

Fund Democracy
Consumer Federation of America

July 24, 2007

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5669
Department of Labor
200 Constitution Avenue
Washington, DC 20210

Re: Fee Disclosure AFI

Dear Ms. Lewis,

We are writing on behalf of Fund Democracy and the Consumer Federation of America in response to the Department's request for information regarding the disclosure of fee information for participant-directed individual account plans ("401(k) plans").¹ We believe that significant fee disclosure reform for 401(k) plans can substantially reduce overall plan expenses for beneficiaries and strengthen the foundation of Americans' financial security in retirement.

A primary goal of 401(k) regulation should be to ensure that Americans experience as much of the performance of the markets as possible. Excessive investment expenses present one of the most significant impediments to the achievement of this goal. Fees paid by 401(k) beneficiaries directly reduce their investment returns and, as a result, their financial security in retirement. Of course, excessive regulatory compliance costs can also reduce investment returns. For that reason, fee disclosure reforms should be designed so that they generate a net benefit to 401(k) participants. We believe that transparent, standardized fee disclosure can create substantial net benefits for 401(k) beneficiaries by raising fee awareness among beneficiaries and increasing competition among industry participants.

We strongly encourage the Department to enact significant changes to existing fee disclosure rules as described below. The underlying principle behind our recommendations is that fee disclosures should be designed, not with the self-directed, fee-sensitive investor in mind, but rather to increase awareness of fees and their impact on investment returns among those retirement plan beneficiaries who do not currently demonstrate fee-sensitivity. To be effective in reaching these beneficiaries with meaningful information, disclosures must provide them with the information they need,

¹ For convenience, we refer to such plans as "401(k) plans," although our comments generally apply to all types of participant-directed plans. In addition, we use mutual funds as examples of 401(k) investment options because they are the most common type of investment option used in 401(k) plans.

in a form they can understand, and at a time when it is useful to them in making and assessing their investment decisions. Current disclosure practice fails all these standards. With that in mind, our principal recommendations are as follows:

- Delivery Vehicles: Require inclusion of a fee table (described below) in the plan summary for all investment options available through the plan and require fee disclosures in account statements for each investment option in which the beneficiary is invested.
- Content: Require disclosure of hypothetical fees paid on a \$1,000 investment, total expense ratios for the investment, and average expense ratios for comparable investment vehicles, with separate disclosure of additional (non-expense-ratio) expenses as applicable.
- Fee Table: The plan summary fee table should show: expense ratios for the investment option, total plan expenses for each investment option; the dollar amount of expenses paid by a hypothetical \$1,000 account; and comparative expense ratios (*see* Exhibit A).
- Additional Expenses: Require disclosure of expenses that are not included in the plan expense ratio immediately below the fee table in the plan summary (*see* Exhibit A).
- Comparative Fee Information: Require disclosure in the fee table of average industry expense ratios for: each investment option and the plan *in toto* (*see* Exhibit A).
- Format: The fee table and other disclosures should be designed in consultation with disclosure experts to ensure that they effectively convey the key information in a way that is both readable and readily understandable by typical beneficiaries.
- Differential Compensation: If differential compensation is allowed for those who advise retirement plan beneficiaries, which we recommend against, require separate disclosure of differential compensation paid to advisers prior to the retention of an adviser, at the time of each recommendation of an investment option in connection with which differential compensation is received, and annually as long as the relationship with the adviser continues.

BACKGROUND

The importance of 401(k) plan fees needs no detailed elaboration here. As noted by the GAO, 401(k) plan fees “can significantly decrease retirement savings over time.”² For example, the GAO estimates that paying an additional 1 percentage point in fees will

² *Private Pensions: Increased Reliance on 401(k) Plans Calls for Better Information on Fees*, Government Accountability Office at 10 (Mar. 6, 2007).

reducing an account's ending balance after 20 years by 17 percent.³ Mutual fund fees have a substantial impact on total 401(k) plan fees because the bulk of 401(k) plan assets are invested in mutual funds. As noted by the SEC, "[t]he focus on fund fees is important because they can have a dramatic impact on an investor's return."⁴ The GAO's and SEC's observations regarding fees apply equally to other 401(k) investment vehicles.

The amount of fees charged by a 401(k) investment option within any particular investment category is arguably the strongest predictor of its investment performance. For example, researchers have demonstrated the inherent unpredictability of mutual fund returns, with funds generally being no more likely, from one quarter to the next, to repeat top-quartile performance and to fall into the second, third or fourth tier. To the extent that a small minority of fund managers outperform the markets over the long-term, there is no evidence that professionals, much less amateurs, can identify those managers *a priori*. Unlike past investment performance, fees are highly predictable and represent a certain reduction in fund's performance. Thus, within any given asset class, fees arguably constitute the most important factor in the evaluation of different 401(k) investment options.

FEE-INSENSITIVE INVESTORS

The purpose of fee disclosure is not to provide the minimum information necessary to enable diligent, fee-sensitive investors to evaluate the cost of investing in their 401(k) plan, but rather to draw the attention of all investors to the importance of fees. The purpose of 401(k) fee disclosure reform should be to provide beneficiaries who are not currently sufficiently sensitive to the effect of fees on the performance of their 401(k) accounts the information they need to raise their awareness of these important issues.⁶

Recent research conducted by CFA and assisted by Fund Democracy indicates that a large percentage of those who invest through workplace retirement plans are not sensitive to fees.⁷ In a recent survey on mutual fund purchase practices, only 51 percent of those respondents who purchased most of their funds through a workplace retirement

³ *Id.*

⁴ Report of Mutual Fund Fees and Expenses, SEC Division of Investment Management at Part IA (Dec. 2000).

⁵ **[[sirri tufano cite]]**

⁶ Jonathan Clements, Wall St. J. at D1 (July 18, 2007) (citing Morningstar finding that 13% of stock fund assets are invested in fund charging more than 1.5% annually and 24% of bond fund assets are invested in funds charging more than 1% annually).

⁷ *Mutual Fund Purchase Practices*, an analysis of survey results by Barbara Roper and Stephen Brobeck, Consumer Federation of America, June 2006.

plan said they considered fees even somewhat important.⁸ Furthermore, workplace purchasers were the least fee-sensitive of the three purchase groups identified by the survey.⁹ This likely reflects in part the fact that workplace purchasers typically make their fund selections from a fairly narrow menu of options. However, the relative lack of investing experience and financial sophistication among workplace purchasers almost certainly also play a role.¹⁰

This general lack of investing sophistication is compounded by the fact that the financial media, financial advertisements and the structure of disclosure requirements consistently overemphasize the importance of past performance and underemphasize the significance of fees. The financial media's focus on "The Best Funds for 2007" as determined by their short-term investment performance sends exactly the wrong message regarding the factors that investors should consider when evaluating investment options. Financial advertisements focus almost solely on past investment performance, which has little predictive power, to the exclusion of fees, the impact of which is significant, relatively certain and quantifiable. Fee disclosure presents fees almost exclusively as a percentage of assets, which structurally minimizes the true significance of fees in the overall picture of an investor's portfolio. The effects can be seen in the fact that 68 percent of workplace purchasers in the CFA survey indicated that a fund's past performance was at least somewhat important to their selection, with 38 percent indicating it was very important – a far higher percentage than considered fees to be even somewhat important.¹¹

For this reason, we believe it is essential that fee disclosure be designed to counter the misleading message that investors generally receive regarding the relative importance of fees. To benefit fee-insensitive investors, fee disclosure must be based on a "push" principle that measures the efficacy of disclosure by its success in promoting competition and efficiency. To accomplish this, fee disclosure for 401(k) plans should be crafted not only to make fee information available, but also to affirmatively direct beneficiaries' attention to fees and to do so in a way that helps them understand those fees and the effect they have on investment returns. In short, fee disclosure should be designed to overcome investors' predilection for overemphasizing past investment performance and discounting fees when making investment decisions. Investors' insensitivity to fees

⁸ *Id.* Thirty percent said fees were a very important factor in their fund selection, while 21 percent indicated fees were somewhat important. In contrast, 70 percent indicated fund company reputation was at least somewhat important, while 68 percent rated past performance as at least somewhat important.

⁹ *Id.* The other groups were direct purchasers and those who purchased most of their funds through a financial professional outside a retirement plan.

¹⁰ *Id.* Just 12 percent rate themselves as very knowledgeable about mutual funds, while nearly a third (32 percent) rate themselves as knowing only a little. They also tend to be somewhat younger and less educated than other mutual fund purchasers, and to have held mutual fund investments for a shorter period of time, particularly when compared with those who purchased most of their funds directly from a fund company or through a discount broker or fund supermarket.

¹¹ *Id.*

represents a market failure for which fee disclosure (rather than price regulation) offers the most cost-effective solution.

DELIVERY VEHICLES

The delivery vehicles used for fee disclosure play a crucial role in determining whether those disclosures are effective in directing fee-insensitive investors to consider fees when making investment decisions. Yet one of the most significant shortcomings of fee disclosure has been the reliance on investor-unfriendly delivery vehicles. Fees for 401(k) plan administration (*i.e.*, plan-level fees, as apart from fees charged by investment options) are required to be disclosed only in Form 5500, where the fees are disclosed as a dollar amount, in contrast with the presentation of fees as a percentage of assets for most investment options. The Form 5500 is not required to be provided to beneficiaries, but is delivered only upon request.

In the mutual fund context, fund expenses are described in the prospectus and the dollar amount of expenses for a hypothetical fund account are provided in the annual report. Employers generally provide plan participants with the prospectus or a document that contains the fee information in the prospectus,¹² but they do not provide the annual report or the hypothetical fee information, and neither fund documents or any documents provided by employers provide fee information about comparable investment options. Thus, basic fee information for each investment option are not provided in the same place as plan-level fees, no hypothetical or comparative fee information is provided at all, and no information is provided that it specific to a beneficiary's account. Investor-specific information is contained only in the quarterly statement. The latter document is generally the document that investors read, whereas fund prospectuses and plan summaries are likely to be summarily discarded with little or no review.

Reliance on these delivery vehicles assumes that investors are proactive and fee sensitive. The prospectus and Form 5500 require 401(k) beneficiaries to request information, calculate their total fees, and seek out comparative data on their own to put their total fees in context. One witness before the Advisory Group suggested that, by combining Form 5500 and prospectus fee disclosure, a 401(k) beneficiary “should be able to readily calculate the aggregate fees that reduce the value of his or her account.”¹³ The witness concluded that 401(k) fees are “currently disclosed to participants in

¹² As discussed further below, although fund expense ratios are standardized, they sometimes are not comparable because expenses that appear in the fund expense ratio for some funds may be excluded from the fund expense ratio for others (*e.g.*, transfer agency expenses may appear either in the fund expense ratio or in plan-level expenses). Expense ratios for non-mutual-fund investment options generally are not even standardized.

¹³ *Report of the Working Group on Fee and Related Disclosures to Participants*, Advisory Council on Employee Welfare and Pension Benefit Plans at n.4 (2004) (*Advisory Report*) (quoting testimony of John Kimpel, Sr. Vice President and Deputy General Counsel, Fidelity Investments). Actually, the fee dollar amounts in the Form 5500 would have be converted to a percentage of assets and then added to the investment option's asset-based fees.

sufficient detail to allow participants to evaluate the costs they pay against the services they receive.”¹⁴

We disagree. Few investors, and certainly not fee-insensitive investors, will make the effort to “calculate” fees in the manner described above. As we have noted previously, they simply do not place sufficient emphasis on fees in the first place. In addition, according to the CFA survey, most workplace mutual fund purchasers are unlikely to make use of the written information sources available to them. Just over four in ten (43 percent), for example, rated the prospectus as even somewhat influential on their investment purchases, with only 19 percent rating it as very influential.

To change the behavior of fee-sensitive beneficiaries, fees must be presented in a document beneficiaries are likely to read, they must be presented in a standardized format, and they must be presented in a manner that makes it easy for beneficiaries to understand how they compare to fees charged by comparable plans and investment options. In keeping with this approach, we urge the Department to use the delivery vehicle most likely to be read by beneficiaries – the account statement – for disclosure of fee and other important information. Investors are most interested in monitoring the value and performance of their account and, secondarily, confirming recent account activity. The account statement therefore provides the ideal vehicle through which to direct beneficiaries’ attention to their 401(k) plans’ fees.

Account statements, however, provide information after the investment selection has been made. To provide beneficiaries with pre-investment fee disclosures, we also urge the Department to require that such disclosures be provided in a short document that summarizes the plans’ essential features. Such plan summaries should be required to be presented to all employees who are eligible to participate in the plan. Like the account statement disclosures described above, these disclosures should also provide information that enables beneficiaries to easily determine how those fees compare to fees for comparable plans and investment options.

Finally, we strongly recommend that the Department encourage the use of the Internet and electronic communications as one appropriate delivery vehicle for fee information. The Internet and electronic communications offer the opportunity both to enhance fee disclosure for beneficiaries and to reduce plan expenses. For increasing numbers of investors, the Internet and email constitute their primary information source and communication tool. According to the CFA survey, for example, nearly all workplace investors (91 percent) have access to the Internet, and the vast majority (87 percent) expressed a willingness to use the Internet for at least some mutual fund purchase-related activities.

At a minimum, all fee disclosure requirements should be required to be made on or should be easily accessible from employer web pages. Where delivery is required, email, including especially employer intranets, should be mandated as a delivery option investors can choose to use. In appropriate circumstances, such as when an employee has

¹⁴ *Id.*

affirmatively decided to use either medium to obtain and receive information, Internet posting and delivery by email should be deemed sufficient to satisfy legal delivery requirements.

FORM OF DISCLOSURE

Disclosure of 401(k) fees should be provided in two forms. As noted above, 401(k) fees should be disclosed on beneficiaries' account statements, in order to ensure that they take fees into account when evaluating their 401(k) plans, and in a plan summary document, to ensure that beneficiaries are made aware of fees when they make their initial investment selections.

Account Statement Disclosure. The 401(k) plan document that investors are most likely to review is their account statement, and the Department therefore should require that account statements include 401(k) fee disclosure. The GAO recently recommended, for example, that the SEC require mutual funds to disclose in shareholders' account statements the dollar amount of fees paid during the period covered.¹⁵ The SEC decided instead to require the disclosure of the dollar amount of fees charged on a hypothetical account in the annual report.¹⁶ Although there are reasonable arguments regarding the relative costs and benefits of disclosing fees paid on a hypothetical account and actual fees, we believe there is no reasonable argument that fee disclosure is materially improved by including this information in the annual report instead of the account statement. It is simply unrealistic to believe that fee-insensitive investors read the annual report, much less find and study fee information that might be disclosed there.

We recommend that the Department require 401(k) plans to disclose the following information in account statements: the fees paid on a hypothetical \$1,000 account as a dollar amount, fees paid as a percentage of assets, and comparative fees for comparable plans and investments. Although disclosure of actual fees paid by beneficiaries is more likely to be understood by beneficiaries than hypothetical fees, we recognize that, at this stage in the development of fee disclosure for different collective investment vehicles, requiring disclosure of hypothetical expenses may be the best solution. However, we encourage the Department to work with agencies that are responsible for regulating fee disclosure for collective investment vehicles to move toward a disclosure system under which investors are told the dollar amount of fees they actually have paid.

The disclosure of the dollar amount of fees is of particular value because beneficiaries are more accustomed to thinking about expenses in dollars rather than percentages. Fee-insensitive beneficiaries are more likely to take notice of disclosure that

¹⁵ See *Mutual Funds: Information On Trends In Fees And Their Related Disclosure*, Government Accounting Office (March 12, 2003).

¹⁶ See *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Investment Company Act Rel. No. 26372 (Feb. 27, 2004).

looks more like a common bill for services than a mathematical calculation. A limitation of both dollar amount and percentage fee disclosures is that they mean little or nothing without a comparative context in which to place them. We therefore recommend that account statements also include comparative expense information (as described below) for each investment option. This information will help put the dollar amount of expenses in context and provide a basis for beneficiaries to consider whether the fees that they are paying are worth the price.

Standardized Fee Disclosure. Fee disclosure for 401(k) plans should be provided in the plan summary document and standardized to facilitate comparisons across different investment options within the 401(k) plans and to expenses in other comparable plans. To some extent, standardization of investment option fees already exists. For example, mutual funds are required to use a standardized format for their expenses ratios and other expenses. However, other investment options use non-standardized fee disclosure, which prevents investors from comparing the true cost of different investment options. The goal of standardization is further frustrated by the fact that payments for services sometimes occur at the investment option level and sometimes at the plan level. For example, 401(k) plans that invest in a retail class of mutual fund shares often pay lower plan expenses, because the mutual fund rebates part of its fees to the plan administrator to cover those expenses. If the mutual fund's fees are compared to investment options that do not use such a rebate structure, the mutual fund's fees will appear higher. An accurate fee comparison can be made only when the plan's total fees are considered.

There are a number of potential solutions to the standardization challenge. One solution would be for the Department to impose fee disclosure requirements on non-mutual-fund investment options that are similar to those for mutual fund. Such standardization is clearly in the best interests of beneficiaries. However, a variety of agencies have primary responsibility for fee disclosure for non-mutual-fund collective investment vehicles, and it is appropriate that these agencies' rules govern disclosure of fees charged by these investment vehicles. Until these agencies' rules can be brought into alignment, this is probably not a realistic approach. Nonetheless, we encourage the Department to work with other agencies toward establishing standardized fee disclosure for 401(k) investment options.

Another potential solution would be to require the disclosure of 401(k) fees on a functional basis. For example, fees for transfer agency functions could be identified separately, which would permit comparisons of these fees across different plans regardless of whether the fees were collected by the plan administrator, or by a mutual fund and then rebated to the plan administrator. We believe that, at this stage, such functional fee disclosure could be administratively burdensome and excessively costly, and would be unlikely to greatly benefit plan beneficiaries. Fees generally are not disclosed on a functional basis under existing legal rules for collective investment vehicles or for 401(k) plans, and the cost of designing and implementing new systems to provide functional disclosure might not be justified. In any case, it is not clear that

functional fee disclosure as a general matter is a cost-effective disclosure approach, and it can be misleading.¹⁷

We believe that the best immediate solution to the problem of standardizing 401(k) fees is to present each fee component in the context the plan's total fees. Toward this end, we recommend that standardization of 401(k) fees be accomplished through the use of a fee table (including a fee example) and a list of additional expenses as described below.¹⁸

Fee Table. As illustrated in Exhibit A, the fee table would include three categories of data for each investment option. These are: the investment option expense ratio,¹⁹ total plan fees (including both the investment fees and the plan-level fees) as a percentage of assets, and the dollar amount of fees on a hypothetical account. For each category, a comparative expense figure would also be included. This approach has the advantage of permitting easy comparison of different investment options when the investment options' expense ratios are comparable, such as for mutual funds, and when they are not. The total expense ratio figure would not only provide a total cost figure, it would also help address the problem of non-comparable investment fee information. Where easily comparable fee information of the type provided by mutual funds is not available,²⁰ it would indirectly indicate the relative cost of different investment options, because the plan-level expenses for each option generally could be assumed to be relatively constant. Assuming that plan-level expenses are comparable across different investment options, to the extent that the total expense ratio for different investment options differed, the difference generally would be attributable to the cost of the investment options.

¹⁷ For example, one of the problems with mutual fund 12b-1 fees, which purport to reflect the use of mutual fund assets for distribution services, is that investors in funds that do not charge 12b-1 may actually pay just as much for distribution services as investors in 12b-1 fee funds. It can be extremely difficult to define precisely the different types of services for purposes of functional disclosure of fees.

¹⁸ The overall structure of this approach is similar to fee disclosure for mutual funds, which includes an expense ratio, a list of other expenses, and a dollar-amount fee illustration.

¹⁹ We note that a significant failing of the mutual fund expense ratio is its omission of portfolio transaction costs, which can equal many multiples of a fund's other expenses. See Jason Karceski, Miles Livingston and Edward O'Neal, Portfolio Transaction Costs at U.S. Equity Mutual Funds (2004), available at http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf. Although the SEC has requested comments on ways to address this omission, it has yet to take final action. See Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Rel. No. 26313 (Dec. 18, 2003). We strongly encourage the Department to work with the SEC and with other regulators to ensure that the mutual fund expense ratio and the expense ratio of other investment options include all of the relative costs of investing.

²⁰ As noted *supra* note 12, although fund expense ratios are standardized, they sometimes are not comparable because expenses that appear in the fund expense ratio for some funds may be excluded from the fund expense ratio for others (e.g., transfer agency expenses may appear either in the fund expense ratio or in plan-level expenses). This distinction is partly responsible for the recent flurry of excessive fee cases brought against employers in connection with their 401(k) plans.

Additional Expenses. By making expenses charged through asset-based fees more visible, this approach may create an incentive to shift costs to other forms. To minimize any such cost-shifting designed to avoid disclosure, the Department should require that additional disclosures be provided along with the fee table listing expenses that are not included in the expense ratio table but that may be incurred directly or indirectly by beneficiaries. These expenses would include, for example, purchase and redemption fees, minimum account charges, and non-asset-based sales charges. These expenses should be presented as a percentage of assets or a dollar amount, depending on the basis on which they are deducted, with explanations as appropriate.

One disadvantage of the foregoing approach is that it may not fully remove the incentive to shift expenses, in this case from the expense ratio to the additional expenses category. For example, a 401(k) provider could reduce the plan's expense ratio by replacing an asset-based transfer agency fee with a flat fee for each account. This strategy would have the effect of artificially reducing the expense ratio, on the assumption that investors would pay less attention to the concomitant increase in the expenses listed in the additional expenses table. We recommend that the Department address the problem of expenses being shifted out of the expense ratio by requiring that beneficiaries' account statements disclose, either as a dollar amount or a percentage of assets, the expenses incurred during the period that were not included in the expense ratio. Where such expenses were deducted, the disclosure would be disclosed in three parts: the expense ratio, the additional expenses calculated as an expense ratio, and the sum of the two.

CONFLICTS OF INTEREST AND DIFFERENTIAL COMPENSATION

One of the most difficult challenges presented by fee disclosure is the need to apprise investors of the conflicts of interests that fees can create. Advisers to 401(k) beneficiaries are permitted, subject to their fiduciary duty to their clients, to receive compensation from sponsors of products that the adviser recommends ("distribution compensation"). In limited circumstances, distribution compensation can be higher for one product than another, which creates a conflict between the interests of the adviser and the 401(k) beneficiary, as the adviser has an economic incentive to recommend the product that pays him the greatest compensation, even if it is not the best product for the beneficiary. The cleanest and best way to deal with such conflicts, in our view, is to eliminate them, by prohibiting all differential compensation to advisers of 401(k) plan beneficiaries. Absent such a ban, fee disclosure for 401(k) plans should inform beneficiaries of the existence of any conflict of interest created by differential compensation so that they can evaluate the objectivity and quality of the advice provided.

Distribution compensation generally is paid out of other fees that already will have been disclosed to beneficiaries. This means that disclosure of the amount of distribution compensation is not needed to inform investors about the total cost of investing (although it would tell them how their fees were allocated among different

services). Rather, disclosure of the existence and extent of the conflict is needed to inform beneficiaries about advisers' financial incentives.²¹

We recommend that the Department require that advisers prominently disclose the extent to which their compensation may vary based on the investment options selected by the beneficiary. In order to qualify as "prominent," the disclosure should be in separate document, email message or web page. The disclosure must be provided separately because otherwise it is likely to be confused with fee disclosure that is designed to highlight the costs of investing, rather than the economic incentives of the adviser.²² The disclosure should focus on the amount of the adviser's differential compensation in order to permit the beneficiary to evaluate the objectivity of the adviser's recommendations.

Moreover, differential compensation disclosure should be provided before the beneficiary makes the decision to retain the adviser so that the beneficiary can evaluate the adviser's services before soliciting recommendations. After the beneficiary has retained the adviser and received the adviser's recommendations, the opportunity to evaluate the wisdom of retaining that adviser will have passed. In this respect, the Department should require that, in addition to disclosure made prior to the retention of the adviser, the adviser specifically disclose any differential compensation received in connection with the recommended investments at the time that the recommendation is made. Finally, the Department should require that periodic reminders be provided to beneficiaries as long as differential compensation payments continue.

Some may argue that disclosure of differential compensation is too costly and complex. Advisers who choose to create the conflict of interest that differential compensation disclosure would address should not be allowed, however, to avoid disclosure of differential compensation because of the complexity and disclosure costs they are responsible for creating. If, for example, a mutual fund charged dozens of different fees that depended on an investor's particular situation, the fund's sponsor should not be heard to complain that the cost of fee disclosure far exceeded its benefits. In short, the cost of fee disclosure should be viewed not as a reason to permit conflicts of interest to be concealed, but as a natural market constraint on inefficient pricing practices. To the extent that investors reject complex fee structures, such as differential compensation arrangements, when they are fully disclosed, fee disclosure should be viewed as having operated successfully by promoting informed investor choice, competition and efficiency.²³

²¹ See Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Rel. No. 26341, at Part II (Jan. 29, 2004) (explaining conflicts of interest necessitating requirement for point-of-sale of distribution compensation disclosure).

²² See Investment Advisers Act Rule 206(4)-3 (requiring disclosure of solicitor's capacity and compensation in a separate document).

²³ Although the speciousness of arguments that fee disclosure is too costly due to its complexity is most applicable to differential compensation arrangements, it is not limited to such arrangements. The same

COMPARATIVE FEE INFORMATION

As noted above, we believe it is critical that the disclosure of 401(k) fees be accompanied by comparative fee information. The disclosure of fees accomplishes little when it is presented in a vacuum, because few investors can readily assess whether the fees charged are high or low relative to the services provided or the fees charged by comparable investments. Mutual fund investment performance information is required to be compared to the performance of a comparable market index, because regulations recognize the importance of putting performance in context, but funds are not required to do the same for fees. Providing comparative fee information makes even more sense than providing comparative investment performance information, because past fees (unlike past performance) are strongly predictive of future fees. Furthermore, fee comparisons are more valid than performance comparisons, because fees of different 401(k) plans generally will be more comparable than investment performance across different investment options.

Putting fee information in context by providing comparative information is important for a number of reasons. First, comparative information would promote competition among investment option providers and place downward pressure on fees. Second, comparative information would enable beneficiaries to evaluate the costs and benefits of investing in the 401(k) plan relative to other taxable and tax-deferred investment options.²⁴ Third, fiduciaries' interests may conflict with beneficiaries' with respect to the negotiation of 401(k) fees, since fiduciaries may be able to lower the administrative costs paid by the employer by shifting them onto plan beneficiaries in the form of asset-based fees.

Investment Option Fees. Without the context of comparative fee disclosure, the disclosure of an investment option's expense ratio is of limited utility. This information conveys the fact that an investment option and the plan are not free, but virtually all beneficiaries already know this.²⁵ Standing alone, the fees provide little basis for evaluating whether they are reasonable in light of the services provided. The disclosure of comparative fee information would provide beneficiaries with a general sense of whether an investment option is more or less expensive than its peers and increase the likelihood that beneficiaries will think about whether above-average-cost options are

analysis applies to all types of complex fee arrangements, such as the use of different types of account and activity charges that are in addition to a fund's expense ratio and plan expenses as disclosed in the Form 5500.

²⁴ In theory, comparative disclosure would enable employees to compare employers based on the relative qualities of their 401(k) plans. We believe that this potential benefit is secondary to the benefits of promoting competition among investment option providers and facilitating an informed comparison of 401(k) and non-401(k) investment options.

²⁵ Although fee information may disabuse some beneficiaries of the misimpression that their employer pays all of the costs of a 401(k) plan, we are not aware of any evidence that a material number of employees hold this view.

worth the price. Also, providing average cost information for comparable investments should increase the likelihood that beneficiaries will make appropriate cost comparisons – comparing a bond fund’s fees to average bond fund fees rather than to fees for an actively managed stock fund, for example – rather than simply comparing costs among various investment options with very different cost characteristics and choosing the cheapest option.

Providing comparative fee information to beneficiaries would promote competition among investment option providers for several reasons. First, providing this information should help incentivize employers, who are primarily responsible for the selection of investment options, to choose a plan with lower investment costs. Second, many 401(k) plans offer multiple investment options with overlapping asset or style categories. In this context, beneficiaries’ investment decisions constitute a secondary marketplace (the plan itself) within which investment option providers compete for assets. This marketplace is recreated in every plan with multiple investment options, which has the effect of combining the market power of investment decisions by beneficiaries across many plans. Even if fiduciaries fail to populate plans with low-cost investment options, beneficiaries will tend to move assets to lower cost providers, if the comparative cost of different options is prominently disclosed. Such intra-plan dynamics will promote competition and place downward pressure on fees.

Plan Fees. Second, even when a plan does not offer overlapping investment options, and comparative fee information therefore does not facilitate the comparison of different options,²⁶ comparative fee information would enable beneficiaries to make informed comparisons between 401(k) and non-401(k) investment vehicles. The axiom that employees should “max out their 401(k)” before investing elsewhere is no longer always valid advice,²⁷ because employees will sometimes be able to experience superior long-term, after-tax investment returns in other contexts. The proliferation of tax-deferred investment vehicles, many of which are designed, like 401(k) plans, for retirement planning, has provided numerous investment alternatives that offer tax advantages that are comparable to those offered by 401(k) plans. The historically low level of capital gains taxes relative to income taxes means that capital gains in 401(k) plans are taxed at higher income rates when distributed than are capital gains in taxable accounts when they are distributed.²⁸ Tax-managed funds, index funds and exchange-

²⁶ In this context, comparative fee information would allow beneficiaries to appreciate that, for example, an international stock fund charged higher fees than a domestic stock fund, but we believe that the comparison among different investment categories should be based on beneficiaries’ overall investment objectives, not their relative expenses. Comparisons of fees for investment options with different investment objectives may mislead beneficiaries by confusing the primary basis on which comparisons across different options should be made. Comparisons between actively and passively managed investment options, however, would yield significant benefits, and the Department should consider mandating such comparisons.

²⁷ In contrast, the related axiom that employees should always “max out their 401(k) match” (*i.e.*, fully exploit matching employer contributions) still holds.

²⁸ To some extent, this taxable account advantage is reduced because capital gains taxes are paid on an ongoing basis, whereas income taxes on 401(k) capital gains are not paid until distributions from the

traded funds employ strategies that minimize taxes, thereby substantially minimizing their tax disadvantage relative to 401(k) plans. Thus, non-401(k) tax-advantaged investment vehicles, lower capital gains rates, and tax-minimizing investment vehicles mean that an employee may sometimes be better off investing outside of a high-cost 401(k) plan. Fee disclosure for 401(k) plans should facilitate fee comparisons with non-401(k) investment vehicles.

Potential Conflicts of Interest. It is important that comparative fee information be placed in the hands of beneficiaries, as their interests may not be aligned with those of the fiduciaries who choose investment options for plans and negotiate administrative agreements. Beneficiaries may have a stronger economic incentive than fiduciaries to reduce fees, because it is often beneficiaries who pay them. In some cases, beneficiaries' and fiduciaries' interests can conflict. Fiduciaries may have an incentive to choose high-cost investment options as a means of shifting expenses from the employer to the beneficiaries. Plan fiduciaries therefore may be conflicted, because they have an incentive to reduce plan expenses (*i.e.*, expenses incurred by their employer) in return for accepting higher investment option expenses. Plan fiduciaries also may wish to be perceived as having successfully negotiated a low-cost administrative contract, or may simply be unaware of the trade-off between higher cost investment options and lower cost administrative services. Although fiduciaries generally will be more financially sophisticated than the average beneficiary, this is not always the case. Ultimately, beneficiaries have stronger economic incentives to uncover such tradeoffs. It takes only a single, activist beneficiary, armed with the appropriate information, to bring these issues to the attention of plan fiduciaries.

Form of Comparative Fee Information. Comparative fee information should be provided in the fee table for each investment option. The comparative expense ratio row should show average expense ratios for the investment option, and for total expenses, including investment and plan-level expenses charged as a percentage of assets (*see* Exhibit A). These data should be presented in a manner that ensures that they are easily distinguishable from, and readily comparable to, the plan's actual expense ratios. The Department should consider whether additional comparative information should be provided, such as the amount of the difference between each average expense ratio and the actual expense ratio or a graphic illustration of each investment option's expenses relative to the average. In making such decisions, both about content and format, the Department should consult with disclosure experts to help design disclosures that maximize beneficiaries' ability to understand key fee information.

The Department should permit employers to use a variety of sources for comparative data, provided that the information is provided by an independent third party. The Department may, however, need to establish guidelines regarding what constitutes appropriate comparative data for different types of investment. The Department also should permit employers to use average plan-level expense ratios that reflect the size of the plan, subject to Department guidelines.

account are made. Legislation has been proposed (and is slowly gaining support), however, that would permit the deferral of taxation of capital gain distributions by mutual funds that are reinvested in the funds.

COST ISSUES

In a number of contexts, the Department has requested input regarding which parties should bear the cost of providing fee information. We believe that the allocation of disclosure costs generally should be left to the marketplace. Each of the three principal providers of information to 401(k) beneficiaries – employers, plan administrators and investment option sponsors – has sufficient negotiating power to ensure that markets work efficiently to find the optimal allocation of costs among the different parties. For example, we recommend that beneficiaries' quarterly statements include uniform dollar fee disclosure, which would require the calculation of the dollar amount of fees that would have been paid by a hypothetical \$1,000 account. If the annual cost of producing that information were \$1.00 for the investment option sponsor, \$1.05 for the administrator, and \$1.10 for the employer, then we would expect the cost ultimately to be allocated to the investment option sponsor as the lowest-cost provider. Formally "allocating" the cost to the administrator, for example, would simply result in the administrator's paying the investment option sponsor to provide the information at lower cost, with the only economic difference being the added cost of negotiating the transfer of this responsibility from the administrator to the investment option sponsor.

Thus, allocating costs by rule will not change the ultimate allocation of costs, but it can be expected to increase total costs to the extent that the rule does not choose the most efficient information provider. In a competitive 401(k) market, all costs ultimately will be borne by the lowest-cost provider, because structures that allocate costs to higher-cost providers will lose market share to more efficient, lower-cost competitors.

Another aspect of cost allocation is the allocation of costs across different employers. The greatest risk of implementing new fee disclosure requirements is that they will increase the cost of 401(k) plans for small employers to the point that they will choose not to offer the plan at all. We urge the Department to be sensitive to these relative cost burdens for small plans and to seek ways to minimize them, including by identifying disclosure and other requirements that could be modified or eliminated in order to reduce 401(k) expenses.

Finally, the Department has requested comment on the relative costs and benefits of fee disclosure reform. To a great extent, a cost-benefit analysis of fee disclosure requirements must be based on economic principles rather than hard dollar analysis. The exact dollar amount of the benefit of fee disclosure simply cannot be measured, because there is no way to determine the total reduction in expenses that will result from greater fee transparency and standardization. We believe that the benefits of fee disclosure reform will substantially outweigh the costs based on the economic principle that price transparency promotes competition and reduces expenses. There is substantial evidence that investors are not sufficiently price sensitive, and we believe that enhanced price transparency, price standardization and comparative information will provide a powerful stimulus toward lowering the overall cost of investing by increasing price sensitivity. The steady migration of mutual fund investors to lower-cost mutual funds is partly, if not

substantially, attributable to the high level of fee transparency mandated by the securities laws. We believe that fee disclosure reform will generate substantial net economic benefits to 401(k) participants.

CONCLUSION

Investment expenses represent a significant drag on the performance of 401(k) accounts that can be substantially mitigated through well-designed fee disclosure requirements. Although it is possible for an enterprising beneficiary to determine the total cost of his or her 401(k) plan's investment options and to find comparative fee information to place those costs in context, it requires enormous effort that only a tiny number of beneficiaries are likely to make. Fee disclosure reform is premised on the failure of many beneficiaries to be sufficiently sensitive to the impact of fees on their investment returns. Fee disclosure should therefore be designed to proactively direct fee-insensitive beneficiaries' attention to fees in order to stimulate competitive market forces and thereby reduce beneficiaries' expenses. We strongly encourage the Department to embrace the opportunity that efficient, proactive 401(k) fee disclosure reform offers as a means to enhance the retirement security of tens of millions of Americans.

Sincerely,

Mercer Bullard
President and Founder
Fund Democracy, Inc.

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc: The Honorable Elaine Chao, Secretary of Labor
Bradford Campbell, Assistant Secretary of Labor (EBSA)
Andrew Donohue, Director, Division of Investment Management, SEC

EXHIBIT A

Fee table:

| Investment Option | Fund Expenses | Total Plan Expenses | Illustrative Annual Fee Paid on \$1,000 Balance |
|-------------------------|---------------|---------------------|---|
| Stock Fund | 0.80% | 1.00% | \$10.00 |
| <i>Industry Average</i> | 0.70% | 0.88% | \$8.80 |
| Bond Fund | 0.50% | 0.70% | \$7.00 |
| <i>Industry Average</i> | 0.45% | 0.63% | \$6.30 |
| Balanced Fund | 0.65% | 0.85% | \$8.50 |
| <i>Industry Average</i> | 0.60% | 0.78% | \$7.80 |

Additional Expenses:

Small Account Fee: \$2.50/quarter

Redemption Fee: 1.00%