New fee disclosure regulations could put pressure on popular asset managers that control trillions of dollars in 401(k) plans. According to an analyst at Moody's, the reaction from plan sponsors may shake up the defined contribution market.

By **Jenny Ivy** | June 14, 2012 at 03:41 PM | Originally published on **Benefitspro.Com**

Will sponsors think twice about the 401(k) they offer? (photo: freedigitalphotos.net)

New fee disclosure regulations could put pressure on popular asset managers that control trillions of dollars in 401(k) plans.

According to an analyst at Moody's, once plan sponsors know exactly what they're paying for, the reaction may shake up the defined contribution market.

"As people start to process and consider what it costs to run a 401(k) plan, it might make them change their choices in terms of what they offer their beneficiaries. That in turn could change the supply and demand of money management services," said Neil Epstein, vice president-senior credit officer at Moody's Investors Service.

The effective date for fee disclosure is July 1 – that's when plan providers must provide information to plan fiduciaries that explains what they're providing and all direct and indirect compensation they, or their affiliates, will receive for services, administration and investments.

Under new regulations, with high-cost providers being "less attractive" to plan sponsors and investors, there are implications that this could impact competition. At least, that was the prediction Epstein made in February, just as the Department of Labor was issuing its final rule.

Although it's too early to guess the size of impact on provider business, the change in oversight was enough to raise a red flag at Moody's. In a "Weekly Credit Outlook," a publication that offers opinions on credit market trends, Epstein declared fee disclosure regulations as being "credit negative" for major plan providers such as Fidelity, Franklin Resources, Invesco and Janus.

When BenefitsPro spoke to Epstein recently, he stuck by his initial remarks.

"As a credit rating agency, we're always concerned about credit worthiness impacted by news events — things that might be particular to a given business or things that might be on an industry-wide basis — impacting competitors and changing competitive conditions. That in turn would change the credit worthiness of somebody," Epstein said. "That particular week, I thought it was interesting that more information about the cost structure of 401(k) plans could change competitive behavior."

What exactly does credit negative mean? It's not a downgrade, but more of a warning sign for the industry that this could be a game-changing situation. The new rules will lift the veil on all fees — many that are indirect and hidden — imposed by asset managers that can impact overall savings.

The "greatest fee pressure," Epstein writes, is going to be on those firms that serve as recordkeepers that bundle asset management and other plan services together. These companies will need to disclose the extent to which products cross-subsidize one another and whether there's any conflict of interest.

If plan fiduciaries determine the fees are unreasonable or there's a conflict of interest, they may reconsider their plan offerings and shop somewhere else. Or, plan sponsors may simply opt for the cheapest investment products they can find — namely, index funds that are passively managed mutual funds, which track performance based on existing market benchmarks, as opposed to actively managed funds that try to beat the market.

[Read: 5 fee disclosure risks for plan sponsors]

What this means for traditional investment managers is that they're going to be "competing over a shrinking pie," as Epstein puts it. "With more attention focused on costs, that could further along that process of promoting the use of passive over active products."

Other costly aspects of 401(k)s include compliance and recordkeeping, which tracks things like transactions. Recordkeeping services could also include educational materials and communication.

To pay for all this plan management, providers issue several types of fees and use varying types of fee arrangements. The most prominent plan fees, according to a study from Deloitte and the Investment Company Institute, are asset-based investment related fees, which represent 74 percent of 401(k) fees and expenses.

These fees are used to compensate portfolio managers or investment advisors. They're also part of distribution and service costs (in the case of mutual funds, these are known as 12-b 1 fees). Additionally, they're part of the investment option, and include custodial, recordkeeping and other operating expenses.

When a sponsor is comparing plans, they aren't given a single fee quote, but a range of options as providers compete for the sponsor's business, according to the study.

After next month, that all might change. In retrospect, plan sponsors may realize they never really understood what they were paying for. In fact, according to a recent government report, 50 percent of plan sponsors didn't know if they or their plan participants paid investment management fees, or they mistakenly believed those fees were waived.

[See also: Employers don't know enough about 401(k) fees]

"A plan is always a bundle of services," Epstein says. "Plan sponsors may not have adequately understood what all these components are costing them. And by bundling the services, advisors were getting them to buy maybe more than they wanted for their participants. So it's possible that if there's an impact on cost overall, it's going to be because plan sponsors are going to say, I didn't realize how much all this was costing me."

Bundling may not be suitable for everyone, but it's appropriate for many employers, says Beth McHugh, Fidelity's VP Market Insight at Fidelity Investments. McHugh didn't wish to respond directly to Moody's claim, but offered insight on the new disclosure rules.

"What fee disclosure does is help ensure that individuals and employers have more information and access to fee data and to help them make the most appropriate decisions regarding their investment lineup.

"Bundling both the investments and the recordkeeping together [is] a good model for many companies," McHugh continued. "It provides employees with the ability to get access to name-brand investment products or mutual funds. It gives [employers] the opportunity to offer a wide range of options, so many employers will look to create a tiered offering of investments for their employees and they try to do that in ways that meet the diverse needs of their employee populations."

There will be some "winners" of fee disclosure, Epstein notes in the report. Companies such as Vanguard and Charles Schwab already specialize in offering low-cost funds and administrative services, so the disclosure rules will be "credit positive as it will highlight their competitive advantage."

But going forward, everyone will have to tread a little more carefully, Epstein says. "[There are] different issues for each of the players. The investment consultant has to be careful that they're no longer seen to be pushing services that a 401(k) plan might not want. The investment manager has to be seen to be providing competitive products that are earning their cost. The providers of plan services need to seem to be efficient and effective. Fee disclosure impacts everybody a little bit in the overall equation."

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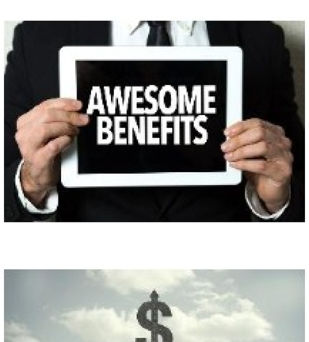

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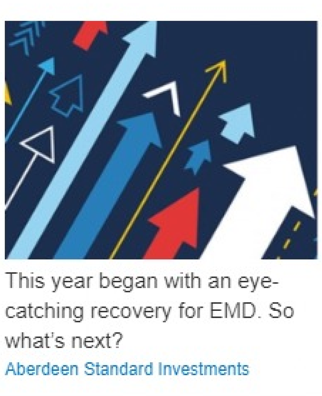

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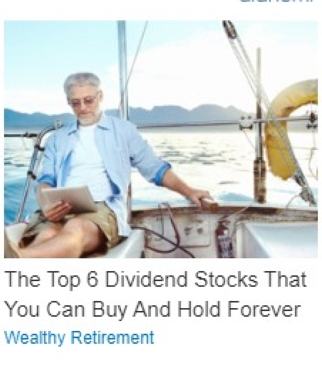

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