

A PRIMER ON PLAN FEES
AND AN ANALYSIS OF H.R. 3185,
THE 401(k) FAIR DISCLOSURE FOR RETIREMENT SECURITY ACT OF 2007

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AMERICAN BANKERS ASSOCIATION
COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS
THE ERISA INDUSTRY COMMITTEE
THE FINANCIAL SERVICES ROUNDTABLE
INVESTMENT ADVISER ASSOCIATION
INVESTMENT COMPANY INSTITUTE
NATIONAL ASSOCIATION OF MANUFACTURERS
PROFIT SHARING/401k COUNCIL OF AMERICA
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
SOCIETY FOR HUMAN RESOURCE MANAGEMENT
UNITED STATES CHAMBER OF COMMERCE

INTRODUCTION

ERISA provides many safeguards for the protection of workers' retirement assets. Plan assets must be held in a trust that is separate from the employer's assets. The fiduciary of the trust (normally the employer or committee within the employer) must operate the trust for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. In other words, the fiduciary has a duty under ERISA to ensure that any expenses of operating the plan, to the extent they are paid with plan assets, are reasonable.

PLAN FEES

As Congress examines retirement plan fees, it is critically important that policymakers have accurate information regarding such fees. The vast majority of participants in ERISA plans have access to capital markets at lower cost through their plans than the participants could obtain in the retail markets because of economies of scale and the fiduciary's role in selecting investments and monitoring fees. The level of fees paid among all ERISA plan participants will vary considerably, however, based on variables that include plan size (in dollars and/or number of participants), participant account balances, asset mix, and the types of investments and the level of services being provided. Below is data from surveys conducted by various organizations that monitor and analyze plan fees. The studies reflect, in particular, the impact of plan size and average account balances on fees:

CEM Benchmarking Inc. — CEM is a benchmarking company that serves 300 of the world's largest public and corporate pension plans in the US, Canada, Europe and Australia. A study of 88 US defined contribution plans with total assets of \$512 billion (ranging from \$4 million to over \$10 billion per plan) and 8.3 million participants (ranging from fewer than

1,000 to over 100,000 per plan) found that **total costs ranged from 6 to 154 basis points¹ (bps)** of plan assets in 2005. Total costs varied with overall plan size. Plans with assets in excess of \$10 billion averaged 28 bps while plans between \$0.5 billion and \$2.0 billion averaged 52 bps. Further, costs depended on the average account balance. Plans with an average account balance less than \$55,000 paid four bps more in administrative compliance costs than plans with an average account balance exceeding \$55,000. Total costs were also affected significantly by asset mix. Costs rose as the proportion of plan assets invested in domestic small cap stock and alternative investments (i.e., real estate) increased. In a separate analysis conducted for the Profit Sharing / 401k Council of America, **CEM reported that, in 2005, its private sector corporate plans had total average costs of 33.4 bps and median costs of 29.8 bps.**

HR Investment Consultants — HR Investment Consultants is a consulting firm providing a wide range of services to employers offering participant-directed retirement plans. It publishes the **401(k) Averages Book** that contains plan fee benchmarking data. The 2007 edition of the book reveals that **average total plan costs ranged from 159 bps for plans with 25 participants to 107 bps for plans with 5,000 participants.**

Committee on Investment of Employee Benefit Assets (CIEBA) - CIEBA is the voice of the Association of Financial Professionals (AFP) on employee benefit plan asset management and investment issues. CIEBA represents more than 115 of the country's largest pension/retirement funds. Its members manage \$1.4 trillion in defined benefit and defined contribution plan assets, on behalf of 16 million (defined benefit and defined contribution) plan participants and beneficiaries. **A 2005 survey of 109 CIEBA members revealed that plan costs paid by defined contribution plan participants averaged 22 bps.**

DEPARTMENT OF LABOR FEE TRANSPARENCY INITIATIVES

Fee disclosure and transparency present complex issues. Amending ERISA through legislation to prescribe specific fee disclosure will lock in disclosure standards built around today's practices and could discourage product and service innovation. The Department of Labor (DOL) has announced a series of regulatory initiatives that will make significant improvements to fee disclosure and transparency. **The undersigned support the DOL's efforts. We believe that this is the best approach to enhance fee transparency in a measured and balanced manner and we urge Congress to delay taking legislative action until the Department of Labor has completed its work.** The DOL's initiatives are as follows:

Annual Reporting Requirements Among the new impending fee disclosure obligations are revised annual reporting requirements for plan sponsors. DOL is about to finalize modifications to the Form 5500 and the accompanying Schedule C, on which sponsors report compensation paid to plan service providers. The modifications will expand the number of service providers that must be listed and impose new requirements to report service provider revenue-sharing. The final regulations implementing the new Form 5500 are expected in the very near future and are expected to first be applicable to the 2009 plan year.

Service Provider Disclosure Obligations DOL also intends later this year to issue a revised regulation under ERISA Section 408(b)(2), which is a statutory rule dictating that a plan may pay no more than reasonable compensation to plan service providers. The expected proposal

¹ One basis point is one-hundredth of one percent — 100 basis points equals one percent.

is designed to ensure that plan fiduciaries have access to information about all forms and sources of compensation that service providers receive (including revenue-sharing). Both sponsors and providers will be subject to new legal requirements under these proposed rules, including an anticipated requirement that all third party compensation be disclosed in contracts or other service provider agreements with the plan sponsor.

Participant Disclosure Rules The DOL's remaining initiative focuses on revamping participant-level disclosure of defined contribution plan fees. DOL issued a Request for Information ("RFI") in April 2007 seeking comment on the current state of fee disclosure, the existing legal requirements and possible new disclosure rules. Comments were filed by July 24, 2007. DOL has indicated that it intends to propose new participant disclosure rules early in 2008 that will likely apply to all participant-directed individual account retirement plans.

PRINCIPLES FOR REFORM

We support regulatory reforms that reflect the following principles:

- **Sponsors and Participants' Information Needs Are Markedly Different.** Any new disclosure regime must recognize that plan sponsors (employers) and plan participants (employees) have markedly different disclosure needs.
- **Overloading Participants with Unduly Detailed Information Can Be Counterproductive.** Overly detailed and voluminous information may impair rather than enhance a participant's decision-making.
- **New Disclosure Requirements Will Carry Costs for Participants and So Must Be Fully Justified.** Participants will likely bear the costs of any new disclosure requirements so such new requirements must be justified in terms of providing a material benefit to plan participants' participation and investment decisions.
- **Information About Fees Must Be Provided Along with Other Information Participants Need to Make Sound Investment Decisions.** Participants need to know about fees and other costs associated with investing in the plan, but not in isolation. Fee information should appear in context with other key facts that participants should consider in making sound investment decisions. These facts include each plan investment option's historical performance, relative risks, investment objectives, and the identity of its adviser or manager.
- **Disclosure Should Facilitate Comparison But Sponsors Need Flexibility Regarding Format.** Disclosure should facilitate comparison among investment options, although employers should retain flexibility as to the appropriate format for workers.
- **Participants Should Receive Information at Enrollment and Have Ongoing Access Annually.** Participants should receive fee and other key investment option information at enrollment and be notified annually where they can find or how they can request updated information.

ANALYSIS OF H.R. 3185
(generally applicable to participant-directed individual account plans)

Disclosures to plan administrators Under H.R. 3185, plan service providers are required to provide a “service disclosure statement” that describes all plan fees, in twelve specific detailed categories, as a condition of entering into a contract. The proposal would also require that this information be broken down by each cost component or be “unbundled.” The statement must describe the nature of any “conflicts of interests,” the impact of mutual fund share class if other than “retail” shares are offered and if revenue sharing is used to pay for “free” services. Estimates are permitted only when actual amounts are not known. Service disclosure statements must be posted on the employer’s intranet site and be provided to participants upon request.

The requirements of H.R. 3185 are duplicative with the existing fiduciary requirement that fees paid with plan assets be reasonable. The DOL’s pending proposed regulatory changes under section 408(b)(2) likely will result in similar disclosures, provided at the same general point in time, as this new provision. Under the DOL’s approach, the disclosures will be incorporated into fiduciary requirements regarding plan fees, making noncompliance a prohibited transaction.

The purpose of the requirement to “unbundle” all fees for all services is unclear. It is likely to be costly and is not likely to provide additional helpful information. Bundled service providers incorporate all services under a single price or several broad categories of prices. Plan administrators must ensure that the aggregate price of all services in a bundled arrangement is reasonable at the time the plan contracts for the services and that the aggregate price for those services continues to be reasonable over time. For example, asset-based fees should be monitored as plan assets grow to ensure that fee levels continue to be reasonable for services with relatively fixed costs such as plan administration and per-participant recordkeeping. The plan administrator should be fully informed of all the services included in a bundled arrangement to make this assessment. Many plan administrators, particularly small employer plan administrators, may prefer reviewing costs in an aggregate manner and, as long as they are fully informed of the services being provided, they can compare and evaluate whether the overall fees are reasonable without being required to analyze each fee on an itemized basis. Imposing “unbundled” fee disclosure also raises significant concerns as to how a service provider would disclose component costs for services that are not offered outside a bundled contract. The posting of detailed unbundled services information could also force the public disclosure of proprietary information regarding contracts between service providers and plan sponsors.

The provision relating to “conflicts of interest” should be substantially revised. ERISA already prescribes strict rules for prohibited activities for service providers who are parties-in-interest or fiduciaries to a plan. While disclosure of conflicts is important, the provision goes much further by requiring the disclosure of relationships and affiliations between different providers, regardless of whether these relationships involve a conflict of interest. Plan sponsors are expected to be provided with considerably expanded disclosures in the near future as the result of the DOL initiatives (in all likelihood sooner than if new legislation is enacted). This additional information will be very helpful to plan sponsors in meeting their fiduciary requirements related to administering an ERISA-covered retirement plan.

The purpose of the share class disclosure requirement is not clear. Depending on the size of a plan and its service needs, participants may pay fees that are lower, higher, or the same as “retail” prices. There are myriad costs associated with administering a 401(k) plan that do not apply to individual ownership of

a mutual fund and, for this reason, participants in some plans, particularly new small business plans, may pay additional costs. A comparison with an “institutional” share in this situation could result in an incorrect conclusion that the plan is paying more than reasonable expenses.

Disclosures to plan participants Under H.R. 3185, plan administrators must provide an advance notice of investment election information to participants and beneficiaries, generally 15 days prior to the beginning of the plan year. The notice must include the name of the option; investment objectives; risk level; whether the option is a “comprehensive investment designed to achieve long-term retirement security or should be combined with other options in order to achieve such security”; historical return and percentage fee assessment; explanation of differences between asset-based and other annual fees; benchmarking against a nationally recognized market-based index or other benchmark retirement plan investment; and where and how additional plan-specific and generally available investment information regarding the option can be obtained. The notice must include a statement explaining that investment selection should not be based solely on fees but on other factors such as risk and historical returns. The notice must include a fee menu of the potential service fees that could be assessed against the account in the plan year. Fees must be categorized as, 1) varying by investment option (including expense ratios, investment fees, redemption fees, surrender charges); 2) asset-based fees assessed regardless of investment option selected; and 3) administration and transaction fees, including plan loan fees, that are either automatically deducted each year or result from certain transactions. The fee menu shall include a general description of the purpose of each fee, i.e., investment management, commissions, administration, recordkeeping. The menu will also include disclosure of potential conflicts of interest that may exist with service providers or parties in interest, as directed by the Secretary of Labor.

Plan administrators must also provide an annual benefit statement that includes starting balance; vesting status; contributions by employer and employee during the plan year; earnings during the plan year; fees assessed in the plan year; ending balance; asset allocation by investment option, including current balance, annual change, net return as an amount and a percentage; service fees charged in the year for each investment, including, separately, investment fees (expense ratios and trading costs), load fees, total asset based fees (including variable annuity charges), mortality and expense charges, guaranteed investment contract (GIC) fees, employer stock fees, directed brokerage charges, administrative fees, participant transaction fees, total fees, and total fees as a percent of current assets; and the annual performance of the investment options selected by the participant as compared to a nationally recognized market based index

The new disclosure requirements that would be imposed by H.R. 3185 are overly complex and costly. We support disclosure of relevant fee information about the plan, but flexibility should be provided to ensure that the plan administrator can tailor the disclosure to meet the needs of plan participants. The participant disclosure requirements as presently drafted will likely result in lengthy “legalese” documents that would confuse most participants and possibly hinder rather than help them make investment decisions. The scope and detail of the disclosure might well result in a document that, at best, is ignored and, at worst, deters participation in the plan.

We agree that fee information should not be provided in a vacuum. Some of the required data elements and comparisons in the legislation use confusing terminology, have overlapping requirements, or are excessively detailed. For example, a “benchmark retirement plan investment” does not currently exist and no single benchmark is appropriate for every kind of investment. In many cases the required participant disclosure item would apply to some products and not others, and could be difficult to calculate, especially by the plan administrator.

Recordkeeping systems are not currently able to meet all the requirements of the annual benefit statement in H.R. 3185. Additional costs to participants will result from the significant system changes needed to comply and simpler disclosure would provide much of the same benefits to participants. Much of the required data about the plan and the participant's account is already required to be disclosed in the new benefit statement mandated under the Pension Protection Act, yet there is no coordination of the two requirements.

Minimum investment option requirement - Plans must include at least one investment option which is a nationally recognized market-based index fund that, as determined by the DOL, offers a combination of historical returns, risks, and fees that is likely to meet retirement income needs at adequate levels of contribution.

Plans should not be required to include a particular investment (with resulting fiduciary liability if the investment is found not to meet statutory and regulatory requirements). The provision would override a plan's ability to select and monitor plan investments by reaching a values conclusion that this investment is appropriate for all plans. It sets a precedent for further mandates regarding the investment of plan assets which is counter to ERISA's focus on a prudent process and would preempt the judgment of investment professionals. It is unlikely that any one "market-based index" alone is "...likely to meet retirement income needs." Further, embedding a particular investment option in law may lead participants to believe that this is either the "best" option or the government-sanctioned option, thereby steering plan participants into the investment which may not be appropriate for the individual participant.