Fiduciary Risks: Nonplan Products and Services

by **Daniel Alexander** | *RetireAware* and **Allen Steinberg** | *RetireAware*

The defined contribution (DC) ecosystem has changed in many dramatic ways over the past 15 years. Indexed funds and exchange-traded funds (ETFs) have driven down the cost of investing, fee disclosure and the threat of litigation have raised the awareness of plan costs, and the ubiquity of mobile devices—coupled with heightened sensitivity to hacking and security breaches—has changed how all parties view data security.

These changes have affected many of the inhabitants of the DC ecosystem, including sponsors, fiduciary advisors and plan providers. And these entities have been forced to adapt to this changing environment. With all of the changes occurring in the retirement plan ecosystem—and all of the attention focused on these changes by sponsors and outside fiduciaries—plan sponsors and fiduciaries may be unaware of risks presented by the sale of nonplan products and services to their participants.

Nonplan Products and Services: Risks (for Fiduciaries)

Nonplan products and services can include retail advisory and investment products, retail variable annuities and fixed annuities, banking services, life insurance, long-term care coverage and 529 college savings plans.

Plan providers—including bundled recordkeepers and 403(b) annuity providers—may be feeling the pressure to reduce fees charged to plan participants, and nonplan products and services represent an alternative revenue stream. Whereas a provider may charge relatively low, competitive institutional pricing to administer a plan, nonplan products often carry higher fees for the service provider. Following are examples of such fees.

- Retail advisory products (such as mutual fund–based managed accounts) carry advisory fees typically ranging from 1-3%, plus the fees associated with the underlying investments.
- Retail investment products, such as mutual funds, can carry up-front or back-end sales loads (or commissions) that may range from 2.5-5%, depending on the share class and amount of investment.
- Retail variable annuities, inclusive of riders and under-

AT A GLANCE

- Employees who are ready to retire may turn to a representative of the company that provides their employer-sponsored retirement plan or the plan provider's service center for consultation on what to do with their defined contribution plan savings in retirement.
- The promotion of nonplan products and services offered by group retirement plan service providers can pose risks to plan sponsors and fiduciaries, including participant data privacy and security issues.
- Fiduciaries can take steps to minimize risks including conducting an audit of service provider models or negotiating contractual protections for plan participants.

lying fund expenses, can include fees in excess of 3% per year—with hefty surrender and/or withdrawal charges that can exceed 5% on amounts that have not satisfied the surrender/withdrawal schedule in the contract.

In addition, these products typically generate higher commission and bonus payments to sales personnel.

The disparity between the fees for in-plan, compared with those for nonplan, products and services creates an inherent conflict in provider service models. This conflict may not be recognized by plan participants—even those participants who are sophisticated investors. And these conflicts may not be on the radar screen for plan fiduciaries, who are focused on fees and services within the employer-sponsored plan.

The Distributable Event and the Solicitation

Employees separating from service are faced with a choice of three alternative directions for their distributable amounts:

- Leave the money in the plan
- Cash out
- Roll the money over into another account, such as an individual retirement account (IRA).

Over the last two decades, the momentum for transferring retirement plan assets to IRAs has increased. According to the Investment Company Institute (ICI), contributions to IRAs grew modestly from $14 billion in 1996 to $17 billion in 2015, while rollovers to IRAs ballooned from $114 billion to $459 billion[1] during the same period. This increase occurred as plan providers sought to increase revenue and retain assets in nonplan-related products. These rollovers, and the revenue they generate, are more than just "ancillary services" to supplement profitable plan-related revenue. Rather, nonplan revenue may be a key part of providers' market strategy. For plan sponsors, the lack of transparency and specifics around this nonplan-related activity poses risks that permeate the actual plan.

When an employee meets a distributable event (such as retirement or attainment of normal retirement age), a reasonable and natural instinct may be to turn to the plan provider representative or plan provider's service center—often reached through a toll-free number—for consultation. Indeed, a recent survey by T. Rowe Price finds that 64% of workers turn to their plan provider as their first source for financial advice.[2]

The plan representative, on-site or remote, may have a financial incentive (in the form of commission, bonus, job performance rating, sales quota, contests) to transfer plan assets to an IRA, more specifically to one of the provider's proprietary products. The authors' review of the U.S. Securities and Exchange Commission (SEC) Form ADV-2A for several providers illustrates the economic incentives—and the inherent conflict—for providers (and their employees) to promote rolling over group retirement assets to nonplan-related advisory, investment and insurance products.

Plan sponsors should take note that their explicit endorsement of the plan provider for the retirement plan can effectively create an implicit endorsement of the provider's products and services offered to employees. This affects the decision-making process of employees, who may assume that the plan provider is a good option because the provider was hired by the plan sponsor. The incumbent provider has access not only to the employees' contact information but to information about their plan balances, age, contribution rates, investment allocations and other demographic data that support the provider representative's proactive solicitation of employees. Furthermore, the recommendation to transfer plan assets to specific products is often based on a suitability standard—and not as a plan fiduciary. The sponsor, who has not vetted the nonplan products, has essentially facilitated the establishment of a sales environment that exposes employees to investment, insurance and banking products.

The promotion of nonplan products and services poses a number of risks to plan sponsors and fiduciaries:

- Nonplan products are actively promoted when participants incur distributable events. Drawing these larger account balances out of a plan adversely affects the financial health of the plan (especially with regard to pricing models for future recordkeepers).
- Drawing larger balances out of a plan upon a distributable event to retail products/services may reduce participant retirement income and could undermine plan fiduciary efforts to provide a low-cost plan with income-generating funds and retirement distribution options.

- Participants may not fully understand when plan provider representatives are providing a plan-related service and when these representatives are promoting nonplan products. Moreover, participants may believe the employer has implicitly endorsed these nonplan products by retaining that provider to administer the employer plan.
- The revenue generated by these nonplan products represents a form of indirect compensation to the providers, and plan fiduciaries need to better understand this indirect compensation as a part of carrying out their fiduciary oversight of the reasonableness of compensation received by these providers.
- The use of participant data by these providers to support sales efforts raises data privacy and security issues.

The Risk of Litigation

Although a number of recent court decisions have resulted in victories for plan fiduciaries (especially in the higher education markets), the plaintiffs' bar is still out there looking for opportunities to claim fiduciary breaches. And, although these cases remain focused on in-plan fees and investment performance, plan sponsors can expect to see litigation regarding the use of participant data to sell nonplan products and the revenue generated for plan providers. Most notably, the (third) complaint filed against New York University specifically alleged:[3]

- Private, confidential information that recordkeepers obtain about plan participants is information of value belonging to the plan and its participants and is a plan asset.
- Plan fiduciaries violated the prudence and exclusive benefit rules contained in the Employee Retirement Income Security Act (ERISA) by allowing the plan recordkeeper to use participants to promote the sales of nonplan products.

Although the defendants ultimately prevailed in the NYU case, one can anticipate that other complaints will raise—and refine—the issues regarding use of participant data and the sale of nonplan products.

No (Clear) Answers in Sight

The risks posed by the promotion of nonplan products and services are harder to identify than more traditional fiduciary risks. Generally, plan fiduciaries focus on in-plan fees and services and do not focus on provider service models. Moreover, information on nonplan offerings can be very difficult to obtain.

In analyzing the service models (including regulatory filings) of a number of plan providers, here are several of the revelations that a fiduciary is likely to unearth:

- A surprising number of the plan representatives who service retirement plans receive some form of compensation (such as bonuses and commissions) based on their ability to sell nonplan products. This form of compensation creates a conflict with participants' best interests.
- Providers are, by and large, free to share participant information with affiliated companies that may use this data solely to support the sales of nonplan financial products. (By way of contrast, the Health Insurance Portability and Accountability Act (HIPAA) imposes strict limits on internal sharing by providers of health information for marketing purposes. There is no real legal analogue with respect to the internal sharing—even for marketing purposes—of financial data.)
- A large percentage of nontaxable distributions, including those of larger account balances, are going into individual retirement accounts (IRAs) or other investment vehicles maintained by the plan provider.

Regulatory Resources

Regulators, in particular the U.S. Department of Labor (DOL) and SEC, are not expected to provide much guidance on this issue. Many of the issues raised with respect to these conflicted service models could have been addressed through the now-defunct DOL restatement of the definition of *fiduciary*. Although SEC has proposed new rules governing the conduct of broker-dealers, it is unlikely to have a significant impact on curbing the use of conflicted service models to promote nonplan products. Fiduciaries who are concerned with these issues likely must take matters into their own hands.

International Society of Certified Employee Benefit Specialists

Reprinted from the Second Quarter 2019 issue of *BENEFITS QUARTERLY*, published by the International Society of Certified Employee Benefit Specialists. With the exception of official Society announcements, the opinions given in articles are those of the authors. The International Society of Certified Employee Benefit Specialists disclaims responsibility for views expressed and statements made in articles published. No further transmission or electronic distribution of this material is permitted without permission. Subscription information can be found at iscebs.org.

©2019 International Society of Certified Employee Benefit Specialists

PDF/519

What Can Be Done?

As a starting point, when putting a plan out to bid, sponsors can take proactive steps to narrow the field of potential plan bidders by including probing questions in the request for proposals that address plan conflict and nonplan product sales. Such a process will put the selected provider on notice of the plan's expectations and weed out providers with alternative motives.

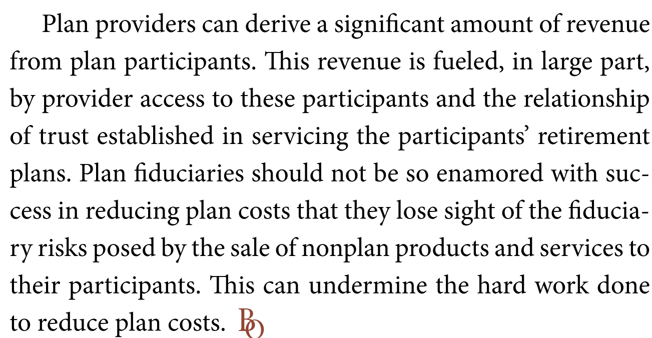
After selecting a provider, plan fiduciaries and sponsors can take a number of steps to reduce the risks related to nonplan products and services. Here are a few:

- Fiduciaries can conduct a targeted audit of the provider service model. Such an audit would address provider compensation structures and service models, participant services and data utilization practices, administrative and regulatory disclosures, and information on the nonplan products and services sold to participants.
- Fiduciaries can negotiate a number of contractual protections for participants, covering areas such as data utilization and limits on the sales of nonplan products and services.
- Plan sponsors can communicate to participants any limits on participant solicitation by providers and can dispel any perception that the employer has implicitly endorsed the nonplan products and services offered by the provider.

On an ongoing basis, sponsors should address the risks of a conflicted service model with the same diligence they apply to other key aspects of plan management: plan investments, plan fees and expenses, and oversight of service levels. In effect, sponsors should have a process and a methodology for monitoring provider nonplan activity. Verbal assurances, backed up by vague contractual provisions, are ineffective in the face of a determined—and financially motivated—sales organization. Sponsors should be mindful of catchphrases and sound bites, such as "holistic financial planning," which can mask the presence of nonplan sales.

While financial plans and financial wellness programs can be positive and highly valued additions to the plan, they also may be used to prospect for other lines of business, garner additional financial data and solicit nonplan products.

Conclusion



Plan providers can derive a significant amount of revenue from plan participants. This revenue is fueled, in large part, by provider access to these participants and the relationship of trust established in servicing the participants' retirement plans. Plan fiduciaries should not be so enamored with success in reducing plan costs that they lose sight of the fiduciary risks posed by the sale of nonplan products and services to their participants. This can undermine the hard work done to reduce plan costs. BQ

AUTHORS

Daniel Alexander is an industry veteran and the founder of RetireAware, an independent plan fiduciary committed to investment and transactional transparency. He has extensive knowledge of the group-sponsored retirement market, ranging from sales and distribution to plan design and administration. Prior to founding RetireAware, Alexander served in a senior sales leadership role for a leading U.S.-based retirement company.

Allen Steinberg is the chief legal officer of RetireAware. He has more than 35 years of experience providing employers with advice, ideas and support for a broad range of benefit plans. During his career, Steinberg has been an associate with a major Chicago law firm, a partner at a global consulting and actuarial firm, and the owner of a law firm focused solely on employee benefits.

Endnotes

1. Investment Company Institute. Available at www.ici.org/research/stats.

2. T. Rowe Price, *Retirement Savings and Spending 4: Behaviors and Attitudes Toward Financial Advice*, December 2018. Available at www3.troweprice.com/usrps/content/dam/b2bdx/resources/RetirementForAll/Press%20Release%20deck%20for%20Advice_FINAL.pdf.

3. See *Sacerdote v. New York University*, Case 1:17-cv-08834-KBF, filed January 10, 2018, paragraphs 81-89 and 302-317: https://s3.amazonaws.com/si-interactive/prod/plansponsor-com/wp-content/uploads/2018/01/22150733/SacerdotevNYUComplaint3WithCammack.pdf.