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Seek but You Will Not Find – Indirect Fee Disclosures, a Persistent Issue

The IRS, DOL and Pension Benefit Guaranty Corporation jointly developed the Form 5500-series returns for employee benefit plans to satisfy annual reporting requirements under ERISA and the Internal Revenue Code.[1] Within these forms is the Schedule C, which is designed to capture sponsors' service provider information for large-plan filers (plans covering 100 or more participants). On Schedule C sponsors are required to list all service providers who receive $5000 dollars or more (direct or indirect) through fees or compensation in relation to the services being provided.

In part II – 4 of the Schedule C, sponsors may also list information that a service provider has failed to provide the sponsor. The question specifically states:

- *Provide, to the extent possible, the following information for each service provider who failed or refused to provide the information necessary to complete this Schedule.*

The DOL further clarified how and when a sponsor should list this information[2]:

- *Provide the requested information for each plan fiduciary or service provider who you believe failed or refused to provide any of the information necessary to complete Part I of this schedule. Important Reminder. Before identifying a fiduciary or service provider as a person who failed or refused to provide information, you should contact the fiduciary or service provider to request the necessary information and tell them that you will list them on the Schedule C as a fiduciary or service provider who failed or refused to provide information if they do not provide the necessary information.*

Most sections in Schedule C (and all form 5500s for that matter) offer sponsors preselected options to choose from or ask for a precise piece of information (e.g., total dollar value amount). Part II – 4, however, allows the sponsor to provide free form comments. As a result, sponsors have the discretion to comment however they'd like.

As a service provider for non-qualified deferred compensation plans, Nolan Financial wanted to further investigate these free form comments to gain a better understanding of which items service providers failed to report to their client. This information can help service providers make smarter and more well informed business decisions to ensure we exceed our client expectations. Furthermore, and to the best of our knowledge, a study of this nature has not been conducted.

With thousands of free form comments, however, this analysis is a bit more difficult than analyzing a defined set or binary options. One useful way to examine free form comments is the use of text analysis and in particular, a word cloud. A word cloud is a visual representation of word frequencies contained in a body of text. Words that appear more frequently will be larger than words that appear less often. For example, a word that appears 20 total times in a body of text will be much larger than a word that appears only 5 total times in that same body of text. Before conducting a text analysis and building a word cloud, the text must be prepped in order to remove stop words (e.g., is, of, the, to, as, in, etc.) and other dead words (e.g., company, insurance, finance) that don't offer any valuable insight into the body of text.

Schedule C part II – 4 comments were evaluated for the past five years, 2015 – 2011, which included a total of approximately 8000 unique entries by plan sponsors.   It should be noted that 2015 is the most current form 5500 data available as sponsors have ten months after the fiscal year to file this information.   The full 2016 data set should be available by October 2017. The results of the word cloud appear in Figure 1 and the top ten words and their frequency count is presented in Table 1.

Figure 1. Word Cloud Schedule C Part II – 4, 2015 – 2011

Table 1. Top Ten Word Frequency, Schedule C Part II – 4, 2015 – 2011

Word	Total Word Count
comp	4066
indirect	3792
respond	1750
service	1718
direct	643
questionnaire	630
requests	380
response	308
fee	231
amount	152

Since the Schedule C filings pertain to various benefit plans including, defined benefit, defined contribution and welfare benefit plans (e.g., group life, group health, etc.), a breakdown is provided in Table 2, which shows the distribution of these comments.

Table 2. Benefit Type, Schedule C Part II – 4, 2015 – 2011

Benefit Type	Total Plan Type Count	% of Total
Defined Benefit	1082	14%
Defined Contribution	3421	43%
Welfare Benefit	3433	43%

Interpreting the Results

Interpreting a word cloud requires a solid understanding of the context of the words in the body of text. The most frequently cited words, therefore, need to be presented in a manner that is not misleading. After randomly reviewing many comments, we are able to conclude that the two most commonly cited words, `indirect` and `comp`, do in fact convey that indirect compensation is the most frequently cited item that sponsors fail to receive from their service providers upon request. Actual sponsor entries may look as follows:

- *did not respond to plan's multiple request for information regarding indirect compensation received*
- *indirect compensation*
- *information on indirect compensation*
- *the service provider failed to provide information regarding indirect compensation*

In general, the results of the world cloud indicate that the larger category of compensation is the most frequent piece of information that is not provided to their clients. It's also important to note that this analysis does not provide evidence that sponsors are being charged indirect fees. It simply means that sponsors failed to receive this information. A further investigation would be needed to determine the presence of indirect fees and to what extent. By not disclosing this information, though, it's reasonable to believe there is a good chance indirect are being applied to the sponsor's account.

The DOL defines indirect compensation as the following:

- Compensation received from sources other than directly from the plan or plan sponsor is reportable on Schedule C as indirect compensation from the plan if the compensation was received in connection with services rendered to the plan during the plan year or the person's position with the plan. For this purpose, compensation is considered to have been received in connection with services rendered to the plan or the person's position with the plan if the person's eligibility for a payment is based, in whole or in part, on services that were rendered to the plan or on a transaction or series of transactions with the plan.

- Examples of reportable indirect compensation include fees and expense reimbursement payments received by a person from mutual funds, bank commingled trusts, insurance company pooled separate accounts, and other separately managed accounts and pooled investment funds in which the plan invests that are charged against the fund or account and reflected in the value of the plan's investment (such as management fees paid by a mutual fund to its investment adviser, sub-transfer agency fees, shareholder servicing fees, account maintenance fees, and 12b-1 distribution fees).

  Other examples of reportable indirect compensation are finder's fees, float revenue, brokerage commissions (regardless of whether the broker is granted discretion), research or other products or services, other than execution, received from a broker-dealer or other third party in connection with securities transactions (soft dollars), and other transaction based fees received in connection with transactions or services involving the plan whether or not they are capitalized as investment costs.

Conclusion

These results are discouraging. In an era where increased fiduciary regulations aim to reduce fee opaqueness, it's evident sponsors are still encountering difficulty obtaining this critical information. Withholding this information hinders plan sponsors ability to make sound decisions that maximize the benefit to participants, while minimizing the total cost to the firm.

This knowledge can be useful for service providers, fiduciaries, advisors, and plan sponsors. For service providers and advisors, it should serve as a reminder to proactively communicate indirect fee disclosures to their clients without solicitation. Plan sponsors may now have the impetus to proactively request indirect fee disclosures from their service providers, especially if they have never done so before. Moreover, while it seems the bulk of fee disclosure attention is focused the defined contribution market, this analysis shows that indirect fee disclosures afflict other services as well such as defined benefit and welfare benefit plans. As a result, sponsors may now have the motivation to determine if indirect fees are being applied to other benefits they are providing. Lastly, sponsors should also carefully evaluate service provider proposals with hard dollar fees that are demonstrably lower than their competitors. It's plausible that in some of these instances, indirect fees, will be applied to the account in the future without the sponsors' and participants' awareness.

It's incumbent upon the entire financial community to continue to strive to act in the best interest of the client to ensure they and their participants are not only receiving a high quality benefit, but at a cost they understand and can afford. This results from this report provide new and compelling evidence that reinforces this position.

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About Nolan Financial

Nolan Financial is a fully integrated nonqualified deferred compensation service provider committed to fee transparency and has worked with for-profit, tax-exempt, public, and private organizations for the past 28 years. For questions about this report or if you would like to contact Nolan Financial we can be reached at 301.907.9500 or at inf@nolanfinancial.com

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3. https://www.dol.gov/