ERISA Advisory Council
Report of the Working Group on Plan Fees and Reporting on Form 5500

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I. The Working Group's Purpose and Scope.

The 2004 Advisory Council on Employee Welfare and Pension Benefit Plans ("Advisory Council") created a Working Group to study retirement plan investment management fees and expenses as they are currently reported on Form 5500. The Working Group was charged with studying whether plan sponsors adequately understand the total fees and expenses they are paying and whether those fees are reported on the Form 5500 in a manner consistent with the Department of Labor's reporting objectives. In particular, the Working Group was interested in determining whether the Form 5500's fee reporting requirements (along with the accompanying Schedules) meet the Department of Labor's objectives with regard to the data that is collected. The Working Group was also interested in determining whether plan sponsors currently receive adequate data from the service providers in order to both understand and report the fees. Finally, the Working Group studied whether new reporting methods should be adopted in order to increase the plan sponsor's understanding of overall plan fees and to improve reporting.

The first task of the Working Group on Plan Fees and Reporting on Form 5500 ("Working Group") was to determine what fees and expenses are currently reported by plan sponsors on Form 5500 and to determine whether there are other fees and expenses that should be reported, but currently are not. In general, each plan document has specific provisions stating whether the plan sponsor/employer will pay the expenses, or whether the expenses will be paid from plan assets. The plan settlor makes the decision as to how the expenses will be treated when establishing the plan.

In the circumstance where the plan is required to underwrite its expenses and the fiduciaries contract separately with different service providers that are billed explicitly, it is clear that the billed or explicit charges of the plan provider paid from plan assets are reportable on the Form 5500. However, with the evolution of 401(k) and 403(b) plans using mutual funds as a popular investment option[1/], the investment management fees and expenses of the mutual fund are netted from the mutual fund's performance and are not reported to the plan sponsors; as a result, these expenses are not reported on

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1/ While a majority of the testimony before the Working Group addressed the asset based fee model of the mutual fund industry, it is apparent that plan sponsors invest in a wide variety of pooled investment vehicles where fees and expenses are paid directly from the underlying investment vehicle rather than from trust fund assets, and are not reported on Form 5500. The findings and recommendations of the Advisory Committee are not limited to the mutual fund industry but rather apply to any pooled investment vehicle where fees are intrinsic to the underlying investment and not explicitly billed or paid by the plan.

the Form 5500. Additionally, many plan fiduciaries enter into bundled arrangements with plan service providers for record keeping or other administrative services which typically do not entail explicit charges to the plan. Rather, in a bundled arrangement plan service providers such as record keepers and trustees often are compensated for their services to the plan from the underlying mutual fund investment through either (1) "sub-transfer agent fees," 12(b)(1) fees, or other administrative fees, or (2) through "revenue sharing" arrangements whereby the mutual fund's advisor compensates the provider directly from its profits for the services provided. In either case, the fees and expenses are not paid from "plan assets", but rather from a portion of the mutual funds operating expense which is shared with the plan's service provider. These fees also are not reported on the Form 5500.

II. The Working Group Proceedings

The Working Group received oral and written testimony at a series of public hearings. The Working Group also received and discussed research and material from public sources that related to the topic of study.

At the hearing on August 4, 2004, Donald Stone, President of Plan Sponsor Advisors, Inc., reviewed the type of revenue sharing arrangements engaged between plan providers at mutual fund companies and reviewed various surveys of plan sponsors which demonstrated that many plan sponsors are largely unaware of the various revenue sharing arrangements between the vendors and mutual fund companies. The Working Group also heard testimony from John J. Canary, Chief of the Division of Covered Reporting and Disclosure in the Employee Benefit Security Administration Office of Regulations and Interpretations, concerning the current requirements regarding the reporting of fee and expense information as part of the Form 5500 annual report. Additionally, Mr. Canary briefly commented upon the need to employ rule-making if the Department of Labor decided to amend the Form 5500. Additionally, the Working Group heard from Scott Albert, Chief of the Division of Reporting Compliance Office of the Chief Accountant of the Department of Labor, regarding reporting compliance with Form 5500.

At a hearing on September 21, 2004, the Advisory Council received testimony from Elizabeth Krentzman, General Counsel of the Investment Company Institute, who testified that plan sponsors need to receive information from prospective service providers concerning the provider's receipt of compensation, including "revenue sharing" in connection with their services to the plan, but that Form 5500 was not an appropriate vehicle for reporting that information. The Advisory Council also heard testimony from two representatives of The Vanguard Group, Inc., Mr. Dennis Simmons and Mr. Stephen P. Utkus, who testified in favor of encouraging transparency in fee arrangements between retirement plan providers and that greater transparency will foster sharper competition in the marketplace which will contribute to lower overall costs for retirement plans.

On September 23, 2004, the Working Group heard testimony from Lawrence R. Johnson, CPA, of Lawrence Johnson and Associates, concerning the specific fee information that is currently required on the Form 5500 as well as need to improve disclosure of all fees including investment management fees, 12(b)(1) fees, revenue sharing, commissions, "pay to play" arrangements, sales charges, administrative fees, trustees fees, etc. Later that day, Mr. Mark Davis of Mark A. Davis Consulting testified that there exists a significant difference in the disclosure patterns concerning revenue

sharing in the different sectors of the market; the larger and more sophisticated plans tending to require candid and clear disclosures, with mid-size and smaller plans receiving significantly less disclosure. Mr. Lawrence R. Johnson of Lawrence Johnson and Associates testified that 70% to 80% of all 401(k) costs are represented in the internal expense ratios of the mutual fund but are not reported on the Form 5500. Mr. Michael Olah of Schwab Corporate Services testified that Schedules A and C of Form 5500 are an attempt at identifying fees and expenses paid from a plan to a service provider directly out of plan assets (i.e., "hard dollar" payments). However fees intrinsic to specific investment products (i.e., investment management fees and administrative expenses) are not discloseable on Form 5500 because they are not paid with "plan assets". While transparency in fees is important, Schwab does not believe the Form 5500 is appropriate for this task because it is filed too late to be of help to the plan fiduciary in selecting a provider or investment option. Instead, Mr. Olah recommended that existing Department of Labor worksheets be employed. The Working Group also heard from Mr. Edward Ferrigno, Vice President of Profit Sharing / 401k Council of America, who testified that the Form 5500, as currently structured is not useful to government policy makers, plan sponsors, and plan participants, because it does not begin to capture the expenses of many retirement plans. Additionally, Ms. Laura Gough, Chair of the Securities Industry Association Retirement and Savings Committee, testified that the Form 5500 is not an appropriate vehicle for the disclosure of embedded fees to plan sponsors and further described the difficulty in accurately accounting for investment management fees and expenses incurred at the mutual fund level at the retirement plan level. Finally, the Working Group heard testimony from Mr. Thomas M. Kinzler, of the MassMutual Financial Group, who recommended that fee and expense information be reported and monitored on a periodic basis and include explicit as well as imbedded fees and expenses.

III. Findings and Recommendations

A. Executive Summary

Currently the Form 5500 fee reporting requirements do not meet the Department of Labor's objectives with regard to the data collected. There are numerous pooled investment vehicles in which the fees are intrinsic to the underlying investment and are not reported to (or known by) the plan sponsor nor reported on Form 5500. Additionally, fees paid to plan service providers such as record keepers and trustees out of these asset-based fees, in the form of revenue sharing, sub-transfer agency fees, 12(b)(1) fees or the like are not reported on Form 5500 or the accompanying Schedules. While some more sophisticated plan sponsors are cognizant of the overall fees, both explicit and embedded, as well as the revenue sharing arrangements between various providers, many plan sponsors simply do not understand the total fees paid to service providers, nor the revenue streams between them. The fiduciary responsibility provisions of ERISA require that plan sponsors know the amount of fees paid in relationship to the services provided and to understand the revenue sharing arrangements between plan providers. Therefore, the Department of Labor should consider amending the Form 5500 and the accompanying Schedules and, through its rule-making authority, solicit the input from the industry as to the appropriate methodology for capturing that information. In particular, the Department of Labor may wish to consider use of a proxy in order to estimate total fees in light of the significant

difficulties of capturing exact information at the plan level. The Department of Labor may also wish to modify its existing worksheet for plan sponsors in order to provide a tool to help plan sponsors understand the true nature of the non-explicit fees and revenue sharing arrangements among the plan's providers prior to choosing the provider or an investment option.

B. Relevant General Fiduciary Requirements

ERISA imposes certain obligations on plans and their fiduciaries. For example, a plan fiduciary must discharge its duties solely in the interest of the plan and its participants and beneficiaries for the *exclusive* purpose of providing plan benefits and *defray reasonable plan expenses*.

A fiduciary must also act with the care, skill, prudence and due diligence under the circumstances then prevailing that a reasonably prudent person acting in a like capacity (and familiar with such matters) would use in the conduct of an enterprise *of like character and with like aims*. The highlighted terms distinguish ERISA's prudence rule, often described as the "prudent man standard," from the traditional common law "good faith" standards. The prudent man standard means, among other things, that the level of care imposed upon a fiduciary may vary with the complexity of the plan involved.

What is clear however, is that the Department of Labor has consistently held that under Section 404(a)(1) of ERISA, the responsible plan fiduciaries must act prudently and solely in the interest of plan participants and beneficiaries both in deciding whether to enter into or to continue a particular arrangement with a plan service provider and in determining which investment options to utilize or to make available to plan participants. This is true even for fiduciaries of plans where investments are self-directed by the participant and the ultimate benefit is tied to his or her account balance, as is the case with many 401(k) and 403(b) plans. In such cases the fiduciary is responsible for selecting and monitoring the investment options that are available to the participants, as well as the service providers to the plan. In this regard, the responsible plan fiduciary must insure that the compensation paid directly or indirectly by the plan to the service provider is reasonable, taking into account the services being provided to the plan as well as other fees or compensation received by the provider in connection with the investment of plan assets. The Department has repeatedly emphasized its view that the responsible plan fiduciary must obtain sufficient information regarding any fees or other compensation that the service providers receive with respect to the plan's investments and to make an informed decision as to whether or not the service provider's compensation for services is no more than reasonable. See, Department of Labor Advisory Opinion 97-15A and Department of Labor Advisory Opinion 97-16A.

C. Findings

Initially, when ERISA was passed in 1974, the pension world was a very different place than it is today. In an environment populated by defined benefit plans, fees and expenses of the retirement plans were explicit and were paid by the plan sponsor or, alternatively by the plan from plan assets. Additionally, according to generally accepted accounting principles ("GAAP"), these fees and expenses paid by the plan were reported in the expense section of the retirement plan's Income and Expense Statement so that actual fees paid by the plan matched the fees reported both in the plan's audit report and the Form 5500.

The emergence of defined contribution plans in the 1980s, in particular 401(k) and 403(b) plans, with the heavy reliance on pooled investment vehicles such as mutual fund investments, has caused a dramatic change in the way fees are charged. In particular, the pricing methodology has evolved from the explicit charges billed to and paid by the plan (or by the plan sponsor) into an asset-based fee model. Under such an arrangement the investment management fees and expenses of the mutual fund are netted out of its performance on a daily basis in arriving at the mutual fund's net asset value (NAV) and as such, those fees and expenses are intrinsic to the investment and not easily identifiable by the plan sponsor. Likewise other pooled investment vehicles have migrated to the asset-based fee model and suffer from the same reporting deficiencies. To further complicate matters, many plan sponsors have moved to "bundled" arrangements with plan providers whereby other costs of administration such as record keeping or trustee fees are offset, in whole or in part, by revenue sharing arrangements with the mutual funds and other investment vehicles with asset-based fee structures. In many cases the plan sponsor's decision to choose one particular investment vehicle or another is driven by its desire to reduce or eliminate its costs through the revenue sharing devices inherent in such bundled arrangements. Indeed, the testimony established that explicit charges in many plans have been substantially reduced or nearly completely eliminated and the majority of costs associated with administering many retirement plans are now embedded in the form of asset-based fees and borne by the plan participants.

One problem that has emerged is, that as a result of this evolution in how fees are collected, the Form 5500 as currently structured is outdated and simply no longer reflects the way fee structures work in the industry. As noted, many explicit fees have all but disappeared and many very large plans have little or no explicit fees whatsoever. Because the asset-based fees are netted from the investment funds performance (and as such not paid with "plan assets"), the actual costs of operating the plan are reflected only indirectly in the retirement plan's income statement.[2/] Thus the current Form 5500 does not provide plan sponsors, participants, or governmental regulators adequate information to understand true cost of the plan. While the evidence suggests that some of the larger and more sophisticated plan sponsors do in fact understand the totality of fees and expenses, the vast majority of plan sponsors have not calculated and do not know the actual cost of running the plan.[3/] This "out of sight, out of mind," mentality of some plan sponsors is particularly dangerous in asset-based fee arrangement because as the account balances grow, so do the fees regardless of whether additional services are provided. Yet one of Department of Labor objectives in requiring the Form 5500 is

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2/ Indeed any effort to report the indirect or asset-based fees on the current Form 5500 would result in a conflict with the plan's audit report which based on current GAAP standards would be limited to fees, commissions and expenses explicitly charged to, and paid by the plan. Moreover, as will be discussed later in this report, it would be nearly impossible to accurately report and calculate the precise amounts of asset-based fees.

3/ According to a recent Hewitt Survey of Fortune 500 401(k) plans only 33% of plan sponsors even attempted to calculate the cost of maintaining the plan. 2003 Trends and Experience in 401(k) Plans, Hewitt Associates, LLC, pg. 79.

to ensure that plan fiduciaries monitor the operations of the plan, including costs. This is consistent with the overarching fiduciary responsibility provisions of ERISA which require plan fiduciaries to review and monitor fees for reasonableness on a periodic basis.

The Advisory Council respectfully suggests the present reporting requirements are inconsistent with the stated goals of ERISA, which was to provide full and fair disclosure with respect to the fees and costs associated with a retirement plan. A great number of Form 5500's filed by defined contribution plans are of little use to government policy makers, government enforcement personnel, plan sponsors and participants or other interested persons in terms of understanding the cost of the plan. The Advisory Council believes that by capturing indirect fee and expense data on Form 5500, plan fiduciaries will be forced to calculate and therefore fully appreciate the true costs of the plan. Additionally by requiring the reporting of cost information on Form 5500 which is a publicly available document, a data bank will emerge which will undoubtedly be used as a tool by competing providers to drive down overall plan costs. Finally, governmental policy makers and enforcement personnel will have access to more meaningful information regarding plan fees and costs.

However, capturing accurate fee information is a complicated task and in some respects not feasible in light of the current state of the art in record keeping. First, it is unclear to the Working Group as to whether accurate data can be captured concerning exact revenue sharing payments between the mutual fund and plan service providers at the individual plan level. If the information can be accurately gathered at a reasonable cost, it should be reported on Schedules A and C. If the information cannot be accurately and economically captured, it should be estimated and reported. However, the task is even more complicated when it comes to investment management fees and expenses of the mutual fund which are calculated and subtracted on a daily basis to arrive at NAV. The testimony from a wide variety of witnesses suggested that, as a result of the way the mutual fund industry record keeping is currently configured, the industry is unable to account for mutual fund investment management fees and expenses at the plan level. The Advisory Council is also concerned that the costs associated with requiring an informational system overhaul that would allow the differing record keeping platforms of the mutual fund industry and record keeping industry to coordinate information exchange (if feasible) would be excessive and outweigh the benefit of exactitude. However, the Advisory Council does believe a proxy could and should be developed which would fairly approximate the fees and expenses of the plan by taking a snapshot of plans holdings at a given point in time and extrapolating from the mutual funds known operating expense ratio.

The shift to asset-based fees coupled with the proliferation of revenue sharing devices between mutual funds and plan service providers has also made it very difficult for plan sponsors to fully understand the fees that are paid indirectly to various service providers such as record keepers, trustees, etc. The evidence before the Working Group established that there exists an asymmetry of information which impedes plan sponsors from knowing how much the plan provider is paid outside of the explicit or billed fees. A study by Grant Thornton that was provided to the Committee and which included a broad survey of plan sponsors, indicated that 81% of the plan sponsors did not know what the vendors were receiving for sub-transfer agency fees, 69% did not know what the vendor received in 12(b)(1) fees, and 80% of the plan sponsors did not know what the vendor was receiving in placement fees, (i.e., marketing fees, finders

fees, etc.). Although a vast majority of 401(k) plans utilize these bundled arrangements, [4/] the evidence shows that the flow of money in such arrangements is often not disclosed and is accomplished by a variety of revenue sharing devices, that are to say the least, confusing. The lack of transparency in this area has led to an inefficient market where it is extremely difficult for the plan sponsor to determine either the absolute level of fees, or the flow of fees, i.e., who is getting paid what. The latter point is particularly important for a plan fiduciary selecting various investment options; the testimony indicated that certain vendors have steered plan sponsors to mutual funds which pay a high revenue share and de-emphasize funds with little or no revenue share. Alternatively, providers have recommended a particular class of a mutual fund, where a different class (with a lower revenue share) might be more appropriate. Thus we think it is critical that plan sponsors obtain full and complete information concerning all revenue sharing arrangements for each individual investment option, along with alternatives, in order to serve as a check upon the service provider's self-interest in promoting one investment option over another. We believe such a requirement would be consistent with the Department of Labor's repeated admonitions that it is part of the plan sponsors' fiduciary responsibility to ensure that they fully appreciate the amount of fees, both direct and indirect, that are being paid to the providers.

Unfortunately the Form 5500 is not the best vehicle to promote such practices as the Form is filed well after the plan sponsor has already engaged the provider and selected the investment options. While Form 5500 would be helpful in monitoring performance, we believe plan sponsors need a tool to help them understand the revenue sharing arrangement at the point of sale.

As earlier noted, ERISA places substantial responsibilities on plan fiduciaries charged in overseeing the administration and investments of pension plans to understand the total amount of fees paid to a service provider to ensure reasonableness and also to understand the revenue sharing arrangements between various providers. However, many plan sponsors simply do not have sufficient experience or an appropriate source of information concerning industry practice to deal with and understand revenue sharing arrangements. Therefore, the Advisory Council has concluded that educational information would be very useful for all plan sponsors and other fiduciaries, and would be particularly beneficial to fiduciaries of small and medium size pension plans. The Advisory Council notes that as a result of hearings in 1997 and an independent study commissioned by the Department of Labor on 401(k) fees and expenses, the Department developed a pamphlet for plan sponsors, "A Look at 401(k) Plan Fees for Employers" which was later replaced with a brochure entitled "Understanding Retirement Plan Fees and Expenses" which is available on the Department of Labor's website. While these pamphlets advise plan sponsors in general terms of the fiduciary responsibilities in determining that 401(k) plan fees are "reasonable," the Department of Labor website includes a detailed worksheet that enables plan sponsors to evaluate and compare fees of potential 401(k) vendors. The witnesses testified that the worksheet is widely used by plan sponsors in selecting

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[4/] According to a recent survey of over 1,000 retirement plans almost 80% utilized a bundle provider. 46th Annual Survey of Profit Sharing and 401k Plans, Profit Sharing /401k Council of America, (PSCA) Pg. 33 (2003).

service providers. While this form is an excellent tool to analyze explicit fees, it does not attempt to capture the revenue sharing streams that are prevalent in the industry today. The Advisory Council respectfully recommends that the Department of Labor update this worksheet in order to provide tools for fiduciaries to understand the revenue sharing and total fees received by the service provider for each investment option under consideration prior to its selection.

IV. Recommendations for Regulatory Change

The Advisory Council concludes that the Department of Labor should initiate rule-making in order to modify the Form 5500 and the accompanying schedules so that total fees incurred either directly or indirectly by the plan can be reported or estimated. Additionally, the Advisory Council believes that all fees paid to plan providers either directly or indirectly through revenue sharing devices should be reported or estimated. As a result of the significant accounting (and audit) difficulties that might arise through the use of estimation techniques, the Department of Labor may wish to consider developing a new schedule which includes a uniform proxy formula designed to capture the information.

V. Recommendations Involving Plan Sponsor Guidance

The Department of Labor should amend its worksheet for plan sponsors of 401(k) plans in order to provide a tool which will help them fully appreciate the true nature and magnitude of non-explicit fees as well as revenue sharing arrangements. Moreover the Department of Labor should advise plan sponsors that good fiduciary conduct requires the use of the worksheet (or some similar tool) before selecting the service provider or the investment options for the plan.

The Advisory Council makes the following recommendations in an effort to further educate plan sponsors and fiduciaries:

A. Plan sponsors should avoid entering transactions with vendors who refuse to disclose the amount and sources of all fees and compensation received in connection with plan.

B. Plan sponsors should require plan providers to provide a detailed written analysis of all fees and compensation (whether directly or indirectly) to be received for its services to the plan prior to retention.

C. Plan sponsors should obtain all information on fees and expenses as well as revenue sharing arrangements with each investment option. Plan sponsors should also determine the availability of other mutual funds or share classes within a mutual fund with lower revenue sharing arrangements prior to selecting an investment option.

D. Plan sponsors should require vendors to provide annual written statements with respect to all compensation, both direct and indirect, received by the provider in connection its services to the plan.

E. Plan sponsors need to be aware that with asset-based fees, fees can grow just as the size of the asset pool grows, regardless of whether any additional services are provided by the vendor, and as a result, asset-based fees should be monitored periodically.

F. Plan sponsors should calculate the total plan costs annually.

VI. Summary of Testimony Received

Summary of Testimony of Donald Stone

Don Stone is President of Plan Sponsor Advisors, a Chicago-based retirement consulting firm. He began his testimony stating that he felt neither plan sponsors nor participants have a good grasp of the fees they are paying in their defined contribution plans, and the 5500 as currently designed does not provide adequate information. Mr. Stone outlined three key issues: 1) an asymmetry of information, given vendors do not provide plan sponsors with adequate information on the fees or revenues received from the plan, 2) a significant shift in the past decade with regard to how fees are charged causing higher fees, and 3) due to the lack of information, plan sponsors are unable to discern the "reasonableness" of fees.

Mr. Stone explained that plan sponsors do appear to understand the explicit fees charged for plan services, but they do not understand revenue sharing arrangements. They are much more unclear about wrap fees, 12(b)(1) fees, sub-transfer agent fees, in many cases, not really being sure what some of those items actually are. He supported this with data from a survey conducted by Grant Thornton and Plan Sponsor Advisors. He noted that given plan sponsors do not understand the economics of the business, they do not know what questions to ask of their vendors. Without adequate information, plan sponsors are unable to 1) compute the vendor's total revenue generated from the plan, and 2) compare fees in the marketplace to determine reasonableness.

Mr. Stone outlined the types of fees and sources of revenue. Over a decade ago, all fees were "hard dollar" costs, or explicitly defined fees. With the growth in the use of mutual funds and other investment vehicles, many fees and sources of revenue for vendors have become "soft dollar" or embedded in the investment vehicles. He proposed that the shift to asset-based fees has caused 1) an increase in fees, 2) larger accounts within plans to subsidize smaller accounts, and 3) larger plans, or more profitable plans, within a vendor's book of business to subsidize smaller plans, or less profitable plans. Without the appropriate information, plan sponsors will pay more for administrative services than is reasonable just because the participants have high account balances. He cited examples where plans using "soft dollars" or asset-based fees to pay for services were frequently paying significantly more than those who paid for plan fees explicitly or capped the asset based fees.

Mr. Stone explained that the current design of the 5500 is antiquated due to industry changes and does not provide information on the "soft dollar" fees in plans, which are now a substantial component of plan fees. In fact in many plans, no fees would be disclosed on the 5500. The reporting on the 5500 for broker fees is included for insurance products, but not for other investment products such as mutual funds and stable value funds. He recommends increased fee transparency on the 5500 and education for plan sponsors. The two key changes to the 5500 would be 1) require all investment fees to be disclosed, and 2) require all compensation to brokers and advisors to be disclosed.

Summary of Testimony of Joe Canary and Scott Albert

The DOL testified before the Working Group to provide background information regarding the Form 5500 annual reporting requirements generally. Under Part 1 of Title I of ERISA, administrators of pension and welfare benefit plans are required to file reports annually concerning, among other things, the financial condition, investments,

and operations of the employee benefit plan that they administer. The DOL stated that the Form 5500 series is a primary source of information concerning the operation, funding, assets, and investments of pension and other employee benefit plans. In addition to being an important disclosure document for plan participants and beneficiaries, it is a compliance and research tool for the department and a source of information and data for use by other federal agencies, Congress, and the private sector in assessing employee benefit plan issues and related tacks in economic policy issues.

The DOL described the 5500 as a "packaging list." The Form 5500 collects information, basic identifying information, about the plan, the plan administrator, the plan sponsor, the types of benefits provided, the number of participants covered, the form of funding, trust, insurance, general assets, and a list of the separate schedules that are attached. The DOL articulated the types of schedules, the purpose of the schedule and the agency for whom the schedule is applicable. Overall the instructions are subject to user interpretation and are not explicit in regards to the treatment of all fees. Banks and insurance companies are subject to different reporting requirements, so fees appear to be generally disclosed. With mutual funds, fees are not necessarily disclosed or if they are, they are in the gains and losses line item.

The DOL stated that the entire reporting scheme -- and that includes the audit and the Form 5500 -- is that it promotes a discipline whereby plan administrators would actually focus, at least once a year, on their operations of their plans, on the assets, on their performance, and ensure that plan assets have been properly accounted for. In addition, the DOL provides booklets and instructions with tips for selecting and monitoring service providers for employee benefit plan, meeting your fiduciary responsibilities and on understanding retirement plan fees and expenses. There is also a more technical guide called the Troubleshooter's Guide to Filing the Form 5500.

The DOL indicated that the Form 5500 for the Department of Labor is a creature of regulation. And to adjust the Form would require a public notice and comment process and an adjustment to the regulations.

Summary of Testimony of Mark Davis

Mark Davis is President of Davis Consulting. Mr. Davis began his testimony stating that the majority of fiduciaries do not understand what they and/or their participants are truly paying and very few vendors take meaningful steps to help in the process. He proposed that fiduciaries need to be able to judge the reasonableness of all fees to which participants and plans are exposed.

Mr. Davis articulated a couple of key issues with the current reporting. First, commissions paid to NASD registered brokers are not disclosed to sponsors in any widely used or meaningful way. Plans are typical "sold" investments that pay distributors more in order to reduce the "hard dollar" fees charged to the plan sponsor. In many cases, a provider may be a broker/advisor who increases the fees the plan pays without increasing the benefit to the plan. Second, revenue sharing to other providers, such as recordkeepering and custody service providers is not always disclosed. A plan sponsor who does not have this information, can end up paying more than a reasonable fee for service without even being aware. For example, with a mutual fund that does not revenue share with the plan recordkeeper, the participant may be "paying twice" for shareholder recordkeeping services. Third, reporting is quite different based upon type of product and interpretation. Some insurance product fee information is disclosed on Schedule A, while some is not. Fees paid by the plan to fee-based

advisors must be disclosed on Schedule C, while fees paid by the plan to commissioned brokers and advisors may not be disclosed.

Mr. Davis proposed that given many participants now bear the responsibility of paying the fees, plan fiduciaries should be required to be even more vigilant with regards to the reasonableness requirement. He proposed that all fees for services should be reported and all revenues paid to all providers, both direct and indirect, should be reported. He proposed disclosure along with education will enable plan fiduciaries to determine reasonableness of fees.

Summary of Testimony of Larry Johnson

Larry Johnson is President and Founder of Lawrence Johnson & Associates. He began his testimony by stating that 1) plan sponsors don't understand the fees they pay, 2) fees and expenses are not adequately reported on the Form 5500, and 3) the DOL's reporting objectives are not currently being met with the existing Form 5500. He stated that if the employer or plan sponsor pays fees, those are not reported on the Form 5500. Overall, he said, the 5500 today collects expenses such as actuarial costs, record keeping costs that are charged to the plan and investment advisory fees charged to the plan explicitly. But the internal expense ratios or charges of mutual funds will not be disclosed on the 5500, which represent a significant portion of the plan fees. He quoted from a recent Hewitt study that anywhere from 70 to 80% of plan expenses are now indirect and not subject to reporting.

Mr. Johnson stated that over a decade ago, all plan fees were paid explicitly. So plan sponsors understood what fees were paid for what services. Typically, the fee was transaction based. Given the evolution to a system whereby more of the fees are paid indirectly through investment products, fees are now paid for based on account size even though the cost of the transaction is not impacted by account size. Reporting has not kept pace with the change in the system.

Mr. Johnson indicated that for plans whose fees and expenses are paid through revenue sharing,12b-1s, finders' fees, sub-transfer agency fees and other non-disclosed arrangements or any other plan that utilizes mutual funds, the fees are not currently disclosed on the Form 5500, if at all to plan sponsors. He would propose that all fees and revenue sharing with providers be disclosed to plan sponsors.

Mr. Johnson argued that these fees would be easily available on recordkeeping platforms given the recent changes made in recordkeeping platforms to handle the fund redemption rules. Given this new programming now enables recordkeeping systems to track the holding period during the year for each participant of each mutual fund, the corresponding expense ration paid could also be tracked. He did not believe the changes to the system would be considered onerous at this point. He further stated the clarity and accuracy of fee transparency outweighed the expected cost of system changes.

Summary of Testimony of Michael Olah

Michael Olah is the Field Vice President of Schwab Corporate Services. Mr. Olah began by stating "the issue here is not whether service providers are gouging retirement plans and ultimately plan participants by charging exorbitant fees. Nor is it even the difficulty of plan sponsors to perform meaningful fee comparisons. While there may be some plans that are overcharged and that clearly needs to be dealt with, the real issue should be centered around what information is needed by plan fiduciaries to do their jobs and do them well and when and where that information should be provided."

He contended that the form 5500 could not contain the appropriate information to

fulfill this goal. He stated, “This is all about the basics of fiduciary responsibility being proactive about fees not yet incurred rather than reactive in evaluating fees already paid.”

He discussed what he believes ERISA requires. He provided the two obligations imposed on fiduciaries that relate to the disclosure of fees are the exclusive benefit rule and the prudent expert standard. “Under the exclusive benefit rule, plan fiduciaries must operate the plan for the exclusive purpose of providing benefits for the plan participants and offsetting only those fees that are reasonable. This is the only provision of ERISA that even mentions fees and it conditions the use of plan assets for payment only of those fees that are reasonable.” He said only those fees that are paid from plan assets are subject to the exclusive benefit rule but the total of all fees would be subject to the prudent expert standard. He stated plan sponsors should be provided 1) information on both direct fees paid as well as “intrinsic” or indirect fees (which reduce investment earnings), 2) an understanding of sources of revenue received by service providers in administering plans, and 3) costs of services provided. He argued that details do not need to be provided with regard to revenue sharing arrangements or the costs of services be detailed or “unbundled.”

Mr. Olah continued to say that “plan sponsors have been making fee reasonableness determinations knowing only half the picture, the hard dollar half, completely unaware of the existence and magnitude of the revenue sharing half. By disclosing to plan sponsors the revenue received by the service provider from all sources the plan sponsor can make a determination of the reasonableness of the service providers' fees in total.”

From a reporting perspective, Mr. Olah disagreed with others. He stated that the 5500 was not the appropriate place to report the information given the form is provided after the fact and would not provide plan fiduciaries with the information in advance to ensure an appropriate initial decision. He was a proponent of the DOL’s fee worksheet and suggested adding an additional tool that would provide a line item list for the revenue side of the equation for plan sponsors. Although he did not know what percentage of plan sponsors currently use the DOL’s fee worksheet, he did state that most of Schwab’s RFP’s currently include the worksheet.

Mr. Olah concluded his statements by saying, “Fees should be disclosed. Fees should be disclosed in advance of decision making and on an ongoing basis to enable monitoring and fees should be presented in an easy to understand, easy to compare format that allows fiduciaries to do their job and be good fiduciaries.” He later stated that he thought the 5500 was a good tool to provide for the ongoing monitoring of fees and revenue arrangements.

With regard to reporting the fees from a mutual fund, Mr. Olah proposed a snapshot approach. Rather than provide actual reporting of the fees as suggested by Mr. Johnson, he stated that the easier method would be to take a total in each mutual fund either on a period-end date and multiply it by the expense ratio or revenue share basis points to determine the asset-based fees or revenue share component.

Summary of Testimony of Ed Ferrigno

Ed Ferrigno is Vice President of Washington Affairs for the Profit-Sharing 401(k) Council of America. Mr. Ferrigno started by stating that “Form 5500 reporting no longer explicitly lists all of the expenses paid from retirement plan assets. This is especially true for defined contribution plans. As a result, Form 5500 fee-related information is not useful to

government policy-makers, plan sponsors, plan participants and others with an interest in this information."

Mr. Ferrigno agreed with previous testimony that the industry has evolved from paying fees directly to paying indirectly through investment management asset-based fees. The result, he says, is "that a substantial portion of the expenses paid from retirement plan assets are no longer explicitly reported on the Form 5500 makes fiduciary oversight of plans more difficult and has reduced the transparency critical to fiduciary decision-making." He further proposed that transparency of fees paid indirectly on the 5500 would decrease doubts about the credibility of the defined contribution system.

Mr. Ferrigno stated that PSCA recommends the playing field be level for all service providers by ensuring that the most beneficial aspects of Schedules A and C are applied to all providers. Additionally, the DOL should advocate extending the requirement to provide plan administrators with the information needed to file the Form 5500 in a timely manner pursuant to ERISA Section 103(a)(2) to other service providers.

PSCA also suggested the use of an expanded DOL fee worksheet to include fee arrangements designed by a joint industry-government group. PSCA proposed enhanced reporting coupled with increase plan fiduciary education by the DOL will enable plan sponsors to understand the fee and revenue structures and thereby make better decisions.

Summary of Testimony of Laura Gough

Laura Gough is Managing Director of R.W. Baird and 2004 chair of the Securities Industry Association's Retirement and Savings Committee. Ms. Gough began by stating, "With defined contribution plans becoming a key part of American retirement security, SIA and its member firms want to ensure that all disclosure provided to plan sponsors and plan participants is transparent and informative."

She noted that with the increased presence of mutual funds in defined contribution plans, the majority of fees are now asset-based. Those fees, she proposed, are currently provided to plan sponsors since they are "built-in" to the fund's net asset value daily. She cited the following ways plan sponsors can get at fee information: 1) net performance figures compared against benchmarks, 2) proposals submitted by various vendors, 3) prospectus and disclosure booklets, 4) annual and semi-annual reports from the investment vehicles, and 5) through the use of the DOL's fee worksheet. But she stated additional reporting is necessary.

Ms. Gough said, "SIA strongly supports efforts to enhance transparency of revenue sharing and differential compensation. At a minimum, such enhanced disclosure should embody the following elements: (1) a clear simple presentation of the expenses reimbursed pursuant to revenue sharing agreements, (2) identification of funds or fund families with which revenue sharing arrangements exist, and (3) the funds or fund families with respect to which higher percentage rates of compensation are paid to associated persons such as proprietary funds or for sales of different classes of shares."

She indicated, "SIA does not believe that the 5500 form is an appropriate vehicle for disclosure improvements to plan sponsors and would encourage the working group to consider other options. The 5500 would have to be substantially revised. Since it is intended to serve a regulatory purpose, it's probably not the best starting point to educate plan sponsors because it is so after the fact." Additionally she stated mandating a form would be challenging given the significant difference amongst plans. The suggestion was

for increased disclosure and open-book accounting being provided by the industry combined with plan sponsor education from the DOL would be the appropriate response.

Summary of Testimony of Thomas Kinzler

Mr. Tom Kinzler is Vice President and Associate General Counsel of Mass Mutual. Mr. Kinzler started by proposing a simplified and consistent approach to the disclosure of fees to plan participants and plan sponsors in an effort to restore confidence in the retirement system. He recommended that fees be disclosed both at the point of sale and on a regular periodic basis to plan fiduciaries and participants. He further recommended that all financial institutions make such disclosures in a uniform manner that is easily understood and subject to comparison by plan sponsors.

The first suggestion was for a point-of-sale disclosure plan sponsors, requiring the disclosure of all plan expenses on a single, all-in disclosure form. This was stated to be of highest importance to enhance competition in the marketplace. He outlined PTE 77-9 requirements for insurance companies at point of sale to obtain three items in writing from the independent fiduciary. First, is an acknowledgment of receipt of the sales commission paid by the insurance company to the agent, broker, or consultant in connection with the purchase. Second is a description of any charges, fee discounts, penalties or adjustments, which may be imposed under the contract. Third is any affiliation the broker, agent, or consultant has with the insurance company. He proposed that fiduciaries receive a single, full, and fair disclosure at the point of sale – in the form of the PTE 77-9 commission disclosure form or a different disclosure made pursuant to another class exemption for all service providers.

Mr. Kinzler suggested that the disclosure should contain five items:

1) Detailed information about all distribution-related costs including identification of recipients and amounts of sales commissions, finders fees and 12(b)(1) distribution fees;

2) Identification of sources and amounts of revenue sharing payments;

3) Estimated costs of administering and record-keeping the participants' accounts and plan including mutual fund management and administration fees, 12(b)(1) service fees, shareholder servicing fees, sub-transfer agency fees, any start up or conversion-related charges, any service provider termination expenses, and any separately imposed charges for participants, loans, or checks, et cetera;

4) Conflicts on interest that may arise in connection with transactions involving the service provider and plan sponsor and an agreed upon disclosure methodology should a conflict arise;

5) Financial ratings of the financial institution and the unallocated capital or surplus of the financial institution.

For ongoing monitoring, Mr. Kinzler recommended amending Form 5500 Schedule A with a new disclosure schedule that will include all fee information from all financial institutions, administrators, and record keepers. This would include both explicit as well as embedded fees. Currently, he said, there is an uneven playing field since the insurance industry reports information not required of other investment companies.

He further recommended "that administrative expense information currently found on Schedule H for large plan financials and service provider information found on Schedule C also be reported on the new disclosure schedule so that a plan sponsor will go to one place for a comprehensive list of plan expenses." In addition the Harris Trust disclosure provided by insurance companies annually could also be incorporated into the

new proposed disclosure.

Mr. Kinzler raised the issue of timing also. Given the filing of the 5500 can occur up to 120 days after the close of the plan year, the fee disclosure would occur too late to be of any real value. He proposed a 90 day limit to speed the filing and information flow.

Overall, the insurance industry is held to a different standard than other providers, such as mutual fund companies. Mr. Kinzler argues the playing field should be leveled to create a more efficient market.

Additional Information Sources

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

Meeting of August 4, 2004

- Agenda
- Official Transcript
- Statement by Donald Stone, President, Plan Sponsor Advisors, LLC

Meeting of September 23, 2004

- Agenda
- Official Transcript
- Statement by Mark Davis, Davis Consulting
- Statement by Lawrence Johnson, Lawrence Johnson & Associates
- Statement by Michael Olah, Vice President, Schwab Corporate Services
- Statement by Edward Ferrigno, Vice President, Profit Sharing Council of America
- Statement by Laura Gough, Managing Director, Corporate & Executive Services and Retirement Plans, RW Baird
- Statement by Thomas Kinzler, Vice President and Associate General Counsel, Mass Mutual Financial Group
- Hewitt Associates, *Trends and Experience in 401(k) Plans*, 2003

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