consolidation is here to stay and expect to see further instances of merger and acquisition activity in the coming years.

• The Conflict of Interest Rule could act as an accelerant to consolidation as recordkeepers may not be able to generate the same level of profits from their IRA rollover units, which have historically served to offset the declining margins in plan administration.

• Because of fierce competition and price compression, some recordkeepers and asset managers that historically focused on a single plan type by IRS tax code or plan asset segment are widening their service offerings to be able to compete more broadly in different market segments.
Reduction in Use of Proprietary Funds

- Recordkeeping margins are less attractive than investment management, and in some cases, the recordkeeping business is an acknowledged loss leader and more of a means for ancillary product placement (e.g., IRAs).

- According to Cerulli, the industry has shifted away from closed-architecture platforms in favor of open-architecture platforms that offer choice and exposure to asset managers without an affiliation to the recordkeeper.
  - One-quarter of DC plan recordkeepers report that none of their recordkept assets are invested in proprietary funds.
  - About one-fifth (21%) of recordkeepers indicate that 11% to 20% of their recordkept assets are invested in proprietary funds.
  - Only 8% of recordkeepers report that 91% to 100% of their firm’s recordkept assets are invested in proprietary funds.

- Rise of the Pure Recordkeeper -- Pure recordkeepers are few and far between, as only 13% of surveyed recordkeepers do not offer any proprietary funds.
Data is King

• Recordkeepers have regular access to the payroll feeds of their plan sponsor clients, giving them the ability to aggregate and analyze multiple participant data points, such as age, income, gender, and contribution rate.

• Advancements in technology have also enabled providers to track more detailed participant metrics, such as transaction-level data and clicks on specific website links.
Managing Stakeholders – Working with Third Party Administrators, CPAs, Advisors and other service providers/referral sources. Workflow that works and effective communication.
Highlights

• DOL concerned about conflicted investment advice to plan participants, IRA owners & “small” plan sponsors
• Broadened the definition of investment advice, resulting in more parties being considered fiduciaries
• Investment advice activities and compensation arrangements are limited, unless an exemption is available
Basics: Definition of Investment Advice

• Broader definition of fiduciary for providing investment advice... anyone who:
  – Renders individualized advice by making a recommendation pursuant to a written agreement or verbal understanding;
  – Directs advice or recommendation to a specific recipient; or
  – Represents or acknowledges fiduciary status

• Investment recommendations generally include:
  – Recommendations on the advisability of buying, selling holding plan investments
  – Advising on rollovers, transfers, or distributions from a Plan, including recommendations as to the amount, form or destination of such rollover
  – Advising on how investment property should be invested after it is rolled over, transferred or distributed from the Plan

• The advice must be in exchange for direct or indirect compensation
New Definition of Investment Advice

• Generally, a “recommendation” as to the advisability to buy, hold, sell or exchange investments, or recommendation that investments be rolled over or distributed from an plan or IRA. Includes:
  – Recommending or selecting others to provide advice
  – Recommending types of accounts (brokerage vs. advisory)

• A “recommendation” is a communication that would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action
Exceptions

• The rule includes a number of exceptions that excludes certain activities from the definition of advice, including:
  – Investment education
  – Open architecture platform providers
  – General communications
Key Challenges

• All Firms Face Several Key Challenges
  – Cloudiness
  – Initial costs
  – System requirements
  – Ongoing maintenance
  – Short implementation timeframe
Impact on Operating Model

• Sales practices and pricing
• Legal contracts, disclosures and compliance
• Ongoing account management
• Cross-selling products to existing clients
• Compensation
Participant Impact

• Better/More choices
  – Retirement plan
  – Rollovers
• Enhanced education
• More competitive fees
Plan Sponsor Impact

- Understand roles & responsibilities
- Plan to address fiduciaries
- Oversight of Plan and Rollovers
Advisor Impact

• Greatest impact
• Additional liability, oversight and risk
• Sales practices and pricing
  – Know Your Client (KYC)
  – Commissions/Transaction-based comp
  – Best Interest Contract (BIC)
Advisor Impact... continued

• Fees
  – Reduced fees/compensation
  – Level fees
  – Performance-based compensation

• Rollover assets

• Additional opportunities
Investment Manager Impact

• Boost compliance oversight
• Update disclosures
• Incentive bonuses, quotas, awards or trips
• Performance-based compensation
• Educational opportunities
• Business opportunities
TPA/Recordkeeper Impact

• Educate Plan Sponsor and Advisors
• Review partnerships with Advisors
• Expand partnerships
• New entrants/competition
• Business opportunities
Business Opportunities

• Fiduciary oversight: 3(16) + 3(21) + 3(38)
• Strategic Partnerships
• IRA Rollover tools
• Guidance for Plan Sponsors & Advisors
• Software providers
• New entrants
Workflow & Logistics

• Communication & coordination
• Software is being built/tweaked
  – KYC
  – BIC
  – More customized solutions
  – Disclosures
Fee Processing
Trends and Risks/Considerations

TRENDS
• Per participant fees on the uptick since Summer of 2012 with 404(a)(5) Participant Fee Disclosure and 408(b)(2) Plan Sponsor Disclosures;
• Increased Sensitivity around low cost investments;
• Remuneration sent back to participants – either based on current elections OR to the fund that generated the revenue sharing;
• Participants allocated the recordkeeping fee in ways beyond straight pro-rata and per-capita; and
• Increased transparency into recordkeeping fees vs. legal, consultant etc. fees.

RISKS/CONSIDERATIONS
• Risk in push back on line item fees on statements etc.
• Difficulty in finding a completely equitable formula for pulling fees (pro-rata, per-capita etc.) creates complexity operationally.
• Participant communication challenges around complexity of the concept.
Summer of 2012 – began to see more transparency of fees through 404(a)(5) Participant fee Disclosure and 408(b)(2) Sponsor Notices.
Fee Leveling

• Increase in consultative conversations around participant paid fees and fund remuneration (revenue sharing).
• Participants gain an overall appreciation for the services provided to the plan and the fees for such services.
• Value in aligning fee allocation method with the plan sponsor philosophy.