

**ADVISORY COUNCIL ON EMPLOYEE WELFARE AND  
PENSION BENEFIT PLANS  
REPORT OF THE WORKING GROUP ON FEE AND RELATED DISCLOSURES TO  
PARTICIPANTS**

**Introduction**

The working group on fee and related disclosures to participants<sup>1</sup> framed the issue for study as follows:

*Description:*

This working group is going to study fee and related disclosures to participants in defined contribution plans that relate to investment decisions and retirement savings. The scope of the study will encompass both plans that are intended to meet the ERISA<sup>2</sup> §404(c) requirements and those that are not intended to meet those requirements. Existing disclosure requirements within the scope of this study will be examined. The goal is to assess the adequacy and usefulness of the current requirements and whether changing the disclosure requirements could help participants to more effectively manage their retirement savings. Among the hoped for results are a determination of whether:

1. Present fee disclosures to participants adequately inform participants to enable them to make rational investment decisions;
2. The present division between required disclosures and disclosures upon request in the §404(c) regulations is appropriate; and
3. New disclosure methods could be utilized to make compliance less costly and enhance utility for participants.

*Questions:*

1. What information is typically available for participants to know and understand the fees and expenses paid in their defined contribution accounts?
2. What information must be disclosed to participants relating to fees and expenses associated with their defined contribution accounts in plans subject to ERISA §404(c) and in plans not subject to ERISA §404(c)?
3. What is among the information presently required to be disclosed under plans subject to ERISA §404(c) and in plans not subject to ERISA §404(c) that should not have to be disclosed?
4. What additional information should be subject to required disclosure for both plans subject to ERISA §404(c) and in plans not subject to ERISA §404(c)?

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<sup>1</sup> Hereinafter referred to as the working group.

<sup>2</sup> Meaning the Employee Retirement Income Security Act of 1974.

5. What information is available upon request by participants relating to fees and expenses associated with their defined contribution accounts in plans subject to ERISA §404(c) and in plans not subject to ERISA §404(c)?
6. Should any of the information that is available on request be subject to required disclosure?
7. Is information readily available, and presented in a context that is understandable by a typical plan participant?
8. Do disclosures relating to fees and expenses associated with defined contribution accounts typically use electronic means of communication? If these means are not typically utilized, should they be utilized more often?
9. Typically, investment returns and account balances are presented on both a consolidated and individual account basis for a participant. Is it possible for fees and expenses to be presented on a consolidated or aggregate basis also, or is it up to the participant to calculate and aggregate this information in order to determine the total fees and expenses to which his/her account is subject?
10. Is it possible to develop a prototype format for presenting usable fee and expense information in a cost efficient manner?

The description and questions were given to all of the witnesses in advance of their testimony. The witnesses were all told that the questions were merely a starting point to generate thought and discussion of the issue being studied. The questions were not intended to limit the parameters of their testimony.

The working group solicited testimony of witnesses from a variety different backgrounds. The witnesses and the dates of their testimony are as follows:

*August 5, 2004*

- Louis Campagna, Chief, Division of Fiduciary Interpretations, Office of Regulations and Interpretations, US Department of Labor, Washington D.C.
- Mercer Bullard, President and Founder Fund Democracy, Inc. and Assistant Professor of Law, University of Mississippi
- Russell K. Ivinjack, Principal, Ennis Knupp & Associates, Inc.

*September 21, 2004*

- Edward Ferrigno, Vice President, Profit Sharing/401k Council of America
- Dennis Simmons, Principal and Senior Counsel and Stephen P. Utkus, Principal, both of the Vanguard Group
- Elizabeth Krentzman, General Counsel, Investment Company Institute
- Bruce Ashton, President, ASPA and partner of Reish, Luftman, Reicher & Cohen
- Norman P. Stein, Professor of Law, University of Alabama
- John Kimpel, Senior Vice President and Deputy General Counsel, Fidelity Investments

## **Presently Required Investment Expense Disclosures**

ERISA contains numerous statutory and regulatory disclosures. Disclosure requirements aimed at identifying investment expenses are relatively few.

Russell Ivinjack identified general disclosure requirements applicable to ERISA defined contribution plans that can involve some identification of plan investment expenses. Most such plans are required to distribute to participants a summary annual report that identifies total expenses and benefit payments for the plan year. Additionally, a summary plan description of the plan's rules is required and some description of expenses might be included in that document.

Louis Campagna's testimony listed the materials that must be disclosed and the materials disclosed on request under the ERISA §404(c) regulations. The testimony of Russell Ivinjack and his handout material also described these disclosures.

ERISA §404(c) and the regulations interpreting that provision allow plan fiduciaries to avoid liability for participant investment decisions if specified requirements are met<sup>3</sup>. These requirements include a mandatory expense disclosure and an expense disclosure that must be made upon request.

The required or automatic disclosure in this regard is a description of transaction fees and expenses that affect the value of the participant's account. Examples of these expenses are commissions, sales loads, deferred sales charges and redemption or exchange fees. Expense information can also be extracted from the investment option prospectus that must be distributed to the participant after the initial investment. This requirement only applies to investment options subject to the Securities Act of 1933.

There are two kinds of investment expense information available on request. The first is the annual operating expenses that reduce the rate of return of the investment options. The participant may also request to see these expenses as a percentage of average net assets. Examples of these expenses include investment management fees, administrative fees and transactions costs. The second is information about the value of shares or units in the investment options, as well as the past and current investment performance determined net of expenses.

John Kimple also testified that ERISA §105 requires that participants be given a statement of their accrued benefits upon demand. He said that this requires that the account balance of a participant in a defined contribution plan be provided net of all expenses that reduce the account and that all such fees be identified on any account statement.

## **Range of Available Investment Expense Disclosures**

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<sup>3</sup> Meeting these requirements does not eliminate the plan fiduciary's responsibility to prudently choose and monitor investment options made available to plan participants.

The working group heard a variety of testimony about the wealth of information available to plan participants about plan investment options. Much of this material goes beyond what is legally required to distribute to participants. A common problem concerned the format in which much of this information may be presented. Some formats, like a prospectus, are not user friendly. Additionally, many witnesses noted that the available information is so dispersed that it takes a determined participant to corral it all<sup>4</sup>.

Examples of the available information (which include some items produced pursuant to legal requirements) are 5500 annual reports; summary annual reports (SARs); prospectus for plan investments subject to regulation under the Securities Act of 1933; summary plan descriptions; fund fact sheets; information on investment option expenses available through the Employee Benefits Security Administration (EBSA) webpage on the Department of Labor's (DOL's) website<sup>5</sup>; and recordkeeper websites.

### **Consensus Recommendation**

#### *Scope of Plans Subject to Consensus Recommendation*

The consensus is for additional disclosure of fees in defined contribution plans that seek the protections of ERISA §404(c). This makes sense because plan sponsors use §404(c) for protection against fiduciary liability for participant investment choices, although the plan sponsor still retains the fiduciary obligation to monitor the funds available for investment decisions by the participants. Testimony from Louis Campagna, an attorney with the DOL is consistent with this conclusion. He testified that ERISA §404(c) "offers a defense for liability for plan sponsors and other plan fiduciaries if there is an informed choice and control by the participant with respect to the investment choices available to them under the plan." He also testified that plans not intended to meet the 404(c) requirements operate under the working assumption that the fiduciary decided to be the party liable for investment choices, "[s]o the same type of control issues won't be present in those types of plans."

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<sup>4</sup> John Kimple was a contrarian on this point. He testified:

*We therefore, interpret this requirement [ERISA §105] to require the identification of any such fee on the participant's statements. Therefore, by looking at the expense ratios for a plan's investment options as disclosed in the mutual fund prospectus or the 404(c) required fund description for investments other than mutual funds, together with additional fees, if any, assessed against the participant's account as disclosed in the participant's statement, the participant should be able to readily calculate the aggregate fees that reduce the value of his or her account. As a consequence, the expense ratios for mutual fund and non-mutual fund investments and any administrative expenses that reduce the value of the participant's account balance are all currently disclosed to participants in sufficient detail to allow participants to evaluate the costs they pay against the services they receive.*

<sup>5</sup> John Kimpel and others in their testimony spoke favorably about these existing resources on the DOL website – *A Look at 401(k) Plan Fees for Employees, A Look at 401(k) Plan Fees for Employers* and a fee worksheet.

This does not minimize the need for disclosure and the availability of information for participants in defined contribution plans not subject to §404(c). The sponsors of those plans, however, do not have any special protection from investment choices that may be allowed to participants. Therefore, the level of participant disclosure may not be as acutely needed as it is in the context of §404(c) plans. Nonetheless, we do not purport to address the general fiduciary duties of sponsors under such plans as those duties may relate to participant disclosures. That topic is beyond the scope of this investigation.

### *Considerations in Arriving at the Consensus*

The working group heard testimony that information on investment option expenses is important to the health and vitality of plan participants' retirement accumulations. Testimony from Professor Mercer Bullard and from Stephen Utkus indicated that while future investment returns are unpredictable and beyond a participant's control, investment expenses are known.

The working group agrees that disclosure to participants of factual information on investment option expenses is, in the abstract, beneficial. Nonetheless, there are practical constraints on the degree, quantity and cost of disclosures. A balance must be struck between the desire for complete disclosure and the utility of additional disclosure.

Additionally, a balance must be struck between what can reasonably be expected of small plan sponsors and the potential capabilities of larger plan sponsors. The working group wants to avoid a rule that is so burdensome that it discourages the adoption and maintenance of defined contribution plans. Section 401(k) plans in particular have become popular and convenient investment vehicles for the US workforce. Disclosure rules should not be so onerous that they impede this popular and useful savings vehicle.

Finally, the fee disclosure rules should be user friendly. The disclosures must be in an easy to read format that provides pertinent information for the investment decision. The disclosures must be easy to read and understand<sup>6</sup>. They must also be presented in a context of other investment information typically utilized by investors to make investment decisions. One item of information cannot be presented in a vacuum and fees must be presented with other information about the investment option.

### *Recommendation*

The working group recognizes that providing actual fee information for a particular participant's account over a stated period of time is not justified at this time by the cost of providing that information. Given the current state of technology and recordkeeping

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<sup>6</sup> In his testimony, Professor Stein emphasized the need for easily understandable materials because many participants lack sophistication regarding investments. He also noted that while he believed that the DOL should work with the SEC to develop appropriate rules for disclosures, he believed the DOL was the agency that should prescribe the format because the DOL has more experience designing materials for employees and plan participants.

practices, it is a complex and costly procedure to sum the total costs to a particular participant's account because of investment changes over time<sup>7</sup>.

Nonetheless, the working group saw examples of investment statements showing the expense of each investment option expressed as a ratio for each fund in which a participant was invested as of the date of the statement. The working group believes that this is pertinent information that is helpful in making the investment decision. This information can also be presented in an understandable format.

One example was in materials distributed in connection with Russell Ivinjack's testimony. It consisted of a table having the following information going across the page: fund name, fund type, objective/strategy, risk level and expense ratio. Another example was in materials distributed by Dennis Simmons and Stephen Utkus who were from the Vanguard Group. The sample all-in fee report and the sample fund fact sheet are attached as exhibits to this report. The sample all-in fee report is substantially similar to the DOL Fee Disclosure Form.

The consensus of the working group results in only minor suggestions for regulatory improvement. The weakness of the present §404(c) regulatory framework is in the manner the fee information is made available. The working group recommends a remedy to this without suggesting drastic changes to the information that must be provided. The working group, however, recognizes that different considerations apply to open platform (also known as open brokerage) options in plans subject to §404(c). Therefore, the recommendations of the working group do not apply to such investment options<sup>8</sup>.

The consensus recommendation is as follows:

1. The profile prospectus of each investment option should be delivered to each employee upon eligibility to participate<sup>9</sup>. The profile prospectus is a summary prospectus allowed under Securities and Exchange Act Rule 498 (*see* Form N-1A). It has vital investment information that includes investment expense information. It is logical to require some modicum of information on the investment options before a participant is asked to invest his or her money. Some investment fund options are not subject to regulation by the SEC. For those options, the DOL should require a

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<sup>7</sup> For example, Russell Ivinjack testified as follows: "It would be too complex to go on a day-by-day basis, calculate their balances as the market changes, as contributions go in, to accurately calculate what their exact calculation would be for that full year."

<sup>8</sup> For example, Bruce Ashton testified that "it would be unfeasible for a plan sponsor to disclose to the plan participant many of the costs sustained through open brokerage windows . . ."

<sup>9</sup> Advisory Opinion 2003-11A allowed a profile prospectus to be used as a prospectus when it is the most recent prospectus in the possession of the plan to satisfy the §404(c) regulatory requirement regarding the delivery of a prospectus. The Department of Labor has already seen the utility of the profile prospectus. Professor Bullard spoke favorably of the DOL position in his testimony by saying "ERISA has actually moved ahead of the SEC in this area by allowing the profiles . . . to serve in place of the prospectus." His criticism was that the DOL does not require the delivery of the profile before the investment decision. The working group's recommendation partially addresses this concern.

disclosure with information substantially similar to the information on the profile prospectus<sup>10</sup>. Providing this information prior to the initial investment decision should eliminate the need to automatically provide a full prospectus or other information concerning the particular investment options elected immediately after the investment options are elected. A participant would still be able to request such materials.

2. An educational requirement would be a corollary to the recommendation in item 1. Participants must be given materials (like a glossary) that explain the meaning of the terms used in the profile prospectus (or other like document) coincident with the delivery of the profile prospectus. This explanation would include a description of an expense ratio and what it means to have the investment expenses of an investment option expressed as a ratio. Included in this would be a mathematical example demonstrating the calculation necessary to approximately determine the expenses that apply to a particular participant's account investments as of a particular date.

Account and investment recordkeepers should be encouraged to develop internet websites where participants can research information about plan investment options and review information about their own investment choices. Additionally, these recordkeepers should be encouraged to develop web-based tools for participants to calculate alternative investment scenarios that incorporate assumptions about investment expenses as well as rates of return. Nonetheless, it is not intended that the suggestions in this paragraph be made into requirements.

3. To the extent that an annual statement is provided by the recordkeeper, the statement must provide the expenses of each investment option expressed as a ratio along with other information provided about the investment options<sup>11</sup>. There must also be an identification of the investment expenses that are paid entirely or in part by the plan sponsor. The investment expenses do not include other expenses for general plan maintenance paid by the plan sponsor, including, but not limited to, legal expenses, consulting expenses and accounting expenses. If such investment expenses were paid in part by the plan sponsor the portion so paid would be identified.

Any new requirement implemented under this item 3 should have a delayed effective date as applied to small and medium sized plans, based on the number of participants. New requirements like those described in this item could be more costly to implement for such plans than for large plans. Defining what a small to

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<sup>10</sup> Elizabeth Krentzman's testimony noted a gap between the information that may be available for mutual fund options that are subject to SEC regulation and investment options that are not. She said that "[w]ithout equivalent information, plan sponsors may not be able to make meaningful fee comparisons among investment products." The working group believes that this observation applies equally to plan participants, as does Ms. Krentzman as demonstrated in her second recommendation to the DOL regarding participant disclosures.

<sup>11</sup> This is consistent with Edward Ferrigno's testimony where he recommended the changes in investment costs be provided automatically on an annual basis for plans subject to ERISA §404(c). Dennis Simmons also recommended that this information be provided on an annual basis.

medium size plan is for these purposes should err on the high side. Perhaps plans covering fewer than 500 participants would come within this classification. Delaying the application would likely allow service providers time to design necessary systems to provide the contemplated disclosures in a cost effective manner for such sponsors.

4. The DOL should provide a sample model disclosure format that is available on its website. This would be a helpful addition to existing tools already provided on its website for understanding expenses both from the perspective of a participant and a plan sponsor.

### **Summary of Testimony**

Summary of Louis Campagna, Chief, Division of Fiduciary Interpretations, Office of Regulations and Interpretations, US Department of Labor, Washington D.C., August 5, 2004

Section 404(c) is the starting point for ERISA fee and related disclosure requirements for defined contribution plans. To come within the protections of 404 (c), participants must have investment control and must have information sufficient to enable them to make informed investment decisions. To accomplish this goal, there are information disclosure requirements. Some are automatic and some are upon request (or the plan sponsor can go ahead and provide some or all of the materials that are available upon request).

Automatic disclosure includes information fundamental to all participants. The requirements are intended to be flexible enough to respond to different plan designs and numbers of participants. The requirements should not be a burden. Automatic disclosure requirements include: with respect to investments, description of investment alternatives and their investment objectives, risk-return characteristics, the nature of assets, identification of fund managers, how to give investment instructions and any limits on those (*e.g.*, transfer restrictions); with respect to fees and related items, fees, commissions, sales loads and deferred sales charges, exchange fees, and redemption fees must be disclosed (generally transaction related fees). The disclosures can be part of a prospectus; they needn't be in a separate document. The prospectus can be given either immediately before or immediately after the first investment in a plan investment alternative. In September, 2003, the DOL issued an Advisory Opinion ruling that a mutual fund profile prospectus, as defined by the SEC, could be used instead of a prospectus. A profile is a summary of the prospectus – shorter, clearer, simple and easier to understand. He said that the profile prospectus was “designed for participants and it should be helpful in this regard with respect to disclosure information to the participants.” Nonetheless, if the full prospectus was the most recent prospectus available to the plan then that still had to be used to satisfy the requirement.

Plans that charge brokerage fees, or charge for loans or other investment instructions, must provide periodic information regarding these fees.



On request information includes for each investment alternative the latest information on annual operating expenses that reduce the rate of return (*e.g.*, management fees), the average amount, information on past and current performance net of expenses on a reasonable and consistent basis, and the value of shares. Only information and documents the plan already has need to be provided, and the plan can limit the number of times and frequency of such requests.

For non-404(c) plans, only general disclosures are required – SPD, summary annual reports. Communications need not mirror 404(c) communications.

In choosing the funds menu, the plan fiduciary needs to examine the fees, which must be at a reasonable level given the services and their quality. In the 1997 Advisory Opinion (the “Frost Opinion”), it was stated that compensation to a service provider needs to be reasonable taking into account services provided as well as other compensation the service provider receives such as from asset fees.

In 2002, the “Electronic Communication Regulation” addressed getting information to plan participants via electronic means and provides a safe harbor to use electronic media where participants have electronic access at work or beyond. In 2004, the DOL updated its booklet on fees of which to be aware. Also, there is a worksheet on the DOL website for 401(k) plans to use for comparison shopping for mutual funds.

During questioning, Mr. Campagna noted the plan fiduciary can make someone else the agent for the delivery of information. Investment fees are not required to be displayed in any particular way to facilitate comparison among investment choices, other than as a percentage of assets. The comparison of fees among potential vendors is part of the plan fiduciary's role in choosing the investment menu. He also noted that there is no requirement to vary the communication to adapt to the literacy level of participants.

Summary of Mercer Bullard, President and Founder Fund Democracy, Inc. and Assistant Professor of Law, University of Mississippi, August 5, 2004

Professor Bullard testified that ERISA was never set up as an investment statute. This committee is in a good position to consider the basis for government intervention in this area and the economics of government intervention. He believes there is a role for government intervention in this area.

Excessive fees are one area where government intervention can be justified. The SEC has the authority to bring cases on excessive fees but never has done so. Nor does Professor Bullard believe the DOL has ever brought such a case.

Another justification for government intervention is that investors are not very efficient at finding and using the information they need. Required fee disclosure would promote competition. The mutual fund industry is a good example of the effectiveness of competition – the fee table is the reason for this. Fees have dropped in recent years and Professor Bullard attributes the drop to disclosure. In the end, this disclosure enhances personal freedom.

Therefore, this working group should ask the following specific questions that neither Congress nor the SEC asks.

1. How are 401(k) participants' investments performing?
2. Do they pay more in fees than other investors pay?

Professor Bullard speculates that participants do pay higher fees than other investors because fees are less transparent in qualified plans. He also believes that 401(k) participants' investments perform better than the investments of individuals outside of 401(k) plans. He attributes this to the fact that 401(k) investors trade less often than other investors partially because their objectives are long-term and partially because of inertia.

Mutual funds are required to disclose their fees in a fee table in the prospectus. It is important that fees be disclosed as a percentage of assets.

The mutual fund fee table divides the costs of investing into two categories: shareholder fees and operating expenses. Shareholder fees are based on the shareholder's particular account. These include distribution fees such as front-end and back-end sales charges, which are paid to the fund's underwriter and the shareholder's broker, and redemption fees, which are paid to the fund to compensate the fund primarily for the cost of buying and selling portfolio securities and typically apply only to short-term holdings. There also are other shareholder fees.

The term 'operating expenses' is somewhat of a misnomer, as some of these fees are actually used not for operating the fund, but for distributing its shares. As already stated, operating expenses include 12b-1 fees, which are used primarily to compensate the shareholder's broker for distribution services. Part of the management fee also may be used to compensate brokers for distribution services. Operating expenses are also arguably mislabeled because they do not include portfolio transaction costs.

Professor Bullard believes that ERISA regulation is ahead of the SEC by permitting the fund profile to be the required disclosure document. But, the profile should be required to be provided prior to making the investment decision. Nor are updates of information such as the prospectus required in ERISA as it must be under the securities laws. This means that decisions may be being made on stale information.

Professor Bullard believes there are problems with the fee tables. Those issues include:

1. Lack of disclosure on how much brokers are being paid. Professor Bullard believes that legislation will be passed that will be important. Outside the qualified plan context, there are efforts by Congress and the SEC to ensure that the complex fee payments will be disclosed – and there are efforts to bring mutual fund disclosures up-to-date to be more equivalent to disclosures in other areas. Note: these are “push” documents. The key is to force disclosure to people who would not otherwise seek this information.
2. In 2003 the SEC declined to require disclosure on mutual fund quarterly statements. Professor Bullard expects this will be revised and may become a

requirement. The primary argument by the industry is that this would be very expensive but one company has decided to do it voluntarily. Professor Bullard believes this disclosure would be very useful because it would reach people who read nothing except their account statements.

3. The SEC has never supported comparative fee disclosure. Professor Bullard believes this would promote competition.
4. The expense ratio does not include portfolio transactions costs. Consumer groups would like this statistic to be more comprehensive especially in costs related to the fund's trading decisions. This is being considered by the SEC and it is likely that there will be some increased disclosure here.

Professor Bullard maintained that the ERISA statute does not require disclosure of information. Instead, there is just the 404(c) "carrot and stick" that requires some disclosure to get fiduciary protection for the plan and its fiduciaries. Professor Bullard believes the existing disclosure requirements under 404(c) are not very effective. And, he believes the exchange of fiduciary protection for disclosure to be very unusual from the perspective of securities regulation. Although he did acknowledge that the reason for this may be that the plan is the actual customer and not the participant.

Making information available on request is a good thing but that is not where it is important to protect investors as consumers. The key is to ensure that people who are less engaged in the process pay less for their retirement investments.

Q: How have you been estimating costs on turnover?

A: Numerous academics have been doing this using a variety of techniques. It is somewhat subjective and that is one of the objections made by the investment community. The primary objection Professor Bullard has to the current reporting is that information on this would change the behavior of a number of funds. There is a separate question as to which regulators should intervene. There is an obligation to determine how the government can efficiently regulate. He believes the DOL has a stronger obligation to look at regulatory intervention because of the tax-favored nature of qualified plans, etc.

Q: On point of sale requirements, who is the buyer? Who should be required to get POS disclosures?

A: In the 401(k) context, the profile should be provided prior to the investment decision. The problem for plans is different for plans because of the goal of plans to participate. If the disclosure decreases participation, then no disclosure would be preferable. Disclosure should be tested. In this context the "before" and "after" distinction is less important.

Q: We are moving into a more passive situation with 401(k) plans where employees make fewer investment decisions and stay in plans after employment termination. How should that affect disclosure?

A: In such a situation, there is a good argument for no disclosure at all. There are wonderful ideas for automatic investment in life-cycle funds, etc. but disclosure does not have a role to play. You do have to regulate the plan provider.

Q: How much volatility is there in fees and expenses within a particular fund?

A: Very little. The largest expense is the management fee and changes to the management contract must be approved by the shareholders. Some changes are created by voluntary and temporary fee waivers. Across funds there is a significant range in expense ratios.

Q: Is it fair to say that the information participants need exists and takes a form similar to the fee table?

A: Yes. The information could be improved by providing comparative information but there is a need to consider the costs of disclosure.

Q: But, what if the plan has many options? The fee table might become overwhelming.

A: True but Professor Bullard doesn't believe that it makes sense to have more than 10 or 20 mutual funds in the plan. It would not be feasible to provide comparative fee information for open platform plans.

Q: So, should options be limited?

A: Yes, at some point increasing the number of investment options becomes counterproductive.

Q: In the example of comparing employer plan costs, since the costs rely primarily on what the employee chooses for investments, is that a helpful comparison?

A: No, that is true. But, a 401(k) is an investment option and it may make sense to compare the ability to invest in 401(k) plans with other tax-favored investment vehicles.

Q: The testimony has concentrated on mutual fund disclosures. To what extent would the disclosures apply to other investment products?

A: Yes the disclosure obligations we have discussed could apply to other investment products, but it would require war with the investment community. There is far less disclosure in other investment vehicles and it surprises Professor Bullard that employers would use those vehicles. Optimally employers would require all investment vehicles make equivalent disclosure.

Q: Another witness testified about the broad variety of fees that exist and expressed concerns with how much money some vendors make. What is your view on this?

A: From an economist's view, profit is irrelevant. Instead what matters is the quality that is provided. Courts can't determine when profits are "too high" and the ability to profit is at the heart of capitalism. Professor Bullard believes that disclosure of sub factors of fees, if disclosed at all, should be disclosed in a comparative way such as in a pie chart.

Q: John Templeton's argument was that his strategies were so successful because high fund fees deterred investors from taking short term views and moving money quickly. Is there a conflict of interest in banks and do bank customers choose bank services to protect other benefits?

A: There is not a great deal of conflict in this area. This is not necessarily the type of conflict that raises to the level of required disclosure.

Q: Have you looked at the fees associated with the employer stock holdings?

A: I'm not aware of this. Council discussion indicated that there are no management fees permitted. On the fee issue employer stock is very efficient.

Q: Can you reconcile the lack of concern with profits vs. interest in how much money is going into a broker's pocket?

A: Those are separate matters. The need is to understand what the incentives are for the broker to push one fund over another. The best example is the revenue sharing payments that used to be made to brokers. This allegedly may affect a broker's recommendations.

Q: Are there studies indicating that 401(k) plan participants would make a decision based on fees vs. returns?

A: Not aware of studies within the 401(k) context but there are studies indicating that investors do sometimes make decisions based on fees. Council discussion among members indicated that in plans most decisions are made on returns. Professor Bullard stated that costs are a better predictor of returns than past returns. As a general matter plan participants are better at choosing investments than other mutual fund investors.

Q: Follow up re: statement that lower costs correlate with higher returns.

A: That is true in large cap funds. In response to a question about small cap and international funds, Professor Bullard indicated that it becomes less true in those funds.

Q: Follow-up question to why plan participants do better than other mutual fund investors.

A: That occurs because plan participants trade less. In part that is due to inertia.

Q: Re: POS document, what should it look like?

A: It should be a one pager and the focus is likely to be core information on fees.

Summary Russell K. Ivinjack, Principal, Ennis Knupp & Associates, Inc., August 5, 2004

Mr. Ivinjack discussed his background and that of his firm. Turning to his presentation materials, he discussed the importance of fee disclosure. He indicated that currently there is a good level of fee disclosure in defined contribution plans, but that the information presented is not useful to either plan sponsors or participants. Neither employees nor employers know the true costs they pay each year.

Mr. Ivinjack discussed the amount of information available to participants – SPD's, fund fact sheets, prospectuses, etc., and indicates that it is possibly too much information. He then proceeded to review the costs that are currently required to be disclosed by Section 404(c). He discussed that the requirements for non-404(c) plans are not as stringent. He indicated that the disclosures for plans that are not 404(c) plans present fees on an aggregate basis, and not broken out in terms of explicit costs.

He recommended that some context should be provided with the fee disclosure. For instance, fees relative to an industry average or peer average would be helpful. However, creating a peer or industry average presents some problems of its own. If

you use all relevant information out there to create a universe, it may not be relevant. He indicated that information presented by asset category would be most helpful. For example, equity index fund costs should be compared to other index fund costs, not to active management.

Mr. Ivinjack indicated that each participant should be told explicitly what their costs are on an annual basis in terms of dollars as well as on a percentage basis. Mr. Ivinjack indicated, as other witnesses had, that providing a snapshot point in time annual cost estimate was adequate. Mr. Ivinjack indicated that the industry can do a much better job of helping participants understand what the costs are and how that weighs into their investment decisions.

Summary of Edward Ferrigno, Vice President, Profit Sharing/401k Council of America, September 21, 2004

Ed Ferrigno spoke on behalf of the PSCA. Mr. Ferrigno indicated that although participants need to be aware of the fees paid through their plan investments, ERISA's fiduciary requirement that any fees paid with plan assets be reasonable reduces the risk of improper fees being imposed on participants.

Mr. Ferrigno stated that PSCA supports improving the information that is provided in a mutual fund's prospectus by mandating that additional expenses which are reported in the fund's Statement of Additional Information (SAI) be included in the prospectus. Brokerage fees, which are usually not included in the expense ratio in the prospectus but are reported in the SAI, should be included in the prospectus and the fund profile.

The DOL should determine whether the prospectus information provided on mutual funds is provided for other types of investments and, if not, the regulations should be changed to achieve this.

Mr. Ferrigno stated that the PSCA supports revising 404(c) to require disclosure of changes in investment costs annually. However, Mr. Ferrigno cautioned that mandatory fee disclosure could produce unintended results. An unsophisticated investor could be improperly influenced by relative plan fees if that investor does not understand what drives fee levels. He addressed the cost-benefit issues that should accompany any discussion of enhanced fee disclosure. Mr. Ferrigno also addressed fees not connected with investment decisions such as trustee fees, recordkeeping fees, etc.

He stated that PSCA is intrigued by the concept of analyzing and reporting at the account level on fees not related to investment decisions. He stated this should be further investigated.

Summary of Dennis Simmons, Principal and Senior Counsel and Stephen P. Utkus, Principal, both of the Vanguard Group, September 21, 2004

The Vanguard Group is the world's second largest mutual fund family, and the nation's second largest provider of investments and recordkeeping services. Vanguard

administers more than \$215 billion of defined contribution plan assets on behalf of more than 3200 plan sponsors and more than 2.5 million plan participants.

Vanguard was represented by Dennis Simmons and Stephen P. Utkus. Mr. Simmons is Senior Counsel in Vanguard's ERISA Legal Department and manages Vanguard's Plan Consulting Group. Mr. Utkus is the director of Vanguard's Center for Retirement Research.

Mr. Utkus testified that retirement plan costs have a critical influence on retirement savings plan participants. Lower plan costs lead to higher retirement accumulations and greater security for plan participants. While plan sponsors and participants cannot control investment returns or performance, they have some control over the costs they pay for participating in capital markets through plan investments. Any steps taken to encourage price competition and reduce fees and expenses charged against retirement plan accounts directly contribute to the long-term retirement security of American workers.

Mr. Utkus provided an illustration of how costs affect retirement plan savings over a working career. In his illustration, a participant in a low-cost retirement plan (30 bp annually) would save \$132,000 more over the participant's working lifetime than a participant in a medium-cost plan (100 bp annually), and \$182,000 more than a participant in a high-cost plan (130 bp annually).

Because plan sponsors set the aggregate level of fees and expenses charged to the plan as a whole and to plan participants, plan sponsors must take the initiative to obtain competing bids for services and to negotiate the fees and expenses charged against participants' plan accounts. To assist plan sponsors, a public policy goal should be to encourage greater price transparency and greater price competition at plan sponsor level.

Plan participants must understand the costs associated with each available plan investment options and assess those costs in relation to other factors and characteristics of the options that are important to investment decision making. To assist plan participants, a public policy goal should be to insure that plan participants have full access to information on the costs of investment options available to them. This disclosure should be simple to understand and provided in a uniform manner for all investment options.

Costs incurred by defined contribution retirement plans are either flat fees for participant accounts, commonly but not universally paid by employer, or asset-based fees usually charged against the investment return of individual participant accounts. Mr. Utkus indicated that there has been a shift in the last decade away from flat fees to all asset-based fees, which are less visible to both plan sponsors and plan participants. This is a harmful development for plan participants because, according to research cited by Mr. Utkus, investors will go to great lengths to avoid visible flat fees, but can be oblivious to amount of indirect investment management fees charged against investment performance. Therefore, enhancing participants' and sponsors' understanding of

indirect charges should be a top priority for enhancing cost disclosures for sponsors and participants.

Mr. Simmons presented Vanguard's recommendations for improving fee and expense disclosures to both plan sponsors and plan participants. The first recommendation for disclosures to plan sponsors is that service providers should provide plan sponsors with an all-in fee expense ratio (as illustrated by an example provided by Vanguard). The all-in fee expense ratio is a more comprehensive cost measure, and thus is a more helpful and useful measure. The all-in fee expense ratio includes the investment related expense ratio for each plan investment plus direct administrative and recordkeeping charges paid by the plan. The Department of Labor should encourage plan sponsors to use the all-in fee expense ratio because:

- A. It is a simple and effective way to obtain measure of total cost of plan;
- B. Evaluating all plan fees is a fiduciary best practice; and
- C. It enables the plan sponsor to monitor trends with respect to total fees paid by plan, which encourages greater price competition and more cost efficiency.

Vanguard's second recommendation for disclosures to plan sponsors is that the Department should require each investment provider to deliver to the plan sponsor the investment-related expense ratio for each investment offered in the plan. The investment-related expense ratio for an investment includes all fees and expenses taken directly from investment returns, which reduces plan participant's return.

The third Vanguard recommendation for plan sponsor disclosures is that the investment-related expense ratio for each investment option should be accompanied by a comparative benchmark, so plan sponsors can compare the expense ratio of each investment option against an appropriate industry benchmark.

With respect to disclosures to plan participants, Vanguard's first recommendation is that the Department should require, under ERISA Section 404(c), that disclosures to plan participants must include investment-related expenses that indirectly impact a plan participant's retirement savings. This disclosure should be in the form of an expense ratio for each investment option, and should be required to be provided annually. Presently, the plan sponsor is only required to provide this information upon request.

Vanguard's second recommendation for disclosures to plan participants is that the Department should require investment expense ratios disclosed to participants to be accompanied by appropriate comparative benchmark for other investments in similar asset class.

Mr. Simmons testified that the third recommendation for plan participant disclosures is that fund fact sheets should be used as the main format through which to communicate to plan participants costs and other aspects of investment options, because the fact sheets are concise, easy to read summaries of vital investment information.



Vanguard's final recommendation for plan participant disclosures is that the Department should continue to permit and encourage the use of websites and other electronic media for delivery of ERISA disclosures.

In response to questions from the Working Group, Mr. Simmons and Mr. Utkus stated that developing the appropriate comparative benchmarks to be disclosed to plan sponsors and plan participants should not be a difficult or expensive task for investment providers, because in general the required information is already available and only needs to be compiled. They did acknowledge that the comparative benchmarks may be more helpful to plan sponsors than plan participants, because the plan participants do not have any control over the investment options offered in the plan. However, the benchmark provides context to both the plan sponsor and the plan participants, even if the benchmark is more valuable to sponsor. They noted that the benchmark may be more valuable to a plan participant if the plan's options include multiple options from same investment class. It was also noted that the benchmark may be more valuable to a plan participant if the investment-related expenses are expressed as a dollar value instead of a percentage of assets.

Mr. Simmons and Mr. Utkus conceded that the Department may not technically have the authority to require investment providers to make disclosures to plan sponsors. However, if the Department encourages or requires plan sponsors to obtain these disclosures, providers will begin providing the information.

With respect to the contents of disclosures to plan participants, it was noted that wrap fees need to be disclosed in addition to the investment-related expense ratio. However, unless these fees are stated separately or included in the expense ratio without additional explanation, the benchmark comparison may be affected. Plan participants need to know the bottom line of the total fees and expenses charged against their plan accounts as well as the components of that bottom line.

Mr. Simmons and Mr. Utkus agreed that it would be difficult and expensive to tell a plan participant the actual fees that were netted against the participant's individual investment return for a specific period of time. However, it should be simple and inexpensive to provide estimated fees based on a snapshot of the participant's account.

It was noted that plans of different sizes may have different total expense ratios or investment fees for the same investment option. This can also complicate the disclosure of an appropriate benchmark. However, if investment providers are required to provide benchmarks, those providers will develop the appropriate benchmarks, which will make appropriate benchmarks available to small plans.

Summary of Elizabeth Krentzman, General Counsel, Investment Company Institute, September 21, 2004

Ms. Krentzman indicated that the Investment Company Institute strongly supported the disclosure of detailed fee information for all plan alternatives during the DOL hearings on plan fees and expenses, and the Institute continues to strongly support meaningful disclosure, both to plan sponsors and to plan participants.

The marketplace is highly competitive with respect to fees and expenses. Many fiduciaries choose bundled fee arrangements which provide a package of administrative, custodial and investment services. In bundled arrangements, plan providers may receive compensation from the mutual fund itself through 12b-1 fees, or through revenue sharing where the fund advisor compensates the service provider from its profits.

The Institute recommends disclosure to the plan sponsor of the fees and expenses of all investment options. The Institute also recommends that the Department require that plan sponsors receive from prospective service providers information concerning the provider's potential receipt of compensation, including revenue sharing. A third recommendation was for the Department to assemble a task force to assist the Department in developing a disclosure regime for compensation arrangements.

Regarding fee disclosures to plan participants, the Institute recommends that plan participants be provided, upon request, an investment summary for each investment offered under the plan. The summary would include fee disclosure via a fee table. A second recommendation is that participants in 404(c) plans be provided with disclosure comparable to that provided in a mutual fund profile for all investment options provided under the plan. The Institute also recommends that electronic reporting through hyperlinks and e-mail would enhance exposure to participants while reducing costs for plans and participants.

Summary of Bruce Ashton, President, ASPA and partner of Reish, Luftman, Reicher & Cohen, September 21, 2004

Mr. Ashton indicated that by year-end 2003, an estimated 42 million workers in the U.S. participated in 401(k) plans, holding assets of \$1.9 trillion. Given the significant amount of money in defined contribution plans, the level of fees incurred by participants is a major factor in determining whether a participant will ever achieve retirement security. To illustrate the impact of fees, Mr. Ashton indicated that over a 25 year period, a participant account that bears expenses of 0.5% would accumulate 28% more retirement income than a similar plan bearing expenses of 1.5%.

Mr. Ashton pointed out that fees and expenses are an inherent and necessary part of the operation of a plan, and that the per participant cost of operating a plan covering 100,000 participants is less than the cost of operating a 20 life plan. ASPA believes that full disclosure of all plan fees and expenses charges against a participant's individual account in a defined contribution plan should be provided to each participant. Mr. Ashton then discussed the various types of fees charged to participant accounts – third party administration, commissions, wrap fees, 12b-1 fees, recordkeeping, compliance, loan processing and withdrawals. Costs may be charges as a percent of total plan assets, or as a fixed amount per participant.

The current rules relating to the disclosure of plan related fees and expenses only go so far in disclosing to the plan participant what he or she is really paying out. ASPA believes that plan participants should receive full and complete disclosure of all fees and

expenses paid out of plan assets that can be reasonably identified. Further, this disclosure should be provided in a meaningful and understandable format. To minimize administrative burdens, the disclosure could be distributed in conjunction with the plan participants regular year-end statement. Although specific disclosure of the amount actually charged to a participant's account may be preferable, the burden of providing this individualized information is significant, and providing such information could have a chilling effect on the creation and maintenance of such plans.

Mr. Ashton also presented an ASPA recommendation regarding section 404(c) disclosure, and requested guidance on certain applications of 404(c).

Summary of Norman P. Stein, Professor of Law, University of Alabama, September 21, 2004

Professor Stein opened his testimony by framing the three sections of his testimony. The first focuses on the disclosure of fees charged to participants by vendors providing investment products and services to the plan. The second focuses on the fiduciary's responsibility to choose investment products with competitive fees and to regularly monitor those products. The items monitored include investment related fees, non-investment related fees and investment returns. The third section covers other items including non-investment related fees charged against participant account balances.

Professor Stein next told a personal story. In 1987, he was a visiting professor at the University of Texas. While there, he was able to contribute to a 403(b) annuity. An insurance salesman from a prominent company sold him an investment product for this and Professor Stein contributed \$1,000 to it.

There was no discussion of fees, but there was a fee of \$30 per year. That fee sometimes exceeded the investment return. He did not know why he did not ask about fees for this product. He speculated that he might have thought that his employer would not permit an investment product to be sold that could be disadvantageous.

The point of the story was how important the disclosure of fees can be. Nonetheless, Professor Stein also said that he believes that many participants lack the investment savvy for fee disclosure to be of much utility for them.

Clear and understandable disclosure of fees is still important. Uniformity of presentation is necessary so that participants have the same information about all investment options. The disclosure must also provide examples of how fees affect the rate of return and of how fees can make it more expensive to move in and out of investment options. He also points out the DOL does not have expertise in the area of investments. The SEC does, however, have expertise in this area. Therefore, the DOL should consult with the SEC when designing rules for these kinds of disclosures. Nevertheless, the DOL has more expertise in designing the format of such a disclosure than the SEC, so the DOL should prescribe the format.

Disclosure will not be enough for all participants. Participants who lack investment sophistication rely on plan fiduciaries' judgement to choose investment options with

competitive fee structures. This includes the obligation to monitor the options once chosen.

Professor Stein acknowledged the challenges of small plan sponsors with limited resources. Therefore, he urged the DOL to provide useful tools to help these sponsors by providing appropriate benchmarks against which they can judge fees.

Professor Stein also criticized an administration proposal to exempt certain otherwise conflicted parties from giving investment advice from the prohibited transaction rules. He questioned the wisdom of this.

Professor Stein also criticized DOL Field Assistance Bulletin 2000-3. That Field Assistance Bulletin (FAB) gave plan fiduciaries more flexibility to allocate expenses against accounts on either a pro rata or per capita basis. In particular, he is concerned that pro rata allocations of non-investment expenses will inhibit the ability of lower income participants to build retirement savings. Additionally, the FAB would allow a participant's QDRO expenses to be allocated against his or her account. This hits small accounts more significantly than large accounts and is a reversal of the prior position of the DOL. Nonetheless, if fees are charged to accounts in ways permitted by this FAB, participants should receive explicit disclosure with illustrations in the summary plan description.

In response to a question, Professor Stein opined that a balance between cost and benefit of investment expense disclosures could be struck with an initial disclosure of the expenses with that disclosure repeated annually. Also in response to a question, he again stated his opinion that some participants are not capable of making good investment decisions by themselves.

Professor Stein elaborated on his objection to being able to charge QDRO expenses to specific accounts. He opined that such expenses should be paid by the sponsor as part of the costs associated with the privilege of sponsoring a plan.

Summary of John Kimpel, Senior Vice President and Deputy General Counsel, Fidelity Investments, September 21, 2004

Mr. Kimpel commented that much had been written lately about how 401(k) and other plan participants are being "ripped off" by the high fees mutual funds and other providers charge for their services, and that some commentators suggested that participants do not know what fees they are paying. The legal standard embedded in ERISA is for the fees to be "reasonable". Mr. Kimpel then offered four questions to illustrate the issue:

1. Are plan participants (and sponsors) aware of what fees they are paying?
2. What 401(k) plan fees are participants paying?
3. What 401(k) plan services are participants receiving?
4. Are the 401(k) plan fees a reasonable price to pay for the services that participants are receiving?

Mr. Kimpel then discussed the results of an independent study of 401(k) fees and expenses commissioned in 1997 by the DOL as a result of earlier public hearings on the issue of 401(k) fees. The DOL responded to the study by developing a pamphlet for participants, "A Look at 401(k) Plan Fees for Employees", and another entitled "A Look at 401(k) Plan Fees for Employers". Mr. Kimpel then discussed the SEC rules on fee disclosure for mutual funds. Mr. Kimpel indicates that participants should be able to look at available information and calculate the aggregate fees that reduce the value of his or her account. Mr. Kimpel indicates that the answer to the first question is that fees are fully disclosed, readily ascertainable, and easily calculable by any participant who desires to do so.

The second question asks what plan fees are participants paying. Mr. Kimpel walked through an approximation of the average fee paid based on an average account balance, allocated to different investment options as a typical account would be allocated, and including average recordkeeping and other administrative fees paid by participants. The approximate fees worked out to be \$320 per year for an average account balance of \$55,000, or approximately 0.58% (58 basis points).

Mr. Kimpel then discussed the services which the participant receives for this expense, including asset management, administrative services, daily valuation, transfer agent services, payroll and contribution processing, and educational services, among others. Mr. Kimpel then discussed the reasonableness of these fees, comparing the annual expense (\$320) to other expenses in everyday life, such as the cost of a newspaper (\$380 per year), a daily cup of coffee (\$350), taking the family to a football game (\$320) etc.

Mr. Kimpel then indicates that the median participant age at Fidelity is 44 years, and the median compensation is \$53,000 per year. The average participant contributes 7% of pre-tax compensation, and the average effective employer match adds an additional 3%. This average participant should have over \$720,000 at a retirement age of 65. Mr. Kimpel then present additional calculations for the average account balance and median compensation for 44 year olds. Mr. Kimpel concluded his presentation by asking whether anyone can argue that 58 basis points is an unreasonable fee given the menu of investment and other services provided to the typical 401(k) participant.

## **Additional Information Sources**

Exhibits From Vanguard

(Note: Transcripts for the Council's full meetings and working group sessions are available at a cost through the Department of Labor's contracted court reporting service, which is Neal R. Gross and Co., Inc. 1323 Rhode Island Avenue, NW, Washington, DC 20005-3701 at 202.234.4433 or [www.nealgross.com](http://www.nealgross.com))

The members of the working group on fee and related disclosures to participants were:

C. Mark Bongard, Chairperson  
John J. Szczur, Vice Chairperson  
Charles J. Clark  
Lynn L. Franzoi  
Neil Gladstein  
Sherrie E. Grabot  
Timothy W. Knopp  
Mary Maguire  
Dana M. Muir  
Thomas Nyhan  
Antoinette Pilzner  
Judy Weiss  
David L. Wray, *ex officio*  
R. Todd Gardenhire, *ex officio*