Walker MacRae℠

Third Party Administration Survival in the Retirement Market

An analysis of the opportunities and hazards faced in recapturing the retirement plans that were lost to subsidized pricing and "bundled providers" in the 90s

By Lance M. Roberts
October 23, 2002

If you are a third party administration (TPA) firm, this report will help you understand and control the exposure of your business asset base to technical evolution, stagnant investment returns and the refocus on both direct and indirect plan expenses.

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Preface

Why a White Paper?

As a former owner of a regional TPA firm for many years, I witnessed, first-hand, the avarice of large financial institutions in the mid-90s as they employed business practices that were plainly unfair to the TPA community. After selling my TPA practice in 1996, I saw an opportunity to shift the balance of power in the retirement industry away from these same large financial institutions and back to the regional professionals – TPAs as well as investment advisors and the technology vendors that support them. My hope is that a level playing field in the retirement industry can be re-established for the benefit of these regional professionals, plan sponsors and, ultimately, plan participants. It was with this goal in mind that I founded Walker MacRae.

Given developments that have occurred in the industry over the past few years, regional and local TPAs are becoming increasingly aware that something in their business is broken. For those TPAs that choose to ignore the problems inherent in their current business model, "Thriving in 2005" is not a concern – they will be on their way out of the business by then!

The purpose of this White Paper is to provide a national perspective of the retirement industry from which regional providers may develop a "roadmap" for their own success.

I welcome the opportunity to speak with you about TPA issues and how I may be of assistance in helping you achieve your business goals in the dynamic and rapidly changing business environment in which we all operate.

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Executive Summary

There is a burgeoning crisis in 401(k) administration for a vast majority of plan sponsors. The “large plan market,” however, is not where this crisis has manifested. Every service provider wants to handle the top “10% of the plans that contain 90% of the retirement asset base.” Within this group, providers aggressively compete at lowest net cost with nary a concern about withdrawing from the market or withholding pricing information on their services. In the retirement world, this is truly utopia, where full disclosure of fees reigns and plan sponsors pay to hire and retain full-time human resource and financial professionals. Vendors are attracted to the “large plan market” because of the immense size of the asset base that directly translates into large asset-based fees.

Of the 700,000 401(k) plans in existence today, roughly 70% are sponsored by small business owners. These plans typically have less than 100 participants and $1 million or less in assets. This segment of the market has historically been serviced by regional and local TPAs that provided documentation, consulting, administration, reporting, and testing. As large national service providers entered this market, the large asset bases they possessed (and hence, large asset based fees) allowed them to subsidize administration and record keeping services and put ever-increasing price pressures on regional and local TPAs.

Due to a combination of factors, many of these large national service providers have now left, and more will undoubtedly continue to abandon, this market. These factors include stagnant investment growth, hard economic times, and the move toward full disclosure of all plan fees. For a number of these large national service providers it no longer makes sense to service the small market. No longer are they able to continue the historic practice of having medium sized retirement plans subsidize the cost of the small plan market.

This situation has been further compounded by the evolution of non-qualified defined contribution plans, the re-introduction of defined benefit plans for the baby boomer generation, and the possible transfer of Social Security benefits to private investment.

Scope

The economic reality of the small plan market has been a continued withdrawal of bundled providers and an ensuing transfer of this very sizeable block of plans to a fragmented universe of unbundled TPAs. This is the same community of TPAs that for years was decimated by the predatory pricing practices of the industry’s bundled providers in their power grab for plan assets; a troubled economy; a lack of access to business loans to fund expansion or technological investment; and a major consolidation of service providers in “TPA roll-ups” that have been funded by venture capital.

Today, TPA organizations have an unprecedented opportunity to recapture the retire-

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ment plan business base that was lost to those larger national institutions over the past 10 years. For TPAs that recognize and seize this opportunity, they will not only survive until 2005 – they will thrive.

In the near future, Walker MacRae will produce a White Paper for consumption by peripherally interested parties such as investment professionals, plan sponsors, governmental regulators, accountants, lawyers, and the like. This will represent a less-technical, "scaled down" version of this White Paper and will specifically focus on the following issues surrounding the current crisis:

- Product pricing and the legal issue of ownership of revenue sharing dollars generated by retirement plan assets
- Review of alternatives in pension record keeping software
- Marketing strategy conflicts that exist among strategic vendors
- The unsettled marriage between Tier III TPAs and insurance companies that keep the small business industry afloat

Who is Walker MacRae?

Walker MacRae was formed by the author for the express purpose of re-establishing a level playing field in the retirement industry for the benefit of regional professionals such as TPAs. With this in mind, Walker MacRae has two divisions. First, in its capacity as a trading platform vendor for TPAs across the country, Walker MacRae is committed to the idea of **Transparent Pricing℠** which we define as the full disclosure of all plan expenses and 100% pass-through of all revenue sharing dollars that a plan generates. In addition, Walker MacRae provides consulting services to TPAs nationally on issues that are critical to their business. We approach these engagements from the perspective of: "What We Can Do In 2002." and "How to Survive to 2005!" Typical topics of our consulting efforts include but are not limited to:

- How to identify and access capital resources
- How to hire and maintain staff with limited resources
- How to address general business management issues
- How to 'fix' your business - that is, how to remain independent/entrepreneurial and increase the economic payout in an increasingly technical environment

It is from this consulting side of the business that the present White Paper evolved. The goal of the consulting process is, in a useful and practical manner, to share information gathered over many years of industry experience as well as through ongoing consultation and discussions with varied regional and national organizations representing a wide cross-section of all functional areas in the industry. This consultative process is completely separate from the selling of Walker MacRae's products and services.

Both "sides" of Walker MacRae have the same mission: to shift the balance of power in the retirement industry back from the large financial institutions and return control of relationships to the plan sponsor. It is our fervent belief that this will entail a re-emergence of the regional/local TPA as the vendor of choice in the small and medium plan markets. We believe that this "pendulum swing" will ultimately benefit plan participants and do much to alleviate the growing crisis in the retirement market described above.

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Introduction

For the majority of plan sponsors, there is a burgeoning crisis in 401(k) administration. Small plan sponsors and the participants in those plans are being negatively impacted by standard industry pricing and cost recovery practices.

As the large national institutions exited this segment of the market, the vast majority of these plans were taken on and administered by regional TPA firms. These TPAs either have their own daily valuation/record keeping systems ("Tier II" TPAs) or they use the daily valuation/record keeping systems of national product providers ("Tier III" TPAs). Two principal record keeping and trading resources are typically available to these TPAs: services provided by competitive processing vendors; or costly alternatives offered by insurance companies inside group annuity contract arrangements.

Often, the national providers involved in the semi-bundled group annuity products believe that they (and not the TPA) own the retirement plan client. In addition, this approach is characterized by: obfuscated layers of hidden fees; an absence of any revenue sharing; limited investment menus; and a dearth of disclosure relating to plan expenses.

In a "Catch-22" scenario, this situation is further exacerbated by the departure of many system vendors from this segment of the market which, in turn, leaves the regional TPA with even fewer record keeping system alternatives. At the same time, TPAs are challenged to find the funding necessary to secure, maintain and enhance plan and participant level services.

In recent years, the retirement industry has failed to grow at projected rates – a result of stagnant investment returns – forcing bundled providers to re-evaluate/eliminate services that are not profitable.

This report is designed for the following audience:

- Third Party Administrators
- Retirement Plan Sponsors
- Human Resources & Benefits Professionals
- Regulators/Legislators
- Attorneys & Consultants

TPAs Defined

Tier I *- TPAs that provide in-house daily valuation record keeping, administration, asset trading, plan documents and consulting.*

Tier II *- TPAs that provide in-house daily valuation record keeping and administration services, plan documents, consulting, but not asset trading.*

Tier III *- TPAs that provide administration, consulting and plan documents only, and use outside vendors for daily valuation record keeping services and asset trading.*

Note: that all of the above may or may not provide investment advice as an RIA or broker/dealer.

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How to Survive to 2005!

A Brief History of the Impact of Bundled Providers on TPAs

During the 1970s and 1980s, the retirement plan industry was dominated by regional and national TPA firms that offered traditional plan designs - defined contribution plans (profit sharing and money purchase) and defined benefit plans. The large majority of these were balance forward plans where the plan sponsor was required to periodically (i.e., annually) make contributions and file reports with the IRS.

Over time, however, there was a growing movement towards more frequent reporting (i.e., quarterly). The vast majority of plans were still being invested at the direction of the plan trustees for the benefit of plan participants. As the 1980's came to a close, we experienced an economic recession, bank failures, and a tightening of credit. As a result, the trend in the industry shifted away from defined benefit plans (and the large accrued liabilities of past and future service) towards profit sharing plans (where the annual contribution could vary based on the plan sponsor's current financial condition). Given the economy, however, even profit sharing plans reduced contributions and many plan sponsors began to offer CODA (cash or deferred arrangement) plans – 401(k) plans – which offered the participant the opportunity to defer taxation on contributions as well as the earnings on those contributions.

This development started in motion the payroll deduction and remittance process, increased the demand for quarterly reporting and shifted investment decision making from the plan trustee to the plan participant. Regional TPAs experienced a huge demand for 401(k) plans. No one, especially the large financial institutions, wanted the least profitable start-up plans which had low asset bases and required a great deal of “hand holding” in the form of employee education and enrollment. Consequently, regional TPAs were inundated with requests from small to medium sized employers to implement plans. TPAs saw these plans as a business that could be profitable if administration and record keeping fees could be based on the number of participants rather than on assets.

The proliferation of 401(k) plans coincided with the explosive growth in popularity of mutual funds. Mutual funds provided investment alternatives to the plan participants that were perfectly suited to plans characterized by periodic contributions – they were priced daily and this pricing was readily available in any newspaper.

Unfortunately for regional TPAs, mutual fund distributors saw this as an opportunity to gather mutual fund assets by providing “bundled” retirement services. In a typical “bundled” mutual fund product of the early and middle 1990s, a fund family would provide full administration and record keeping services for a plan populated by its own family of funds. In these approaches, the asset-based fees that were generated as plan assets accrued inside the proprietary mutual funds heavily subsidizing the record keeping and administrative service fees.

At that time, subsidization was still not available to TPAs. "Traditional TPAs" typically charged fees for services and did not sell investments. As a result, they had no means by which to compete with the cross-subsidization of administrative fees (by asset based revenues) that these large financial institutions were able to offer inside these "bundled" products. The result was an erosion of the regional TPA customer base, starting with the most desirable large asset-base plans.

To make matters worse, mutual fund distributors began infusing cash into the development of daily valuation record keeping processes and systems. Daily valuation allowed plan participants to move money within the family of funds each business day and trading was executed manually and/or in-house. With this development, TPAs were confronted with a situation where they were struggling against competitors who were perceived as less expensive and possessing superior technological "bells and whistles."

Around this time, Schwab (and then Fidelity) developed a "multi-fund trading platform" which gave plan participants access to a wide range of mutual funds from many different families under the guise of a no-commission, no-transaction fee and no-load cost structure. What was not fully appreciated at the time was the magnitude of "indirect expense costs" generated by this approach. These "indirect expense costs" came to be known as "revenue sharing" – marketing and servicing fees that pass from mutual funds to service vendors as a byproduct of this "multi-fund trading process."

As a result of these developments, traditional TPAs became a transitional administrator, establishing "start-up" plans and maintaining them until the plans became sufficiently large and profitable (i.e., their assets hit a critical mass) to be attractive to bundled providers.

In response to this evolving business reality, some entrepreneurial TPAs purchased daily valuation software or entered into confederations of TPAs to share costs in the purchase of such systems. Unfortunately, more often than not, the technological aspects of the conversion were disastrous, resulting in a negative image of the independent regional TPA community that still lingers to this day. National Pension Administrators (NPA) and Third Party Administration Cooperative (TPAC) are two prime examples of early confederations that experienced significant pricing as well as technological difficulties. TPAC was able to overcome these early difficulties and still exists today while NPA became a casualty of these "first-out-of-the-box" issues.

Even if an independent TPA managed to avoid or overcome these technological hurdles, it was then confronted with the problem of how to pay for this necessary technology while remaining cost competitive with national providers and bundlers that were subsidizing administration fees as described above. Borrowing from banks for technology improvements without having a traditional form of collateral is always difficult, as all service providers are painfully aware. However, attempting to do so in the very tight credit market that existed around that time put TPAs in a situation that was even more onerous than usual.

Often the best (and perhaps only) means to make this investment feasible was to expand the traditional TPA service offering to include investment advisory services and/or product sales. For TPAs that added these revenue sources, access to fee and commission streams allowed them to better compete with the "bundled" providers because they could now take advantage of cross-subsidization as well – at least to some degree.

A New Century

Since 2000, we in the retirement industry have found ourselves in a time of major structural change characterized by a number of bundled service providers – both large and small – departing the business either by selling off or consolidating services. To a large extent, this mass exodus has been the product of an overall slowdown in the economy coupled with stagnant equity markets. This resulted in a significant shortfall in projected retirement plan asset levels, not to mention a related slowdown in deposit flows.

This is particularly true in the small employer market which, like "rocks on a raft," weighed down and eventually "sank" many providers' overall profitability. For these asset-motivated vendors with a client base populated with too many unprofitable small market plans and no long-term strategic advantage in their business model, selling off or consolidating their business has often been the only move they make. A small sampling of "big name" bundled providers that have found themselves in this situation and been forced to exit at least a portion of the retirement market include Merrill Lynch, John Hancock, Morgan Stanley, and New England Financial Services.

Current Trends in the Industry

Full Disclosure

Confronted with this same reality, traditional TPAs generally had four options, none of which was ideal:

1. **Option:** Trading through multi-fund platforms typically offered by large national institutions such as Schwab or Fidelity. This option offered mutual funds from various fund complexes with no commission, no load and no transaction costs...and no revenue sharing
   Problem: Schwab and Fidelity were and are competitors. They offer bundled retirement plans services. Obviously, this "deal with the devil" approach places the TPA's most significant asset base at risk (plans characterized by a significant asset base and/or a high participant count).

2. **Option:** Selling investment products as a licensed broker or RIA
   Problem: Selling investment products changes the relationship with clients and potentially places the TPA at risk as an investment fiduciary.

3. **Option:** Negotiating contracts directly with mutual fund families to receive sub-transfer agency and/or share servicing fees
   Problem: In addition to taking on the laborious and time-consuming task of negotiation, the TPA must confront the issue of identifying what, if any, disclosures must be made to plan sponsor clients.

4. **Option:** Negotiating a "fee" arrangement directly with a willing trust company where the "fees" equal a percentage of total revenue sharing collected
   Problem: Re-classifying "commissions" and "trailers" as "fees" is clearly a thinly veiled attempt to avoid the added expense and regulatory oversight associated with some or all of the options listed above. As a result, its long-term viability is questionable.

If selected, the second, and to a greater degree, third and fourth options above have implications relating to the issue of fee disclosure for the TPA. ERISA only requires that plan expenses be "reasonable." It can (quite convincingly) be argued that fiduciaries cannot make this determination without being made aware of all plan costs – including all direct and indirect fees, commissions and revenue sharing fee arrangements. Thus, the issue of fee disclosure – particularly with respect to those various forms of revenue sharing to which the TPA has begun to have access – have to be considered by the TPA community.

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Given the limited alternatives TPAs had available to them in their struggle to compete in a market dominated by firms with access to subsidized administrative costs, is it any wonder the initial reaction of TPAs to revenue sharing was to keep and not disclose it? In the recent White Paper on revenue sharing, “Whose Money Is It?” the McHenry Consulting Group stated:

> *Despite increased pressure from the Pension and Welfare Benefits Administration of the Department of Labor to apply revenue from mutual fund companies toward the expenses charged to 401(k) plan sponsors, 69% of the firms surveyed said they did not tell their clients about profits stemming from managing pension assets.*

A largely ignored, albeit basic, tenet of ERISA is that plan fiduciaries must evaluate the expenses of the plan. Historically, however, plan sponsors/fiduciaries have only been aware of, and based their cost analysis on, a portion of plan expenses – those that the vendors chose to disclose to them. As a result, they were not able to evaluate the actual total cost to the plan despite their best efforts and intent.

Full disclosure is an issue whose time has come. Expense costs are now paramount, and unless all direct and indirect expenses are disclosed, the plan sponsor’s fiduciary duty to monitor costs cannot be discharged!

100% Pass-Through of Revenue Sharing

Mutual funds are allowed to charge fees for the promotion of their products and, as a result, they have made revenue sharing available to service providers in the industry to gain access to the retirement assets held in plans serviced by them. It did not take long before vendors began competing for these revenue sharing dollars. A recent shift in this competition has involved who received these dollars. Many service providers are opting to “pass-through” this cash flow to the plan – its ultimate use to be determined by the plan sponsor.

The basic tenet of the recently filed Nationwide lawsuit (*Haddock, et. al. v. Nationwide Financial Services Inc. and Nationwide Life Insurance Company*, USDC CT, filed September 5, 2001) is that all revenue sharing is a plan asset. As such, the plan sponsor should ultimately determine its disposition or use – whether to meet plan expenses or to pay a dividend to participants. By redirecting revenue sharing without advising the plan sponsor, the Plaintiffs in the case allege that Nationwide acted as a fiduciary and violated the exclusive benefit rule. Brooke Southall, in Investment News (January 7, 2002) reported:

> *Nationwide represented that its management fees ran between 0.75% and 1.00%. But in some cases mutual fund firms rebated more than 0.50%. Nationwide failed to disclose that fact and kept the undisclosed kickbacks for itself. What’s more, Nationwide has been systematically replacing funds in its bundled annuity product in favor of ones*

that pay better revenue sharing rebates. Nationwide has steadily replaced mutual funds managed by competitors with its own. [This] has resulted in holding funds that provide inferior returns. Nationwide's response is that they are not a fiduciary under ERISA and in a prepared statement defended its actions: "...our practices are in line with standard industry practice."

Indeed, at a Pensions & Investments Conference (October 2001), a J.P. Morgan representative had this to say about revenue sharing: "everybody (plan sponsors) knows about it" and "the market wants top services regardless of cost."

The result is that plan sponsors and/or participants rarely acknowledge fund companies for the millions of dollars they pay in revenue sharing year after year. Instead of receiving credit for contributions that they often make to subsidizing overall plan expenses, fund companies find themselves in a "what have you done for me lately" situation where they are a few quarters of poor performance away from being supplanted in a plan's menu of investments. As a result, the opportunity to receive the recognition to which they are entitled has many fund companies excited by, and in full support of, this latest trend of "passing through" revenue sharing dollars to the plan.

Revenue Sharing Defined

The Securities Exchange Commission (SEC) allows mutual fund distributors to charge customers for marketing expenses. There are four principal areas of revenue sharing that we will focus on as the basis of this report:

Finder's Fees - Commission-based mutual funds often pay a finder's fee that are not specifically identified in the prospectus (as much as 1% of the contribution) for net "new money" contributions.

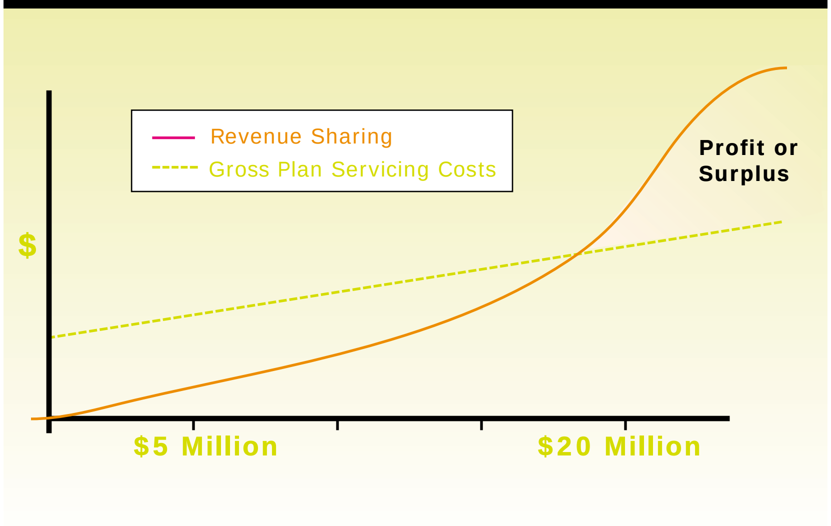
12(b)-1 Fees - Disclosed in the prospectus of load mutual funds, these fees compensate for "marketing and distribution expenses".

Sub-Transfer Agency Fees - Mutual fund distributors will generally pay fees to service providers (which can be asset or participant-based) that are not a reportable item in the prospectus. These fees are used by fund companies as a means of subsidizing servicing expenses (i.e., some transfer agency activities – such as the production of statements – are often performed by the service provider/bundler and not the fund company) as well as gaining access to retirement assets. In the past, TPA service providers have not reported these subsidies. However, several insurance companies and bundled fund family providers are now beginning to show these expenses on Form 5500. These payments are typically on par with 12(b)-1 fees.

Shareholder Servicing Fees - Shareholder Servicing fees are a second type of non-prospectus expense item. Similar to Sub-Transfer Agency fees above, these fees are used by fund companies as a means of subsidizing shareholder servicing expenses (i.e., some communication/servicing activities – such as staffing of a call center or maintenance of VRU and internet systems – are often performed by the service provider/bundler and not the fund company) as well as gaining access to retirement assets. Like the Sub-Transfer Agency fees, these fees, historically undisclosed, are now beginning to be shown on the Form 5500 with greater frequency. Lastly, these payments are also typically on par with 12(b)-1 fees.

The following chart illustrates the relationship between the basic costs for providing services versus sources of revenue sharing. This difference between "Expense" and "Revenue Sharing" is where the next industry battle will be waged.

Chart 1: Servicing Costs versus Revenue Sharing



TPAs know that the cost of administering a plan is driven primarily by the participant count rather than by the size of plan assets. In the Chart above, true plan expenses are largely flat even as plan assets grow. There is not much difference in the cost of running a 500-employee retirement plan whether it has $5 million or $20 million in plan assets. However, revenue sharing payments are generally driven by assets and, as a result, revenues generated by this hypothetical 500 participant, $20 million plan will be significantly higher (4 times?) than the 500 participant, $5 million plan.

In smaller plans (to the left of the "crossover point") there is insufficient revenue sharing to have a significant impact on a plan's net cost. As assets grow, however, revenue sharing eventually equals and then exceeds the true or gross cost of servicing a plan. These are the plans that have historically generated the revenue sharing dollars that subsidized the smaller, less profitable plans (falling further left on this chart) for the service provider who kept those revenue streams. In fact, the average account balance of the plan often determines the location of the "crossover point".

Ethical Revenue Sharing

Transparent Pricing℠ is defined as a two-step process: first, full disclosure of all plan expenses, and second, 100% pass-through of all revenue sharing generated by plan assets back to the plan. To define each of these steps, "full disclosure of all plan expenses," means exactly that: ALL plan expenses means ALL costs - whether direct or indirect; participant or asset-based; soft or hard. Pass-through of 100% - ALL - revenue sharing generated by plan assets back to the plan exists when all revenue sharing monies are proactively re-captured and deposited into an account in the name of the plan. In this scenario, the plan sponsor/fiduciary takes control of the plan's costs and the process by which these costs are paid, rather than having the process controlled by either the bundled or unbundled providers.

As has been the case in so many industry developments and innovations over the years, this approach has been common place in the world of Fortune 500 companies

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for some time but is just now beginning to "trickle down" to the medium-sized and smaller retirement plans. **Transparent Pricing℠**, and the full revenue sharing pass-through it entails, represents the best opportunity for regional and local TPAs to combat the national provider's subsidized fees and regain the business base they lost in the early 1990s.

This process is being driven by competition, not by any commitment on the part of those that currently control the cash. In a recent Regional Client Conference, Schwab announced its new 2002 Pilot Pricing Program to TPA users in which more of the revenue sharing was being made available to the plan sponsor. In a handout which was disseminated to the attendees, Schwab touted, "Why New Pricing? - Offer a more competitive platform vs. our competitors."

A Legal Safe Harbor On Revenue Sharing

Dechert, an international law firm with attorneys that specialize in employee benefits, discussed issues presented by the Nationwide case (Financial Services Memo 2002-04, dated January 30, 2002, "Payments to Employee Benefit Plan Service Providers"):

> **When the Provider is not a Plan Fiduciary,** the DOL permits the Provider to receive <u>and</u> retain revenue sharing payments, and concludes that the Provider's additions or removals of funds from its investment platform will not cause the provider to be an ERISA Fiduciary with respect to a participating plan, if:
>
> 1. The Provider makes certain written disclosures, including that it may receive revenue sharing fees, the rate of fees paid, and the services it is performing;
>
> 2. The Provider gives at least 60 days' written notice of any proposed changes in available funds, which notice must contain certain additional disclosures; and
>
> 3. The Provider gives any plan that decides to reject a proposed change in available funds an additional 60 days to convert to another service provider.
>
> **When the Provider is a Plan Fiduciary,** the DOL concludes that its receipt of revenue sharing payments will not constitute a prohibited transaction only if:
>
> 1. The terms of the Provider's fee arrangements with the funds are fully disclosed;
>
> 2. The Provider either will offset or credit the fees it receives from the funds against the fees it receives from the plan; and
>
> 3. If the fees the Provider receives from the funds exceeds the fees a plan owes to the Provider, the plan will be entitled to that excess amount.
>
> (Emphasis in bold supplied. Dechert: This should not be considered legal advice. Legal counsel should be sought on specific facts.)

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Can Revenue Sharing for Retail, DB & Non-Qualified Retirement Accounts be far behind?

During a discussion on revenue sharing, Dennis Miller, President Miller/Russell, an influential investment advisory firm in Phoenix AZ, postulated that whoever could figure out how to generate revenue sharing for defined benefit, non-qualified retirement plans and personal retail accounts could "...go out and buy the company jet!" He makes a very relevant point. After all is said and done and all the parties are bloodied in the defined contribution market, the next vast untapped markets for revenue sharing will be in the personal retail, defined benefit and non-qualified retirement accounts.

Disintermediation of Bundled Providers

Chart 1, *Servicing Costs vs. Revenue Sharing*, shows why some bundled providers are setting minimum plan sizes, billing minimum fees or leaving the small plan market altogether. Bundled providers want larger plans that generate sizable revenue sharing dollars and often use these "cash rich" plans to subsidize the servicing of the smaller, less "cash poor" plans. As competition and regulators force revenue sharing to be divulged, more and more bundled providers are exiting the administration business and focusing on their core business which is typically money management.

It is useful to keep in mind that bundled providers are generally in the retirement business to drive assets to money managers that they own or control (e.g., MassMutual, Merrill Lynch or Fidelity). Primarily due to competitive pressures, most, if not all, of these bundled providers have added non-proprietary funds to their line up in recent years. By controlling the custody, trading and share/unit pricing, the bundled provider controls the revenue sharing flows inside the platform.

With the ongoing advances in technology, regional and local TPAs can now trade directly with mutual funds and obtain both universal access (i.e., Fund/SERV) and control of revenue sharing flows on behalf of the plan sponsors they service. As a result, bundled providers are increasingly becoming disintermediated and are choosing to exit this market, creating a huge vacuum in the administration support area.

Here is a partial list of the providers that have departed, at least from the small plan market, over the last 12 months:

- American Scandia
- JohnHancock
- MetLife
- Merrill Lynch
- Allmerica Financial
- MassMutual
- MorganStanley
- Key Corporation

> *"There are two parties to the process that cannot be replaced - those that invest plan assets and those that move the cash between the plan participant and the money manager. "*
>
> - Lance M. Roberts,
> President, Walker MacRae Inc.

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Regional TPAs vs. E-commerce Clones

Growing Competition from Data Vendors - Over the last decade, competition in the retirement plan market has come primarily from vendors that control investments. *In the future, competition will come from retirement service vendors that control data.*

For example, many Tier III TPAs rely upon an outside source, such as an insurance company, to provide daily valuation record keeping services. It is imperative that TPAs who utilize this business model understand and be aware of the fact that the outside provider (the insurance company in this instance) controls the plan participant data. As a result, the TPA runs the risk that this outside provider can very easily send the data they maintain to any TPA resource, regardless of the origination of the contact. This scenario is not just a hypothetical exercise, as a number of TPAs who have business with Nationwide can unfortunately attest.

This same concept can also be illustrated on the RIA side of the business where an analogous situation exists with client accounting systems. Advent Technology, a leading client accounting system provider to the RIA community recently entered into an agreement with Sungard Systems in which they would no longer support the trading interface with non-Sungard Systems trading platforms (i.e., non-Expediter). The revolt that ensued on the part of RIAs who would have been adversely affected was so strong that Advent eventually abandoned this policy but the example remains in tact.

There is an interesting question here regarding whether these systems are quasi-public utilities in a macro-economic sense and if so, whether the basic tenets of fair competition are violated when customers are forced by the vendor to use only the compatible systems the vendor unilaterally selects.

TPA Data Vendors

A significant development in recent times is the increasing willingness of Tier I or II TPA firms to provide daily valuation record keeping services (DV RK) to Tier III TPAs as an adjunct solution to keeping current with new technology. In the ideal scenario, both organizations would benefit: the Tier III TPA can compete in the daily marketplace; and the Tier I or II TPA is able to spread their technology costs across a larger pool of participants thus driving their cost structure down and their margins up. This solution is most workable when there is no direct competition between the two TPAs either on a regional or a national basis. For example, BISYS (a Tier I TPA) is currently touting a DV RK product for regional TPAs. However, BISYS is a national business entity and is capable of competing with any regional TPA, where the client is desirable enough.

The Passing of the Great TPA Buyout

In the late 1990s, the heyday of venture capital and the economic boom, a number of ventures were funded to “roll up” regional TPAs into a consolidated, national entity. Investors in this approach held the theory that the buying power of the consolidated entity would be greater than that of its constituent parts and this added buying power would translate into increasing the revenue sharing flows which could, in turn, be turned into profit by the roll up organization.

In many instances, the most attractive acquisitions were those TPAs that controlled the investments of their plan sponsor clients, either as brokers or as RIAs. Venture capitalists saw these as ways of capturing assets and the revenue streams they generate. Most attractive were those with RIA relationships, where the buyer might use revenue sharing as a means of offsetting the purchase cost.

In their article, "Opportunity Knocking in Retirement Services" (American Banker, March 22, 1999), Jeb Britton 3rd and Gregory R. Mennis, posited:

> *Acquisitions of third-party administrators let retirement plan service providers add or expand the service delivery capabilities critical to their long-term success. And owners of third party administrators increasingly are viewing a sale as the ideal way to cash in the sweat equity of their companies, while gaining access to the investment capital and wider distribution needed to remain competitive.*
>
> *A third-party administrator's book of business can provide an immediate revenue stream, though pretax margins on fee-for-service business rarely exceed 10% to 15%. There is some potential to convert a third party administrator's assets under administration to the buyer's investment products.*
>
> *Firms that have established an affiliated registered investment advisor usually provide prospective buyers with a high-margin revenue stream. Though deal values typically fall in the range of 1.5 times to 2.5 times revenues, to establish an appropriate valuation for a specific deal requires a discounted cash flow analysis based on detailed projections of expected synergies.*

A souring economy and the subsequent drying up of available venture capital has resulted in a dramatic reduction of growth opportunities for those independent TPA organizations that remain, requiring them to reevaluate their exit strategies.

The Emergence of an Old Friend - Defined Benefit Plans

As the reality of dismal retirement prospects hits the baby boomer generation, there has been a re-emergence of interest in defined benefit plans. This is particularly true for the small professional employer (i.e., doctor, lawyer, CPA) who is looking for an annual tax deduction considerably greater than that allowed within the framework of defined contribution plans.

An analysis of the marketplace in 2001 by Leaffer, Shapiro LLC indicates that over the next five years there will be between 400,000 and 600,000 small employers looking for this type of solution.

The Growing Significance of Being a Plan Fiduciary

Fiduciary litigation is on the rise - even for those vendors that believe they are not providing fiduciary services. A senior executive at a major brokerage firm confidentially estimates that for 2001 his firm has experienced a 500% increase in fiduciary litigation initiated by plan participants. *There has already been an exponential increase in 2002.* This same executive went on to say that, in his view, two factors have contributed to this increase: first, a failure to provide adequate procedures to develop an Investment Policy Statement (IPS) with minimum investment standards; and second, an absence of written procedures for replacing core fund options once they failed to meet the minimal acceptable criteria laid out in the IPS. This provides only a partial description of the problems plan fiduciaries are facing, particularly as the market continues with stagnant returns.

The bottom line for plan sponsors and service providers alike is that qualified retirement plans should have a clearly defined IPS that actually guides the company in decisions concerning the investment of plan assets. This requires not only executing an IPS, but also monitoring the plan's investments as spelled out in the IPS - in the same manner as anyone responsible for investing someone else's money. It is extremely dangerous to have an IPS and not use it - that is, fail to evaluate whether the investments met the written criteria. It is perhaps a per se breach of the fiduciary obligation, and a particularly compelling argument to juries and judges, when the standard that was not followed is the very same standard set by the plan sponsor itself.

Here are some startling statistics that were drawn from an informal survey of over 100 ERISA plans:

1. One of the basic tenets of ERISA is that a plan fiduciary should develop a written Investment Policy Statement yet 50% of all retirement plans had no basic or comprehensive written IPS

2. Of the remaining 50% that did have some form of an IPS, 25% had no written monitoring or compliance program to enforce the minimum standards of the IPS.

3. Of the remaining 25%, 20% failed to act when a monitoring and compliance program indicated an investment violated the IPS. In addition, actions were seldom documented in the Board of Directors or corporate minutes.

4. In the end, only 5% of all plan fiduciaries conformed to the requirements of ERISA for acting as a prudent fiduciary.

Managed Funds

Michael Malone, an executive with HCM International, a global compensation and benefits consulting firm, points out the following with respect to the investment landscape from inside a 401(k) plan:

> *Enabling plan participants to direct their investments between a wide range of core funds, even with comprehensive education is not all that it is cracked up to be. 401(k) plans are generally comprised of two groups of participants: a small core group with an insatiable appetite for flexibility and an ever-increasing amount of choice; and a larger majority for whom choice is the source of anxiety.*
>
> *For better or worse, those who make the plan design decisions on behalf of the plan sponsor reside almost exclusively in the former category favoring "choice." However, if given the opportunity to use a Managed Fund, where a professional handles the asset allocation, a high percentage of participants would not only favor this option, they would embrace it with a great sense of relief. The plan could maintain a Self-Directed Account (SDA) for those participants who favor individual choice.*

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Interestingly, this advantage does not spill over into Lifestyle Funds. At a recent Pensions & Investments Conference in Hollywood FL, a senior executive at a Fortune 100 firm shared that their participants were offered a three-tiered investment line-up with the following results:

	Program Investment Option	Participation Percentage
I	Lifestyle Funds	5-7%
II	Managed Funds	35-39%
III	Core Funds	50-55%

Managed funds can be utilized as a "barrier to exit" by bundled providers since they are difficult, if not impossible, to replicate by a new provider. In addition, they are an attractive addition to the investment program because it provides an investment option for the unsophisticated participant who does not have the time, the inclination, or the talent to develop and maintain an asset allocation strategy. Lastly, managed funds represent a value-added benefit when they provide a knowledgeable investment advisor who is also typically willing to act as a co-fiduciary, justifying the advisor's role at the point of the plan sale.

Is your Mutual Fund Manager a Fiduciary?

"...under ERISA, the most frightening responsibility...(personal liability) for the plan sponsors - is the investment of the plan assets. Even where participants have some discretion over their own accounts...the employer still bears the ultimate responsibility for selecting and monitoring those investments. Many employers consider providers that sell investment products to be the investment manager for their plan. ...They are not the investment manager unless they specifically state so in their contract. Mutual fund managers, especially bundled providers, typically don't agree to be fiduciaries.

...it is important to note that under ERISA the company does not have to hire an investment manager. But these companies need to realize that should they go this route, they will be held to the "prudent expert" rule. In other words, the DOL can hold these companies to the same standards of expertise and prudence as the most successfully performing investment management firm around. With defined benefit plans, rarely did the company invest all of its assets with one organization. So why do they think it is appropriate to do so with defined contribution plans? How many companies use one fund family for their plan? With this setup, they are putting all of their eggs in one basket. How do they know this one manager will have superior risk-adjusted returns vs. the hundreds, if not thousands, of other managers he or she is competing against? Moreover, the fund name becomes synonymous with the investment option, making it traumatic to change managers from an employee view. Since 401(k)s have been around, we've been in a bull market. ...plan participants have become accustomed to investments that are unidirectional on the upside. ...But once the market reverts to the mean, participants will start asking more questions, and for plan sponsors it might be too late to look at the fiduciary issue. We are only a bear market away from this scenario becoming a reality for many unsuspecting (fiduciaries)."
- David Halseth, Pensions & Investments (May 4, 1998)

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Collective Investment Funds

Collective Investment Funds (CIFs) are one of the more interesting investment vehicles to be introduced in recent years. These mutual fund "look-alikes" provide a means by which private money managers may be introduced to the daily valuation market. In many cases, CIFs are the investment vehicle of choice as they tend to have greater style consistency, lower expense costs and they provide access to institutional quality private investment management for the "masses."

A Monopoly for Data Vendors

A principle concern for the TPA community is the lack of viable options available for the delivery of daily valuation record keeping systems (DV RK). Essentially, TPAs are faced with three alternatives in accessing a DV RK system. They can:

1. Either outsource this function by partnering with a bundled product vendor that provides DV RK as part of an offering (e.g., group annuity contracts offered by insurance companies);

2. Quasi-outsource this function by "leasing" a DV RK solution either from another TPA (i.e., see the discussion above relating to pairing up regional Tier II & Tier III TPAs) or service vendor (e.g., an ASP model similar to that offered by TeamVest); or

3. Take this function "in-house" by purchasing a DV RK system and hiring and training the necessary personnel to required to run it.

In considering these options, TPAs need to keep in mind the risk they run of disintermediation when they give up control of the data and money movement, discussed above. In the first scenario, the TPA sacrifices control of both data and money movement – the bundled product/insurance company provides DV RK services (voice response units, participant web sites, quarterly participant statements, etc.) directly to plan sponsors and their participants and develops a direct relationship with them. A perfect example of this disintermediation is the recent action by Nationwide with respect to their "network" of 300 or so regional TPAs. TPAs who enter into similar arrangements with other similarly structured providers should heed these painful lessons.

In the quasi-outsourcing solution, although the TPA relinquishes control of data and money movement, there is less of a risk that the TPA is disintermediated because the DV RK function is typically not "bundled" with a closed universe of investment options. Perhaps more importantly, this type of solution is typically designed as an "Intel inside" type of approach, where the DV RK function can be effectively "private-labeled" by the TPA and presented to the plan sponsor, as opposed to the "bundled product" described above. In this scenario there is, in effect, no relationship between the plan sponsor (or their participants) and the DV RK provider.

To maintain the maximum amount of control over data and money movement, the TPA should explore the various options available for purchasing outright a DV RK system. In this market, there are a limited number of options/players and no real competition.

This state of affairs results in a higher cost structure whether for Tier III TPAs seeking to upgrade to a Tier II or for Tier II TPAs that wish to upgrade their existing systems. Further complicating the TPAs consideration is the fact that many of the DV RK service vendors are owned by larger national financial institutions that often encroach upon the TPAs' business base - either directly or through another arm of that organization. These DV RK service vendors include:

DV RK Vendor	**Parent Company**
TrustMark	Schwab
Quantech/Relius	SunGard
InvestLink	Federated

If the next wave of competition is coming from data managers, a well-informed TPA will control the data of its DV RK practice by taking the process in-house, thus protecting its key link in the value-chain.

Fiduciary Problems of Bundled Providers: Proprietary Investment Managers

Because bundled providers' investment options are typically quite restrictive, they are often very reluctant to support plan sponsors in creating an Investment Policy Statement that establishes minimum investment standards or to deliver objective periodic monitoring and compliance in fulfillment of an IPS. This is an understandable posture given their objective is to drive assets to, and retain them within, the limited investment options available through their product platforms. Replacing proprietary money managers with better managers with whom they have no corporate affiliation (e.g., revenue sharing arrangement) is obviously contrary to their interests. Thus, there is an inherent conflict of interest in these bundled arrangements.

Group Annuity Contracts

The investment vehicle of choice within the insurance industry is the group annuity contract. These contracts represent the insurance industry's version of the bundled product and, because they are underwritten by an insurance company, they do not fall under the jurisdiction of either the NASD or the SEC. These non-registered investment contracts are entered into by the insurance company and the plan sponsor and are governed by each state's insurance commission.

By their very structure, group annuity contracts magnify the plan sponsor's fiduciary liability. In addition to the issue relating to the steering of investments discussed previously, these contracts generally name an individual or a number of individuals from the plan sponsor's management team as Plan Trustee. The contracts usually layer in additional expenses through "mortality and expense costs," "contract charges," "asset-based fees," or some other cleverly named and seemingly defensible participant-based or (more commonly) asset-based charge.

Termination Provisions of Group Annuity Contracts - Although becoming less prevalent, group annuity contracts locking in plan sponsors and participants with termination penalties do still exist. Like their relatives in the mutual fund industry known as "contingent deferred sales charges," penalties or surrender charges are assessed on assets removed from the contract prematurely. These penalties are typically structured as a declining percentage of assets until a specified maturity date.

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Sometimes, successor insurance companies offer to pay the aggregate surrender charge incurred by the plan in order to capture the plan's assets. As is usually the case, however, "there is no free lunch." In return for making the plan whole in the amount of the surrender charge, the successor insurance company will typically recoup the surrender charge by assessing a higher (above market) expenes ratio to the plan.

Plan fiduciaries who consider such an option are in treacherous territory and need to proceed with a great deal of caution. They (or their predecessors) made the original decision to purchase the group annuity contract with the surrender charges. By allowing another insurance company to pay the surrender charges and then assess a higher asset charge on plan assets prospectively, these costs have effectively been reassigned to current and future plan participants – even though some of the participants may have had no balances whatsoever in the original contract!

To date, not one insurance company that participates in this practice has agreed to indemnify plan sponsors against a determination by regulators (the state insurance commission or the DOL) that the best interests of the participants was not served by shifting to a contract with a higher internal cost structure caused by amortizing the payment of the surrender charge of a predecessor company. This apparent lack of conviction on the part of the very companies that employ this technique may be an indication that this practice is what most suspect – of questionable legality.

Specific Recommendations to Plan Participants - Most, if not all, bundled providers wish to mitigate their own liability in this area. Toward this end, they provide generic "education" to plan participants, thereby attempting to avoid the information they provide as being characterized as "advice." The risk they are attempting to avoid is that recommendations of a bundled provider would be biased. Providing "advice" would, by law, result in the bundled provider being considered a plan fiduciary (they are receiving a fee for their service). There is great exposure for any plan fiduciary that provides biased advice. In fact, in early July 2002 the Senate Finance Committee approved a bill, which mirrors a similar bill approved by the House in April 2001. Essentially, both bills would allow only independent advisers to give investment advice to participants in 401(k) and other qualified retirement plans. This bill is slated to go before the full Senate later in 2002.

How TPAs Can Compete And Thrive All The Way To 2005!

Develop A Business Plan and Strategy

The first rule of any successful business venture is to have a dynamic business plan that addresses both operational and marketing issues. Commonly, principals of TPA organizations have an actuarial or accounting background. As a result of this training they tend to have a backward-looking perspective. They tend to evaluate current versus past performance rather than a forward-looking perspective they design based upon current trends in the industry and future goals that build on those trends.

A well thought-out business plan is essential to the success of any company. It functions as a “road map” to success. It provides:

1. A vehicle by which the business model is defined and the objectives of the business identified so that organizational performance may be benchmarked;

2. A description of the financial, marketing and operational structure of the business (this is very useful in any efforts that may be undertaken to raise debt or equity capital); and

3. The specific business vision of the management team.

Identify A Business Model to Survive Through 2005

There are three basic models available to TPAs for their near-term survival:

1. **Bail Out Strategy -** This first model refers to situations when a TPA comes to the realization they are in the wrong business and should be doing something else - similar to the conclusions reached by many bundled providers during the past few years (as described above). In a number of instances, the TPA realizes they are best suited to sell investment products and have been using their role as plan administrator simply for access to customers or as a useful professional image within the community. This problem is seen quite frequently in local/regional bank trust operations that realize that they are neither “fish nor fowl:” they end up losing money on plan administration and selling investment services that are average at best.

   “Survivors to 2005” must identify their niche and work to be the best that they can be within that area. The retirement industry market will not tolerate economic mediocrity – firms will be weeded out that fail to identify and execute a strategy that plays to that firm’s strengths.

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2. Administration and Consulting Strategy - In this scenario, the TPA determines they are best positioned to provide consulting and plan administration services wrapped around outsourced DV RK services. TPAs employing this strategy may also outsource non-discrimination testing and plan documentation. Historically, insurance company products have been the primary vehicles through which DV RK services are outsourced in these cases.

As previously discussed, this is not an ideal solution from the TPAs standpoint. First, it is an expensive model to operate. Given the various direct and indirect costs intrinsic in insurance company products, plans are vulnerable to competition (particularly the larger and more profitable ones). This vulnerability is only exacerbated in the current economic environment. Second, TPAs employing this strategy leave themselves vulnerable to the management decisions that are made by the insurance companies with whom they work. Such decisions are clearly not made with the interests of the TPA in mind and can range from exiting the market altogether, selling their DV RK operations to competitive TPA firms, and/or deciding to compete for mutual customers with a fully bundled package.

Most recently, we have seen Nationwide decide unilaterally to reduce its Preferred TPA network from over 300 to 200. Nationwide set new plan production requirements (according to Nationwide a "guideline" not a "rule") and is requiring more say in the TPAs marketing plan. Nationwide, responding to an advance copy of this White Paper commented,

> *"We made our decision to cut based upon the ability to provide consistent service to customers across our network of PPAs...many of the PPAs(TPAs) no longer selling proactively with us retain business on our books. We did not ask them to transfer that business."*

At the same time, Nationwide is acquiring strategic regional TPA firms to provide its customers with regional bundled services. Robert Sedor, President and CEO of The Bay Ridge Group, a TPA in Endwell, NY explained:

> *As a TPA, the time is not far off if you are currently doing business with insurance companies' daily valuation products that you will be forced to make a decision on either dressing up your business for ultimate sale to the insurance company or be prepared to go into direct competition with them.*

In implementing this strategy, it is imperative that the TPA look at all options available, including outsourcing DV RK services to compatible Tier II TPA firms or a national provider (e.g., TeamVest) as well as insurance companies. In performing this analysis, the focus needs to be on the long term liability, cost and competitiveness of the solution.

3. Upgrading to In-house Bundled Services - This is the most capital-intensive scenario, but if feasible, it is the strategy that provides the TPA with the most control over their destiny. In this approach, the TPA provides clients with both administration and DV RK services giving the TPA total control over both data and money flows.

For a TPA firm, this is a critical decision for a number of reasons. First, the financial outlay required to upgrade or implement a DV RK is significant, to say the least. Second, in situations where a Tier III TPA is implementing their first DV RK, the issue of re-educating employees involves more than just cost. In most of these situations, Tier III TPA shops have a balance forward work environment that is considerably different than the "daily" environment of DV RK. Another potentially major cost associated with choosing this solution is the transition expense - such as necessary overtime, as well as the inevitable unforeseen technological glitches that occur as one progresses up any learning curve (blown trades, reconciliation errors, and pricing mistakes). These are examples of the various and sundry anticipated and unanticipated one-time expenses in transitioning to any new business process. In order to minimize such costs and the overall disruptions to the business process, an in-house technical expert should be retained to manage this process. Such experts with experience are not cheap and may have to be relocated but the cost incurred – for the right person – is well worth it.

Resources for Capitalization

It is not reasonable to expect a profession decimated by years of unfair business tactics to come up with significant cash in the short term. If local and regional TPAs are going to be expected to expand into the void created by the withdrawal of the bundled providers and to come to the rescue of the small plan market, they are going to require access to financing.

The service industry has always lacked the hard assets traditional bankers prefer for collateralizing loans - unlike car dealers, real estate developers or widget-makers. A cynic might suggest that banks with trust operations have a vested interest in seeing TPAs, potential competitors in the qualified plan arena, fail. At the other end of the capital formation spectrum, venture capitalists are not generally excited with the 10-15% profit margins generated by most traditional TPAs. TPAs' access to either source of capital, therefore, is limited. This area presents the greatest business challenge confronted by TPAs today and solutions may require government resources that have a vested interest, in this crisis environment, in ensuring the survival of the private retirement market. TPAs who are not familiar with this area may be well served by retaining a consultant who is knowledgeable about this process to assist in securing necessary financing.

Exit Strategies

The endgame of any successful business plan or marketing strategy is to create an opportunity, at some point in time, for the principals of the business to harvest the investment that they have made over the years. Typically, a TPA's management team knows this is something to plan for, but they just become too busy "bailing out the boat" to "batten down" their future.

Indeed, the opportunities for a TPA to sell the business to a major financial institution appear to have passed. Many of the TPA conglomerates created over the past few years are struggling simply to cope with the business mergers and realignments that have already been created. They are finding out, firsthand, that attempting to absorb and standardize the financial, operational and marketing functions of disparate TPAs in different parts of the country, each with their own way of doing things, is akin to "herding cats." The likelihood of any more TPA "roll-ups" around the country is slim – especially given the current business environment. As a result, it is back to basics for TPAs. Given this current state of affairs, management needs to simultaneously cultivate select employees as prospective buyers of the firm while developing a business that is attractive to them.

How to Increase Equity Interest

The principal concern for any entrepreneurial TPA, especially those with investors to whom they answer, is how to increase the value of the enterprise. Typically, the sales price of a traditional TPA firm (without any RIA practice) is based on a multiple of fixed, renewable billings excluding consulting and documentation fees.

The main thrust of the American Banker article quoted previously is that potential buyers will pay more for a TPA firm that has an active RIA practice.

Investment Advice as a Competitive Strategy

The fact that TPAs with RIA practices are valued at higher levels than those without any RIA practice is not surprising given the increased control over the clients they possess as well as the additional revenue streams generated by the RIA. TPAs with RIA practices are shown to be much more profitable than those without. The American Banker article concludes, therefore, that TPAs with RIA practices represent more attractive acquisitions than traditional TPA firms.

> *"EPIC Advisors has adopted a two-pronged marketing strategy for the sale of retirement plans. In the immediate area of upstate New York we are very reticent to take on relationships with regional brokers and investment advisors, as we are aggressively approaching the plan sponsors directly offering a bundled package that includes investment advice. Outside the region, for example in the New York City area, we are more interested in outside investment advisory relationships, but only if the advisor adds appreciably to the customer relationship."*
> *- Robert Judd, Principal, EPIC Advisors Inc. (Rochester NY)*

This point was further underscored in a recent conversation with a Tier III TPA in North Carolina. They acknowledged that any buyer of the firm would have a difficult time moving the investments of their retirement plan clients since the preponderance of the investment advisory services for their clients were delivered by outside brokers and RIAs.

Clearly, control of the client base is a major strategic concern for any TPA. More TPAs are avoiding relationships with commission-driven salesmen (i.e., brokers, registered representatives) due to their general lack of commitment to the customer relationship as well as a general absence of any relevant expertise. Indeed, many regional TPAs elect to bypass regional brokers and market directly to plan sponsors. This strategy requires a commitment on the part of the TPA to provide investment advisory services as well as all the concomitant trappings of the required due diligence process.

Daily Valuation Record Keeping -Lease or Buy?

If the Tier III TPA decides to evaluate its alternatives, the following issues need to be considered:

Lease/Rent DV RK

The DV RK choices come down to insurance companies, companies that lease DV RK services and TPA firms that will provide DV RK services only. Be sure to investigate ownership, capitalization, pricing and commitment.

Buy DV RK

There are three principal vendors in the market, so alternatives are limited. However, because the number of TPAs that are looking to buy a DV RK system at any given point in time is relatively small, this market is very competitive and prices fluctuate widely once competition is introduced. The price structure will vary from vendor to vendor and situation to situation. It can be based on fixed costs at initiation, ongoing support costs or per-participant count costs. Pricing should include hardware and software support, training and in-house technical support.

TPAs should invite each of these principal DV RK vendors to bid for the business and use each as a source of competitive information on their own product as well as the others. Be on the lookout for vendors that over-promise and under-deliver. It would be wise to check references.

Summary

Before taking the risk of moving a block of business onto a DV RK system, TPAs must determine how much business needs to run through its system in order to support its operating costs. This will depend upon how much a TPA charges, the amortization of any acquisition costs and the cost of any new technological "bells and whistles." If you are not comfortable making these assumptions/calculations for whatever reason, then it generally makes sense to rent or lease DV RK technology. This will allow the TPA to grow their business base and get a handle on the issues involved in running a "daily shop" before attempting to go through the process of analyzing and purchasing a full blown DV RK system.

Know Your Competition

Traditional TPA firms that have managed to survive over the past several years have done so not necessarily because they were smarter than the rest, but because no one else really wants to do the administration and record keeping for small plan sponsors.

The business model these TPAs have come to accept is one where the professional community feeds them start-up plans that they service until the plans grow large enough to become attractive to the bundled providers who then take them away. This pattern has evolved and solidified over the last several years and serves to prevent TPAs from regaining the preeminent role that they enjoyed in the industry a mere decade ago. Further, a reversal of fortune will not take place until traditional TPAs recognize and respond to the competitive forces that are perpetuating the current state of affairs. An opportunity for the TPA to regain a foothold in the market has presented itself as many bundled providers have left the market through merger, acquisition or closure. However, unless TPAs recognize and understand the structural changes that are currently being felt in the industry and the impact they have on the next wave of competition (i.e., bundled data providers), their fate will never change.

This is not as easy as it would seem. Historically, TPAs have typically embraced:

- Trading partners with whom they compete in the larger plan market (i.e., Schwab, Fidelity).
- DV RK relationships with insurance companies that compete directly for business in relationships that the TPA initially developed and which are actively involved in the purchase or establishment of regional TPA superstores (i.e., Manulife, Nationwide).
- Relationships with mutual fund families that have their own bundled solutions and compete directly in the larger plan market (i.e., MFS, Alliance Capital).

The clear point here is that the traditional TPAs depend on their biggest competitors to deliver services to their clients! Now, more than ever, TPAs must understand their competition and position themselves so that they control their business rather than giving that control up to the very firms that want to put TPAs out of business! TPAs must take charge of the current opportunity presented by the economy and the market.

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Who are Marketing Alliance Partners - Regionally and Nationally?

Given the business challenges and technological cost structures that TPAs face, there is generally little money left over for marketing even when there is a true desire on the part of the TPA to promote services. As a group, TPAs often rely on their professional work to speak for the firm rather than embracing a proactive marketing campaign.

On a regional basis, there are three natural strategic partners for the TPA that also seem to have similar philosophical and/or business perspectives:

1. **Registered Investment Advisory Firms -** RIAs, or fee-based investment advisors, are in a situation similar to that faced by TPAs. These firms are asset-gatherers and can be an ideal marketing alliance partner where both entities have a vested interest in targeting plans with high average balance accounts, many of which are presently serviced by bundled providers.

2. **Accounting Firms -** CPAs are always looking for a means of expanding their fee-based business. The employee benefit area is ideal for them because it fits nicely into the seasonal time frames when they are not consumed by tax preparation activities.

3. **Regional Bank Trust Companies -** For decades, employee benefit products and services offered through regional bank trust companies have been marked by (at best) average investment performance and below average service capabilities. It is not uncommon for banks to "suggest" that companies with which they have a lending relationship place their retirement assets with their trust department regardless of the degree to which the retirement services offered are competitive. There is a real opportunity here for TPAs to provide a back office administrative solution to these organizations, many of which would prefer to focus their limited resources on the investment side of the business.

Who are your Trading Alliance Partners?

The one area that most TPAs continue to outsource is the trading function of the DV RK system, in spite of the NSCC's creation of DCC&S linkages. While there are a number of trading networks available to the Tier II TPA, there are only a few actual trading, confirmation and settlement systems, much like record keeping systems.

Most of the large trust companies that offer trading relationships with the TPA buy the software for moving money. Knowledgeable TPAs like the independence and open architecture of a trading system.

Trading Systems

The independent software technology available in the marketplace for trading originates from only a few providers:

- Vertical Management System, Inc. - Pasadena CA
- Optech Systems, Inc. - New York, NY
- Gail Weiss and Associates - Baltimore MD
- Delta Data - Atlanta, GA
- Walker MacRae Inc. - Manchester, NH

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Each of these systems moves data from multiple TPAs and can link with a variety of pension administration systems. Similarly, they can generally move plan assets from multiple plans from multiple TPAs at either an omnibus or a plan level to at least one, and in some cases, multiple trading platforms which provide varying degrees of investment flexibility and access to funds. Examples of trading platforms with which these systems can link include:

- National Securities Clearing Corporation
  - Fund/SERV
  - DCC&S
- SunGard
  - Expediter
- DST
  - TIPS
  - DAZL
- Trust Connect
- SEI
- Federated
- Bankers Trust
- Fidelity
- Schwab
- Walker MacRae Inc.

Key considerations to keep in mind in understanding and selecting a trading system, as well as the underlying trading platform, to which it provides access, include:

1. **Omnibus or Plan Level Trading -** While omnibus trading can reduce transaction costs, plan level trading allows for better supporting documentation and backup in billing for certain types of revenue sharing. The degree to which a TPA or its clients have access to revenue sharing will determine the importance of this issue in a given situation.

2. **Compatibility -** Can the trading system "link" automatically (not manually) with the pension administration and daily valuation record keeping systems in use by your firm? How do trade file uploads/downloads work each day? When are confirms/settlements provided? How are they provided?

3. **Investment Flexibility -** Which trading platforms can a particular trading system access? Is it an "open" or a "closed" solution? The degree to which a given trading platform "works" for you, the quantity and the quality of the mutual funds to which it provides access must be considered since this will determine, to a great degree, the competitiveness of the TPA's offering.

4. **Reconciliation -** What tools does the trading system provide to assist the TPA in keeping the daily valuation record keeping, the trust accounting and the custodian/fund systems in balance? Some trading systems provide helpful tools to assist the TPA in this all-important function and others do not. Generally, this key function should be performed as frequently as possible so that any discrepancies in share balances among the various systems can be identified and "unwound" as quickly and inexpensively as possible - daily is optimal. Ignoring this task or not performing it as frequently as possible opens the TPA up to exposure to potentially great liability that can best be mitigated by reconciling these positions daily.

5. **Income Processing Features -** How quickly are “capital changes” in mutual funds (i.e., dividends, capital gains distributions, share splits, etc.) reported by the trading platform? Some platforms provide a “shadow accounting” method for reflecting an accurate valuation/balance in a given fund position between the declaration date, the ex date (typically the same in mutual funds) and the payable date. If not properly tracked, daily fund position values will be understated during these “windows” presenting opportunities for errors in processing plan level or participant level distributions and/or transfers.

6. **Pricing of shares -** How does a particular trading system provide share pricing? Some provide this service, some do so at an additional charge and some require the TPA secure their own share pricing.

7. **Interface with Trust Accounting Systems -** With which trust accounting systems can a trading platform interface? And, following on this question, which trust companies can be accessed?

8. **Sub-accounting -** Does the platform have a sub-accounting function that could be used by the TPA to service “retail” and rollover accounts?

9. **Self-Directed Capabilities -** Does the platform provide access to self-directed accounts? If so, which ones? Similarly, can collective investment funds be accessed via the platform? Some platforms have a built-in SDA option while others are able to customize a link with outside SDA providers at the DV RK level.

10. **Overall Service -** What service support mechanisms are in place to resolve inevitable “busted trades” and other service issues?

Trust Company Trading

Over the last five years, a number of trust companies and alliances have evolved to provide custody, trading, settlement and confirmation of mutual fund transactions initiated by the DV RK system:

- Circle Trust/Orbitex - New York, NY
- First Trust - Denver, CO
- Mid-Atlantic Trust - Pittsburgh, PA
- Security Trust - Phoenix, AZ
- Reliance Trust - Atlanta, GA
- Matrix - Denver, CO

Key considerations:

In exploring these options, the following issues need to be examined:

1. **Late-day trading -** The ability to conduct late day trading is a key consideration and must be made available in order to remain competitive in the qualified plan market.

2. **Revenue sharing accounting & pay out policy -** Does the trust company proactively track, bill and re-capture revenue sharing? What forms of revenue sharing do they track, bill and re-capture? How much do they retain for themselves? How much do they pay out? Do they make these flows available to either the TPA or the plan?

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3. **Daily reconciliation -** How often does the trust company reconcile their positions with those held at the fund houses? What tools/processes do they make available to the TPA to reconcile against the DV RK system?

4. **Income Processing -** What procedures do the trust companies employ to track income processing? What access/reporting is provided by the trust company?

5. **Collective Investment Fund administration -** What, if any, services does the trust company provide in support of Collective Investment Funds? Does the trust company have its own "stable" of funds? Do they allow access to non-proprietary Collective Investment Funds? Will they build Collective Investment Funds?

6. **Self-directed brokerage account reporting -** Does the trust company have its own SDA set up? Does it link with specific SDA partners? What process is in place for both, data and cash flows to/from the SDAs? What information is accessible by the TPA and the client? Will the trust company provide a consolidated trust report including assets held in the SDA accounts? How frequently?

7. **Trading agreements -** What platforms does the trust company trade through? To which fund families does it have access?

8. **Pricing reporting -** Does the trust company supply pricing of securities as part of their service? Are there additional charges for this?

9. **Cashiering accounts -** How does the trust company "handle the cash?" What specific processes are in place to move money? ACH? Wire transfer? Check? How does the trust company handle interfaces with SDA (see # 6) from a cashiering standpoint?

One of the most complicated areas in the retirement industry (and also one of the most critical) lies in the tracking, billing and re-capturing of revenue sharing payments. Generally, a TPA firm should outsource this process to a trading partner to the greatest extent possible. This process should include the recapture of any sub-transfer agency and shareholder servicing fees to which the TPA may be entitled. With this said, TPAs must exercise extreme caution with respect to the necessity of giving up control of revenue sharing billing and collection. Unless the TPA is aware of all sources of revenue sharing available and has the ability to audit the revenue sharing collected fund by fund, there is no way to know whether the billing and collection company has access to all revenue sharing, or is properly accounting for it.

WARNING - A number of trust companies are reaching "full capacity" with respect to the number of independent TPAs with which they will work. Some companies will continue to accept TPAs regardless of this capacity constraint (setting the stage for imminent service problems) while others will set very stringent operational requirements that must be met by a TPA before they will "accept" them as a partner (thus restricting access to only the most efficiently run TPAs). Often, a trust company will not accept a TPA into their fold until they have undergone a due diligence review, usually by an approved consultant. In short, purchasing a DV RK system does not provide a TPA with automatic access to national trust entities.

Defined Benefit (DB) Market

Business is cyclical and opportunities tend to recur over time. The retirement market is a perfect example of this. The 1970s were characterized by an essentially flat stock market and, as a result, fixed income-based investments were in vogue. Many of the high net worth individuals of the World War II generation were looking for relief from record-high tax brackets and were consequently attracted to defined benefit plans as a means of reducing their taxable income as well as securing their retirement.

We in the retirement industry find ourselves in a similar situation today with the baby boomer generation. As was the case in the 1970s, the opportunity for defined benefit plans are in the small employer market. This market is comprised primarily of start-up (new) plans, but with good cash flows. These plans are designed to terminate when the key employee(s) retires and can be integrated to work as a part of the exit strategy/buy/sell agreement of the key employee(s).

The DB plan sale is a tax-planning sale – not a "bells and whistles" defined contribution (DC) product sale, in which traditional administration services, trustee-direction, annual contributions and interest assumptions take precedence over simple investment performance. In competitive DC markets, it is not unreasonable to see investment advisors selling four or five DB plans for every DC plan.

These small market DB plans represent a cross-selling opportunity that positions the TPA to expand and deepen existing relationships within their DC client and prospect base. This is especially true for TPA firms that have experience in and/or resources available to provide actuarial services to clients. This opportunity may be of particular interest to TPA firms that are either wholly owned subsidiaries of a CPA firm or who have some type of marketing alliance with one or more CPA firms that are attempting to expand their employee benefit offering.

Non-Qualified Retirement Plans

One of the greatest challenges facing TPAs in their day-to-day business is to think "outside the box" with respect to ways to create business opportunities within their existing customer base.

There is growing demand on the part of plan sponsors for "bundled" administration of both the qualified and non-qualified plans for the same company. Historically, these non-qualified deferred compensation plans have often been administered internally by the plan sponsor. These plans can be relatively easy to administer in their early years. However, their complexity increases with time and can become overly burdensome for internal resources to effectively provide accurate and proper record keeping and administration. If the plan is funded with mutual funds in a "mirror" arrangement, many sponsors require many of the same DV RK services be offered in the non-qualified plan in tandem with the 401(k) plan (i.e., VRU, internet access). In situations where the non-qualified plan is funded using insurance products, there is often still a need on the part of the plan sponsor for consolidated periodic reporting of aggregate retirement plan balances (qualified and non-qualified). TPAs that are able to control all employee benefits within a company tend to "lock out" their competition from getting in the "back door."

Rollover Market

One of the great weaknesses shown by 401(k) plans is that too many plan participants fail to rollover plan accounts into tax sheltered investment options. The Profit Sharing Council of America estimates that 60% of plan participants fail to rollover their distributed assets to a tax deferred option when they terminate from a retirement plan. Too often, terminated participants take the distribution in cash; pay taxes and penalties due and then spend what's left. Many service models are not designed to discourage these questionable decisions. For example, most investment advisors target the high balance accounts, but want nothing to do with the smaller accounts. Often, the delineation between the two is at $50,000 or even higher! Fidelity, on the other hand, does an excellent job of retaining assets from their bundled product by establishing the transfer into a personal IRA account as the norm for terminating participants. If a terminated participant wants to execute a transaction other than rolling over their account (i.e., taking it in cash), they must first speak with a representative and are then required to fill out additional paperwork.

James Hardwick, Principal in Florida Pension Consultants (Tampa, FL) became a broker just to be able to service rollovers from retirement plans his TPA firm serviced (average account minimums of $75,000). In short order, he found that the commission flow from this business became a major profit center in the firm.

Interestingly, Timothy J. Slavin, Chief Executive Officer of InvestLink Technologies, Inc., an innovative daily valuation record keeping system provider to the TPA community says, "TPAs are not just administrators any more. They are asset managers, too. The access TPAs have to rollovers is an enormous opportunity as well as an enormous risk." Upon becoming licensed to sell investment products and eligible to receive either commissions or fees, the TPA has placed itself in a highly regulated area under the watchful eye of the NASD and the SEC. In addition, it is possible that they could be construed, either knowingly or unintentionally, as a co-fiduciary on plan assets as well as personal assets for which they receive compensation.

Sub-Accounting

A forward-thinking TPA firm should consider developing or gaining access to an omnibus IRA trust vehicle and a sub-accounting system for tracking individual accounts invested in mutual funds. This can potentially be developed as a separate profit center within the marketing strategy for TPAs to be used for all rollover accounts regardless of size. Distributions could be rolled-over in kind, as the standard form of distribution, and an IRA account holder could access account balance information on the DV RK system (VRU or Internet) just as they did when they were active plan participants. This represents the future of the business and the sooner that the TPA explores and embraces this approach, the longer the "head start" that firm will have on its competition.

Group Annuities

At the IBF/Pensions & Investment Conference held in Hollywood, FL in February 2002, Elaine Stevenson of MetLife presented a very compelling argument for reintroducing annuity products to prospective retirees. In short, the plan sponsor's experience in educating active plan participants to become better and more knowledgeable investors has proven to be abysmal by all accounts across the industry. It is unrealistic to expect that these same participants suddenly acquire these skills upon retirement. Her conclusion: in the current investment market, retirees may very well be better off with an old-fashioned annuity based upon group underwriting and volume discounts. This approach might also allow TPAs to earn a commission in the process.

Ok, I Know It Is Broken. Where Do I Go From Here?

Consulting Alternatives

First of all, it should be understood that there is no such thing as a "quick fix" to these various and sundry challenges TPAs now face. With that said, there are several issues that need to be understood by the TPA. The first is that it is difficult to find a consulting solution that is not ultimately product-driven. The second is that it is often difficult to find a consulting solution that covers the broad scope of the problems faced by the regional TPA. For example, consultants that deal with the implementation of a daily valuation record keeping process within a company are focused on only one discrete aspect within the vast labyrinth of integrated services, processes and marketing issues that TPAs must consider.

Operational and/or Marketing Focus

In general terms, the consulting needs of a TPA can be summed up as either operational or marketing related. It has been the author's experience that Tier III TPAs typically require a little of both, while Tier II TPAs primarily require assistance in the area of marketing. The bottom line for both types of TPAs is *how can they make more money...and how they can keep it!*

Why Consulting?

Response One: "I can make my own decisions. If only I had the right information upon which to base them."

I don't need anybody to give me advice on how to run my business. However, I do need help knowing what is happening at the national level so that I can be prepared to meet future technological, marketing or operational challenges.

Response Two: "Economic efficiencies go to the bottom line."

I need advice on how to acquire more profitable customers. How do I move "up market?"

Response Three: "I want a major slice of this newly-evolving market."

I recognize there are some macro-changes going on in the industry. These changes seem to afford the TPA community a unique opportunity to take back the business base that was lost to the national bundled providers over the past number of years. Through the proper use of technology, the TPA can increase profitability now and into the future. Further, TPAs can once again become a dominant force in the industry and benefit their investors and their own equity interests. How can I maximize this opportunity?

In essence the time is here when the TPA can once again control its own destiny. Walker MacRae is prepared to provide assistance to any and all TPAs who share this conclusion and who wish to capitalize on the opportunity now confronting the industry.

Pricing - One-Time Hit or On-going Therapy

A TPA may look at consulting much as Robert DeNiro's character did with respect to psychiatry in the movie *Analyze This*, "I have this friend who has a problem."

By definition, consulting should be tailored to the specific circumstances of the client TPA. This can involve initial data gathering followed by more intensive sessions with the goal of developing, implementing and monitoring an action plan; or it can be structured as a longer-term engagement, more generic in scope, that can last several months, quarters or even years in duration.

Government Response

In addition to being developed for use by TPAs, this White Paper has also been designed with an eye toward regulators and legislators for the following reasons:

1. **Enforce ERISA Regulations (DOL) -** Introduced (relatively) early in the retirement plan regulation process, ERISA established the principle that plan sponsors, as plan fiduciaries, must act for the exclusive benefit of plan participants. If they are found liable, fiduciaries (whether they are employees, officers, owners, board members, service providers or any other parties) face personal - not just corporate - liability. In clarifying and promulgating the various aspects of ERISA as amended over the years, regulatory agencies have made pronouncements, issued private letter rulings and been involved in the evolution of case law impacting a great number of matters important to retirement plan participants.

   It is a widely held belief in the industry that these agencies will continue to become increasingly active in the regulation and enforcement in two primary areas of great interest which are both supported by Walker MacRae:

   - Requiring all expense costs (whether direct and indirect) be fully disclosed by service providers that retain them - including all forms of revenue sharing which the author would argue is an unauthorized distribution of a plan asset.

   - Requiring a plan sponsor prepare a written Investment Policy Statement as well as document an ongoing monitoring and compliance process in order to satisfy the "expert man" rule.

2. **Enforce SEC Commission Payment Practices -** It is the author's opinion that trust companies should not be allowed to circumvent clear prohibitions against such actions by collecting commissions, re-categorizing them as fees and then paying them out to unlicensed service providers. At the very least, plan sponsors and fiduciaries should be made aware of this practice and its impact on the plan (i.e., disclosed as an "indirect plan expense"). Similarly, using revenue sharing as a direct pass-through to plan participants should be formally and

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clearly identified as a preferred transaction that works for the ultimate benefit of the participant.

3. **Defeat any efforts to enable bundled providers to charge a fee for, or advise or counsel plan participants about, investments.** One need only take a look at the bundled product investments to see that the current practice does not work. Proprietary investment managers are infrequently replaced in a plan, much less removed from the product platform for poor performance. Alternatively, the registered investment advisor is trained, licensed, and in place to provide unbiased counsel. The bill currently pending in the House and the version that has made it out of the Senate Finance Committee and awaiting full Senate review both identify independent fee-based advisors as the only vendor who should be allowed to render advice to qualified plan participants. The objectivity that this approach ensures is readily apparent and unassailable.

4. **Coordinate DOL and State Insurance Commissions in focusing on group annuity contract termination provision buy-outs by a successor insurance company.** The practice of a successor insurance company "buying out" the termination penalty of a predecessor insurance company contract in return for an inflated (above industry standard) asset management fee has been in resurgence in recent years. This commonplace transaction in the retirement industry has fallen below the radar of the regulatory authorities. Clearly, participants that had no investment in the terminated annuity are penalized by the new higher rate. The new participant is paying more to defray sunk costs of previous investment decisions by the plan sponsor. History has indeed repeated itself. In the late 1970s when interest rates rose to the high teens for Guaranteed Interest Contracts (GICs), a practice arose in which one insurance carrier would buy out another's low interest contract, pay off the market value adjustment and credit a below market interest rate for a fixed period in order to offset the penalty reimbursement advanced. At that time, the DOL responded by reversing these transactions on the basis that the plan sponsor was not acting in the best interests of the plan participants. The similarities here are obvious and the response by DOL should be the same.

5. **Find government support for freeing up capital/loans for the TPA community.** The government should be encouraging and supporting the private retirement service sector by assisting TPAs in remaining competitive by making SBA-type loans available to them so that they can remain viable, which will have the end effect of strengthening the private retirement sector and, ultimately, helping to diffuse the ever-present "retirement crisis in America" issue.

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About the Author

Lance M. Roberts is a principal and founder of Walker MacRae Inc., a firm that specializes in consulting services to the third party administration community. Mr. Roberts has more than twenty years of experience in the retirement industry, as the Regional Group Pensions Manager for Lincoln National Life Company from 1972 to 1979; owner and President of the Roberts-Haddad Group (and predecessor companies) from 1979-1996, a third party administration firm; and most recently, Senior Vice President and National Sales Manager for Sheakley Pension Administration, Inc., headquartered in Cincinnati, Ohio. Mr. Roberts is a graduate of Dartmouth College and attended the Kellogg School of Business, Northwestern University. In addition to consulting services, Walker MacRae offers a highly sophisticated, open-architecture trading portal that specializes in connecting regional TPAs with powerful national relationships that expand their revenue sharing opportunities. He was one of the original group of industry professionals to recognize the problem and opportunity represented by revenue sharing. Mr. Roberts assisted in the development of a number of articles and White Papers on the topic. He has also aided in the development of the idea of providing plan sponsors with a mathematical formula for scoring funds that can provide the basis of a protective due diligence process for use in qualified plans.

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