

## **408(b)(2) Technical Appendix**

This technical appendix presents further detail on the Regulatory Impact Analysis for the proposed 408(b)(2) rule. Technical Appendix A provides additional information on the industry profile and presents an expanded discussion of the qualitative analysis of benefits of the proposed rule. Technical Appendix B presents a discussion of possible secondary benefits of the rule, and Technical Appendix C presents further detail on the Initial Regulatory Flexibility Analysis.

### **Technical Appendix A**

#### **1. Introduction**

This appendix provides technical details on the analysis undertaken for estimating the costs and benefits of the proposed regulation. First, an industry profile is presented which describes the entities that the proposed rule may affect, as well as their interactions. The profile also estimates their numbers over the time frame of the analysis. Next, a qualitative analysis of the potential benefits of the proposed rule is presented.

#### **2. Characterization of Affected Entities**

##### *2.1. Interaction of Affected Entities*

Once an employee benefit plan is established, the employer or another plan fiduciary exercises discretionary authority over the management of the plan. ERISA, which is enforced by EBSA, requires the fiduciary to act in the best interest of the plan's participants and beneficiaries and to prudently select and monitor service providers to the plan. Fiduciaries face personal liability for breach of these duties.

Fiduciaries may search for individual plan service providers on their own, or they may enlist the help of a person to match them up with an appropriate service provider. These service providers in turn may rely on other providers to furnish some of the services.

Many times a package or bundle of multiple services is offered to plans. Often, the service providers within the bundle are affiliated with each other. In other cases, often referred to as an unbundled arrangement, the plan fiduciary locates a separate provider for each individual plan service. Service provider fees may be paid by the employer or from plan assets, including participant accounts.

Service provider fee structures vary widely. ERISA requires that fiduciaries determine that the service providers with whom they contract are paid no more than reasonable compensation. To do so, fiduciaries must consider the direct and indirect compensation the provider may receive under the service contract or arrangement.<sup>1</sup> To assist fiduciaries in obtaining the information

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<sup>1</sup> See Advisory Opinion 97-15A (May 22, 1997).

they need to meet their duties, the proposed 408(b)(2) rule would require certain service providers to disclose their fees and potential conflicts of interest (COI). Absent such disclosures, the service contract or arrangement will not be considered reasonable.

## 2.2. Industry Growth

To estimate the costs of the rule in future years, it is necessary to project the growth of the affected entities. To estimate this growth, we calculated a growth rate from past data on pension plans and participants. We used this growth rate to project numbers out to 2020. In the absence of more specific information, we assumed a growth in pension plans and participants given the general increase in the labor force and the economy. Therefore, we looked at available industry-wide trends in pension plans and participants and estimated a growth rate based on that data.

In 2006, the Investment Company Institute (ICI) published a report on the history of 401(k) plans entitled, “401(k) Plans: A 25-Year Retrospective.” ICI described the changing landscape of private sector pensions in the United States by presenting data on the numbers of active participants and plans from 1975 to 2005. The plans were broken down into the following categories: defined benefit (DB), 401(k), and other defined contribution (DC). We present data from 1985 to 2005 in Exhibits A-2 and A-3 below.<sup>2</sup> Since 1985, there has been a dramatic increase in the number of 401(k) plans and participation, while other DC and DB plans and participation show a marked decrease. Overall, there are slight increases in the total number of plans and participants. These increases are driven by the growth of 401(k) plans.

### Exhibit A-2. Number of Pension Plans

Year	DB	401(k)	Other DC	Total
1985	170,000	30,000	432,000	632,000
1990	113,000	98,000	502,000	713,000
1995	69,000	201,000	423,000	693,000
2000	49,000	348,000	339,000	736,000
2005	41,000	417,000	294,000	752,000

### Exhibit A-3. Number of Participants

Year	DB	401(k)	Other DC	Total
1985	29,000,000	10,000,000	23,000,000	62,000,000
1990	26,000,000	19,000,000	16,000,000	61,000,000
1995	23,000,000	28,000,000	14,000,000	65,000,000
2000	22,000,000	40,000,000	11,000,000	73,000,000
2005	21,000,000	47,000,000	8,000,000	76,000,000

From this data, we fit an exponential curve function that gives constant growth rates for each series. We used these growth rates to model future totals of the number of pension plans and participants in Exhibits A-2 and A-3. The estimated growth rates for pension plans and

<sup>2</sup> Data from 1975 and 1980 was left out because 401(k) plans were not introduced until after 1980, and thus no data on 401(k) plans is available.

participants were 0.00759 and 0.01174, respectively. This simple approach is consistent with the limited available data. As Exhibit A-4 shows, we forecast steady increases in the total number of plans and participants for the years 2010 through 2020.

**Exhibit A-4. Projected Numbers of Plans and Respondents**

<b>Year</b>	<b>Total Pension Plans</b>	<b>Total Participants</b>
2005	752,000	76,000,000
2010	790,620	80,757,980
2015	821,201	85,640,370
2020	852,965	90,817,935

*2.3. Quantitative Characterization*

This section presents a quantitative assessment of the employee benefit plan industry. The data used here come from plan year 2003 submissions of Form 5500, a yearly filing required for the large and some of the small benefit plans. The general approach to presenting the data taken here is to look at the two major plan types, pension (defined benefit and defined contribution) and welfare, and, where appropriate, subcategories within each plan type. The first part of this section provides a general overview of the benefit plan industry in terms of the number of plans. The second part offers a brief overview of plan sponsors. The third part of this section profiles the service providers to benefit plans in terms of the number of providers per plan, the services provided, and the compensation received by service providers. The final part of this section briefly describes the number of participants for the benefit plans.

2.3.1. Plans

For plan year 2003, there were around 762,000 pension (defined benefit and defined contribution only) and welfare plans for which a Form 5500 was filed (see Exhibit A-5 below). This population of benefit plans can be divided into large plans ( $\geq 100$  participants) and small plans ( $< 100$  participants), according to the filing instructions for Form 5500. For plan year 2003, there were nearly 153,000 large plans and nearly 610,000 small plans. Thus, most employee benefit plans have fewer than 100 participants. Furthermore, certain plans are required to file a Schedule C with the Form 5500 submission; this additional filing collects service provider data for a subset of plans. Plans are required to file Schedule C only if they are large plans and if a service provider was paid \$5,000 or more and/or if an accountant or actuary was terminated (see p. 12 of the 2006 Instructions for Form 5500, EBSA). Exhibit A-5 below shows the number of plans with an associated Schedule C for plan year 2003, by plan type and size. In general, only large plans file a Schedule C.

**Exhibit A-5. Summary Data by Plan Type and No. of Participants – Plan Year 2003**

<b>Plan Type and No. of Participants</b>	<b>No. of Plans</b>	<b>No. of Schedule C Filers</b>
Pension (DB, DC) <100 participants	596,641	526
Pension (DB, DC) 100-499 participants	57,961	16,680
Pension (DB, DC) 500-1,000 participants	8,958	4,774
Pension (DB, DC) >1,000 participants	12,427	8,478
<i>All Pension (DB, DC)</i>	<i>675,987</i>	<i>30,458</i>
Welfare <100 participants	13,095	801
Welfare 100-499 participants	46,224	7,366
Welfare 500-1,000 participants	10,475	2,558
Welfare >1,000 participants	16,670	5,075
<i>All Welfare</i>	<i>86,464</i>	<i>15,800</i>
All Plans	762,451	46,258

2.3.2. Plan sponsors

The population of plan sponsors can be characterized roughly using data collected via the Form 5500. Exhibit A-6 shows the number of plans per sponsor's employer identification number (EIN) for plan year 2003. It should be noted that the figures do not necessarily reflect unique sponsors, as some firms may have filed under more than one EIN; therefore, such firms would be counted more than once.<sup>3</sup> For all plans filed that year, there were over 622,000 plan sponsors, with about 86 percent of sponsors having only one benefit plan. Among large plans filed for plan year 2003, there were nearly 79,000 sponsors. Among small plans, there were over 555,000 sponsors.

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<sup>3</sup> In most cases, the employer identification number (EIN) is a unique identifier for plan sponsors as well as service providers. However, in some instances (e.g., due to mergers) a particular firm may report plans under different EINs.

**Exhibit A-6. Number of Plans per Sponsor EIN for All Plans – Plan Year 2003**

<b>Number of Plans</b>	<b>Number of Unique Sponsor EIN<sup>a</sup></b>	<b>% of Total</b>
1	534,684	85.9%
2	65,824	10.6%
3	10,381	1.7%
4	4,432	<1%
5	2,594	<1%
6	1,510	<1%
7	917	<1%
8	507	<1%
9	324	<1%
10	223	<1%
11-20	588	<1%
21-39	89	<1%
40-100	12	<1%
151	1	<1%
<b>Total</b>	<b>622,086</b>	

<sup>a</sup> Plan sponsors are distinguished by an EIN; some double counting of unique sponsors may be present because a single sponsor may use more than one EIN.

2.3.3. Service providers

Data for service providers to benefit plans came from Schedule C submissions. Compared to plan sponsor data, provider data are very limited, as only a subset of plans must file Schedule C. This limitation could be important for the analysis, because data for services and service providers to small plans, which account for over 80 percent of all plans, are not represented. The large plans, on the other hand, cover a substantial portion of all assets, and it is reasonable to think that there would be considerable overlap between the service providers working with both large and small plans.

2.3.3.1. Providers and plans

Exhibit A-7 below describes the population of plans that filed a Schedule C in terms of the approximate number of unique service providers per plan.<sup>4</sup> Since the proposed rule would apply only to providers of certain specified services (“affected service providers”), Exhibit A-8 shows the approximate number of affected service providers per affected plan. Only plans with an affected service provider are counted, and, for these plans, only providers of an affected service

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<sup>4</sup> Although a provider may perform more than one service for a plan, each provider (i.e., provider EIN) is counted only once per plan.

are counted.<sup>5</sup> As shown in the exhibit, most plans have one to two unique service providers. Only 14 plans in 2003 had 40 or more unique providers.

**Exhibit A-7. Number of Service Providers per Plan for All Plans That Filed a Schedule C – Plan Year 2003**

<b>Number of Providers per Plan<sup>a</sup></b>	<b>% of Plans</b>
1-2	72%
3-10	23%
11-20	3%
21-39	1%
≥40	<1%
<b>Total</b>	<b>100%</b>

**Exhibit A-8. Number of Affected Service Providers per Affected Plan for All Affected Plans That Filed a Schedule C – Plan Year 2003**

<b>Number of Affected Providers per Affected Plan<sup>a</sup></b>	<b>Number of Affected Plans</b>	<b>% of total</b>
1-2	35,632	84%
3-10	6,185	15%
11-20	538	1%
21-39	114	0%
≥40	1	0%
<b>Total</b>	<b>42,470</b>	<b>100%</b>

Exhibit A-9 below presents the number of affected services provided by plan type and size (based on the number of participants) for all plans that filed Schedule C for plan year 2003. Note that the figures represent the instances of service provision across all the plans, not the number of unique plan-provider relationships or contracts. These figures can be thought of as the number of plan-provider arrangements. Furthermore, Exhibit A-10 approximates the number of unique affected service providers by plan type and size (based on the number of participants).

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<sup>5</sup> For this analysis, “affected” services are those represented by service codes 12-15, 17, 20, 21, 24-26, and 29.

**Exhibit A-9. Number of Plan-Provider Arrangements (Affected Services Only) by Plan Type and Number of Participants for All Plans That Filed a Schedule C – Plan Year 2003**

<b>Plan Type and Size</b>	<b>Provider-Plan Arrangements</b>
Pension (DB, DC) <100 participants	613
Pension (DB, DC) 100-499 participants	18,846
Pension (DB, DC) 500-1,000 participants	7,470
Pension (DB, DC) >1,000 participants	28,255
<i>All Pension (DB, DC)</i>	55,227
Welfare <100 participants	913
Welfare 100-499 participants	8,811
Welfare 500-1,000 participants	4,286
Welfare >1,000 participants	16,946
<i>All Welfare</i>	31,025
All Plans	86,692

**Exhibit A-10. Number of Unique Affected Service Provider EIN by Plan Type and Number of Participants for All Plans That Filed a Schedule C – Plan Year 2003**

<b>Plan Type and Size</b>	<b>Service Providers (Schedule C)<sup>a b</sup></b>
Pension (DB, DC) <100 participants	372
Pension (DB, DC) 100-499 participants	4,330
Pension (DB, DC) 500-1,000 participants	2,521
Pension (DB, DC) >1,000 participants	5,893
<i>All Pension (DB, DC)</i>	9,878
Welfare <100 participants	516
Welfare 100-499 participants	2,604
Welfare 500-1,000 participants	1,911
Welfare >1,000 participants	4,934
<i>All Welfare</i>	7,519
All Plans	15,609

<sup>b</sup> Figures in the “All” column may not equal sum of plan type figures due to double counting within the respective plan types.

2.3.3.2. Services provided

Exhibit A-11 below presents the number of services provided by service type for all plans that filed Schedule C for plan year 2003. As shown in the exhibit, the four most common plan-provider arrangements are investment management, contract administration, administration, and accounting (including auditing). As seen in the exhibit, the service profiles vary across the three plan types: insurance agents and brokers are more likely to be found serving welfare plans, and investment advisory services are more commonly supplied to the pension plans. Note that the totals do not represent the number of plans having a particular service but only the instances of the service across all the plans; plans may have the same service (by service code) provided by

more than one provider. These figures might be thought of in terms of the number of plan-provider arrangements.

**Exhibit A-11. Number of Plan-Provider Arrangements across All Plans That Filed a Schedule C – Plan Year 2003**

Service (from Schedule C instructions)	Service Code	Count of Plan-Provider Arrangements by Plan Type			
		DB	DC	Welfare	All <sup>b</sup>
<i>Affected Providers</i>					
Contract Administrator	12	2,075	7,133	16,544	25,781
Administration	13	2,796	1,761	8,443	12,963
Brokerage (real estate)	14	22	10	13	45
Brokerage (stocks, bonds, commodities)	15	146	302	49	498
Consulting (general)	17	1,107	700	2,563	4,370
Custodial (securities)	18	1,280	669	506	2,443
Investment advisory	20	3,162	2,059	509	5,718
Investment management	21	14,619	4,269	1,623	20,481
Recordkeeping	24	601	7,227	839	8,661
Trustee (individual)	25	92	68	176	338
Trustee (corporate)	26	3,596	3,852	585	8,031
Investment evaluations	29	187	75	43	289
<i>Typically Unaffected Providers*</i>					
Accounting (including auditing)	10	3,991	3,431	3,500	10,903
Actuarial	11	6,171	338	1,412	7,906
Computing, tabulating, ADP, etc.	16	243	119	367	725
Insurance agents and brokers	19	247	258	3,025	3,544
Legal	22	2,815	1,405	2,891	7,081
Printing and duplicating	23	194	129	426	749
Pension insurance advisor	27	26	5	7	36
Valuation services (appraisals, asset valuations, etc.)	28	40	127	20	186
Medical	30	12	1	2,023	2,037
Legal services to participants	31	13	11	172	196
Other (specify)	99	889	559	3,023	4,376
<b>Total (all providers)</b>		<b>44,324</b>	<b>34,508</b>	<b>48,759</b>	<b>127,357</b>

\* Note: While some service providers shown in the “Typically Unaffected Providers” group could be affected by the regulation, the Department believes that these providers would rarely be affected. Thus, in the estimates for affected providers, the Department did not include service providers from the “Typically Unaffected Providers” group.

Exhibit A-12 shows approximately the number of providers performing the respective services across all plans that filed Schedule C for plan year 2003.

**Exhibit A-12. Number of Unique Provider EIN per Service across All Plans That Filed a Schedule C – Plan Year 2003**

Service (from Schedule C instructions)	Service Code	Count of Providers by Plan Type			
		DB	DC	Welfare	All <sup>b</sup>
<i>Affected Providers</i>					
Contract Administrator	12	754	1,372	3,350	4,824
Administration	13	950	680	2,467	3,662
Brokerage (real estate)	14	21	9	9	39
Brokerage (stocks, bonds, commodities)	15	113	163	38	284
Consulting (general)	17	491	325	1,290	1,812
Custodial (securities)	18	501	326	261	766
Investment advisory	20	1,192	998	290	1,966
Investment management	21	3,082	1,645	796	4,146
Recordkeeping	24	234	748	305	1,173
Trustee (individual)	25	61	43	105	199
Trustee (corporate)	26	1,118	863	242	1,825
Investment evaluations	29	111	58	28	143
<i>Typically Unaffected Providers*</i>					
Accounting (including auditing)	10	1,078	1,444	1,169	2,577
Actuarial	11	704	121	304	886
Computing, tabulating, ADP, etc.	16	154	91	218	364
Insurance agents and brokers	19	113	119	1,486	1,618
Legal	22	1,115	718	1,177	1,884
Printing and duplicating	23	146	106	306	462
Pension insurance advisor	27	16	4	7	24
Valuation services (appraisals, asset valuations, etc.)	28	35	85	15	128
Medical	30	12	1	1,055	1,062
Legal services to participants	31	13	9	134	155
Other (specify)	99	411	158	1,236	1,657
<b>Total (all providers)</b>		<b>12,425</b>	<b>10,086</b>	<b>16,288</b>	<b>31,656</b>

\* Note: While some service providers shown in the “Typically Unaffected Providers” group could be affected by the regulation, the Department believes that these providers would rarely be affected. Thus, in the estimates for affected providers, the Department did not include service providers from the “Typically Unaffected Providers” group.

2.3.3.3. Fees for service providers

Affected service providers can also be categorized by the total compensation received across all plans for which they provided a service (see Exhibit A-13 below). As with the other service provider data, the compensation data comes from Schedule C for plan year 2003. Service provider compensation is reported on Schedule C as either salary or fees, or both in some cases. Moreover, the total compensation estimates used in this analysis are the sum of these figures for each service provider. As shown in the exhibit, there is a tremendous range in the total amount received by service providers.

**Exhibit A-13. Number of Affected Providers by Compensation Received for All Plans That Filed a Schedule C – Plan Year 2003**

Total Compensation (\$1,000)	Number of Affected Providers <sup>a b</sup>
0	434
1 to < 5	215
5 to < 50	6,755
50 to < 100	2,277
100 to < 1,000	4,404
1,000 to < 50,000	1,482
50,000 to < 500,000	38
500,000 to < 1,000,000	4
<b>Total</b>	<b>15,609</b>

2.3.4. Plan participants

Information about benefit plan participants was obtained from Form 5500 submissions for plan year 2003. Exhibit A-14 below shows the number of plan participants by plan type. It should be noted that the totals for pension plans and welfare plans may overlap, as individuals may participate in more than one type of plan.

**Exhibit A-14. Participants by Plan Type – Plan Year 2003**

Plan Type	Total Participants
Pension (DB and DC)	151,816,635
Welfare	162,698,362

**3. Benefits**

The proposed rule may result in benefits accruing to different groups. These benefits are discussed primarily from a qualitative perspective in this report for two reasons. First, these benefits are very difficult to quantify with any satisfactory degree of certainty. Second, apart from being difficult to quantify, the direction of these benefits is not clear in terms of whether they would encourage more or less savings among participants. While these different benefits may possibly arise as a result of the rule, we do not have accurate information on how likely they are to actually eventuate. Although we cannot provide much information about the likelihood and magnitude of these benefits arising, in this section we provide information on these possible benefits and how they might be realized as a result of the proposed changes.

The possible benefits arising from the proposed changes are discussed below. These benefits are divided up into primary benefits, which are direct effects of the rule, and secondary benefits, which are indirect benefits resulting from the rule.

### 3.1. Primary Benefits

As an example of the kind of benefits that could arise from this rule, the possible benefits to defined contribution pension plans were considered due to this being a significant concern that the proposed rule will address. For this segment of employer-sponsored plans, the primary benefits resulting from the proposed rule are thought to arise from potential reduced unit costs incurred by plans for fiduciaries to search for service providers. This class of benefits is discussed and graphically analyzed below. We next discuss the relationship of these potential benefits to the premiums paid for fiduciary liability insurance and how this reduction could be used as a possible measure of these benefits.

#### 3.1.1. Reduced service provider search costs for plans

The primary change resulting from the proposed rule will be a clearer delineation of the information to be provided from service providers to fiduciaries on the fee structures for plan services. Although, as was observed in our interviews with affected entities, a large amount of fee disclosure currently occurs, the proposed rule is expected to increase this disclosure and also increase the transparency of service provider fee structures. One primary effect of this rule is that plans would incur lower unit costs arising from fiduciaries needing to search for service providers. Because costs for obtaining information on service providers would be lower, it is likely that plan fiduciaries would obtain information from a larger set of service providers when they were attempting to make their decisions about which provider to engage. It is also expected that fiduciaries would have fewer barriers to changing service providers if they were not happy with the current fees they were paying, or the returns they were receiving.<sup>6</sup> There are three different possible sets of benefits that could result from the lowered unit search costs: Possible lower fees paid by plans, possible increased efficiency or value of service due to reduced conflicts of interest, and possible higher rates of returns to plans.

- *Possible lower fees paid by plans*

With plans incurring lower unit search costs, it is possible that fiduciaries might be able to reduce the fees paid by their plans since they may consider a wider set of service providers when making their decisions, and also would be more likely to switch providers if they could reduce their plan fees by doing so. The existence of this benefit and its potential magnitude would depend on the degree to which unit search costs were actually lowered, which in turn depends on the amount of inefficiency present in the service provider market.

The possibility of lower plan fees from the proposed rule could result from two possible sources. The first source of these benefits would be if the rule resulted in a general reduction of fees across the set of service providers under the rule as compared to the baseline. Another possibility is that the rule could lower fees by reducing the need for intermediaries (e.g., salespersons) to explain fees. With benefits arising from a general reduction in fees across

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<sup>6</sup> Fees paid to service providers are collected by different means. The fiduciary or the plan sponsor may pay these fees directly or, more commonly, plan participants pay these fees either directly or indirectly through deductions of plan assets. For the sake of simplicity, in this section we refer to all of these possible arrangements as fees paid by the plan.

service providers, a rule-induced reduction in fees on the baseline quantity of services would be a transfer from affected service providers to those that ultimately paid the fees (such as the plan participants). From a societal perspective, this transfer nets to zero, and does not represent any net social benefits.<sup>7</sup>

The second possibility for reduced plan fees would be from any shifts that would occur in the market for service providers. The source of this type of benefits would be if, due to disclosure mandated by the proposed rule, the market share of service providers shifted to more efficient providers who charged lower fees. For example, it is possible that the service provider market is relatively efficient at the larger end of the market and may be less so at the smaller end. If, under the proposed rule as compared to the baseline, there were a shift in the market share of service providers toward the more efficient providers, there would be a resulting benefit for the entities that ultimately paid the lower service provider fees. Unlike the benefits from reduced fees in general, this source of benefits is not a transfer and results in net social benefits.

- *Possible increased efficiency due to reduced conflicts of interest*

The proposed rule requires service providers to disclose any conflicts of interest. This disclosure has the potential to create benefits if current conflicts of interest result in inefficiencies in the operation of plans. This inefficiency of plan operation could occur, for example, through service providers possibly choosing a lower-return investment, choosing a higher-risk or higher-expense investment for the same return, or using an inefficient amount of inputs for the given amount of services. Plans without conflicts of interest may thus operate with increased efficiency as compared to plans in the baseline that might operate with undisclosed conflicts of interest. Fiduciaries and plan sponsors could realize benefits under the proposed rule if, due to reduced unit search costs for plans, they were more able to switch service providers to avoid conflict of interest-related inefficiencies. As with the previous category of benefits, the magnitude of these benefits would depend on the degree to which plans did actually experience lower search costs. The benefits also would depend on the amount of conflict of interest-related inefficiency in the plan market in the baseline that is actually reduced as a result of this rule.

- *Possible higher returns due to reduced search costs by fiduciaries*

The proposed rule also could result in higher returns for fiduciaries' plans if they were more able to switch to service providers offering higher returns. The costs to plans of searching may currently be limiting the degree to which fiduciaries shop around for different service providers. If unit search costs were lowered, fiduciaries might be more willing and able to shop around for new service providers in search of higher returns. Again, the magnitude of these benefits would depend on the amount to which unit search costs were actually lowered by the proposed rule and the degree to which these reduced search costs enabled fiduciaries to increase returns on plans by choosing a different service provider. It is possible, though, that there would be more room for fiduciaries to increase their returns at the smaller end of the market.

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<sup>7</sup> This point concerning transfers applies only to the baseline quantity of services. A change in fees could also lead to a change in the quantity of services, and in that case there could be changes in net social benefits.

### 3.1.2. Graphical analysis of lowered search costs for fiduciaries

The nature of the benefits resulting from lowered unit search costs for plans can be clarified graphically. Plan fiduciaries must choose the amount of effort to expend on searching for a service provider. The benefits a plan receives from searching for service providers are the possibility of getting a better deal on their plan services, either through a higher rate of return, lower fees, or both. Searching for service providers also involves a cost to the plan.<sup>8</sup> The rational fiduciary will weigh the benefits of increased searching for service providers against the costs of doing so. These costs and benefits will be considered at the margin, or by the amount of cost or benefit resulting from an additional unit of search effort. Exhibit A-14 below shows the marginal benefits (MB) to the plan of searching for service providers. For the first few units of effort, the benefits of additional units of searching are high, but the curve slopes downward since each additional unit of search effort provides less benefit than the previous one: the first service provider considered is unlikely to be the best, but after a large number have been considered the chances that the next one is better than all the previous choices are low.

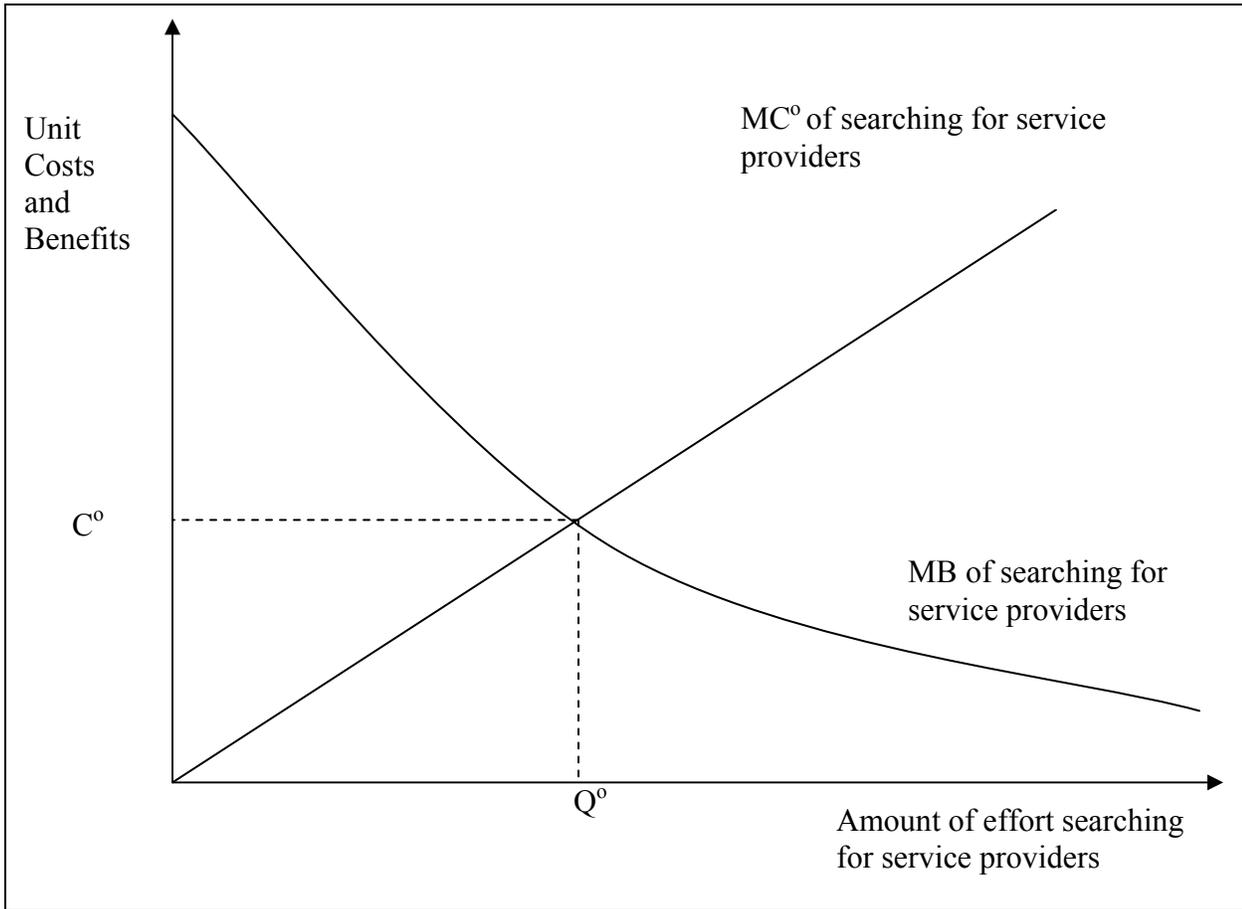
The marginal costs (MC) to the plan for searching for service providers are also shown in Exhibit A-14. The MC curve is upward sloping since as more and more units of effort are spent, the marginal cost of each unit increases. This assumes that fiduciaries employ the easiest methods of searching first and then must resort to increasingly difficult methods after these initial searching methods have been exploited.

The proposed rule does not specify a particular amount of search effort that should be expended. Instead, the rational fiduciary chooses a level of effort where the marginal benefits of searching for service providers equals the marginal cost of searching. This results in  $Q^0$  units of effort expended in the search for service providers at a marginal cost of  $C^0$ .

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<sup>8</sup> In this analysis, costs incurred by fiduciaries are considered costs to the plan, since the fiduciary is legally bound to the interests of the plan and its participants. In performing their fiduciary duty, a fiduciary may incur costs that do not accrue to the plan, but consideration of these costs is outside of the scope of this analysis.

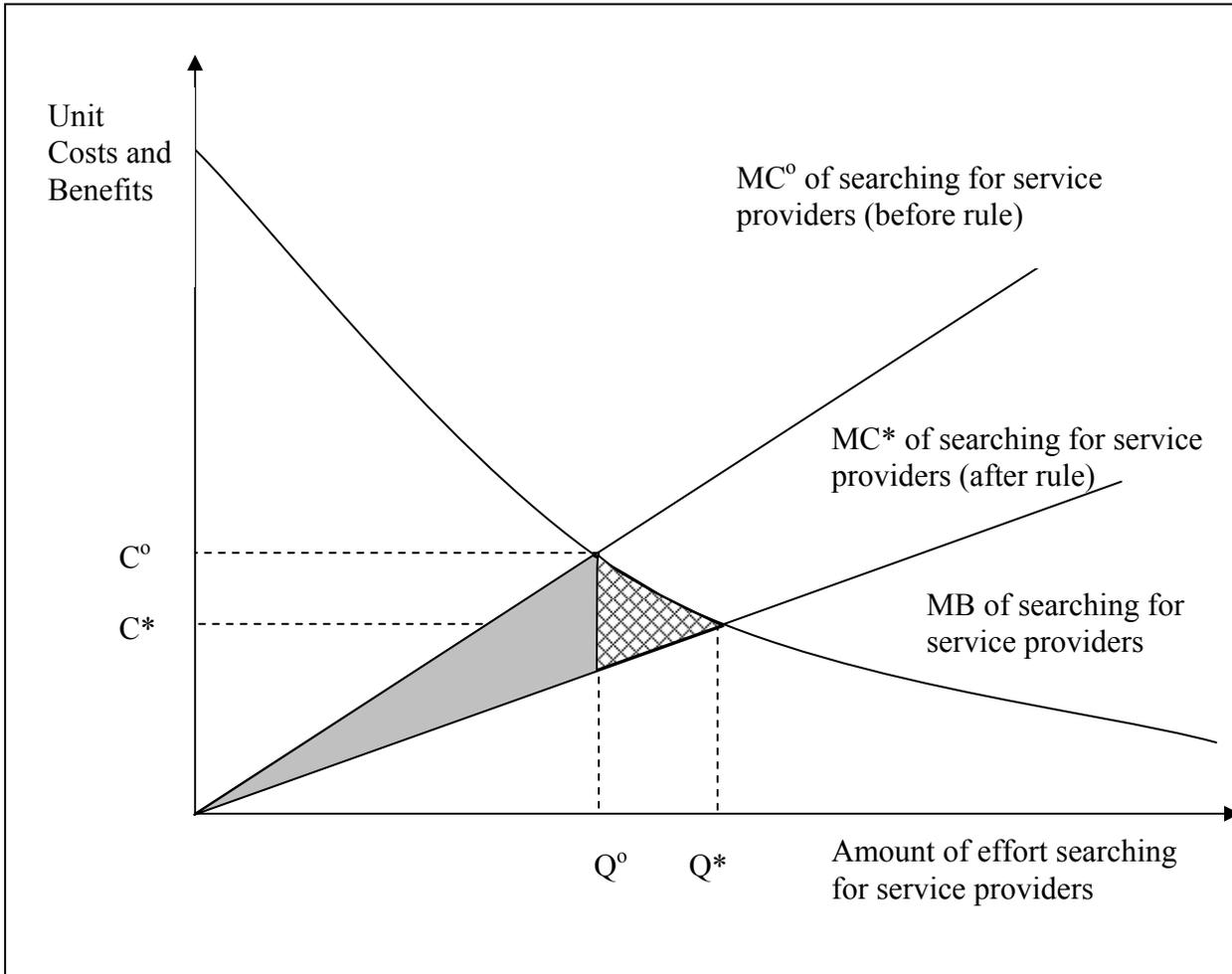
### Exhibit A-14: Search by Fiduciaries



The proposed rule is expected to have the effect of reducing the unit search costs for plans. As shown below in Exhibit A-15, this reduction would rotate the marginal cost curve downward. With the rule in effect, the fiduciary would again search to the point where the marginal cost of searching equaled the marginal benefit. Due to the reduced cost of searching under the rule, equating marginal costs and marginal benefits under the rule results in  $Q^*$  units of effort expended in searching for service providers at a reduced marginal cost of  $C^*$ . Thus, under the rule, fiduciaries may expend more effort in searching for service providers and incur a lower marginal per-unit search cost. The difference between  $Q^*$  and  $Q^{\circ}$  is the difference in the activity undertaken by fiduciaries in searching for service providers before and after the rule. The difference between  $C^*$  and  $C^{\circ}$  is the difference in marginal search costs borne by plans due to fiduciary search efforts before and after the proposed rule change.<sup>9</sup>

<sup>9</sup> To the extent that inefficient service providers leave the market due to the proposed rule, fiduciary search costs would decrease because the fiduciary would no longer have to spend time evaluating the inefficient service providers. We did not include this effect in the graphical analysis because we do not anticipate a reduction in the number of service providers due to the rule.

**Exhibit A-15: Search Costs for Fiduciaries After 408(b)(2) Rule Change**



The social benefits arising from reduced unit search costs is the sum of the benefits from the three possible scenarios mentioned above. These changes can be measured as both the reduced cost for the baseline level of search activities (shown by the shaded triangle between the  $MC^\circ$  and  $MC^*$  from the origin to  $Q^\circ$ ), plus the net benefits for the additional units undertaken as a result of the reduced per-unit cost (shown as the hatched area between the marginal benefit curve and  $MC^*$ ). Thus, the total net benefits of the reduction in search costs can be seen as the sum of the shaded and hatched areas in Exhibit A-15.

### 3.1.3. Relationship of primary benefits to possible reductions in fiduciary liability insurance premiums

There are two reasons why a fiduciary would devote effort and resources to searching for service providers. First, to the extent that a fiduciary can realize benefits for the plan from searching for service providers, the rational fiduciary would do so to fulfill their fiduciary duty. In connection with their obligations to the plan participants, fiduciaries have a personal interest in searching for

the best service provider. Fiduciaries are liable to the plan participants for any breach of fiduciary duty. Fiduciaries thus have an interest in conducting a prudent search for service providers, since it helps protect them against possible claims of breaches of fiduciary duty.

One method fiduciaries use to protect themselves against liability risks is to purchase fiduciary liability insurance. The practice of insuring against fiduciary liability risk is increasingly common as claims against fiduciaries have continued to grow. A recent survey of the market for fiduciary liability insurance reported that 39 percent of the fiduciaries surveyed in their study carried insurance of this type.<sup>10</sup> Insuring against fiduciary liability risk is likely the most common for larger plans, due to the larger amount of assets, and thus liability, associated with larger plans.

As with the effort a fiduciary puts into searching for service providers, a rational fiduciary would do a similar equating of marginal costs and benefits when making decisions about carrying fiduciary liability insurance. While it would be possible for a fiduciary to reduce their liability to zero, this is not what the rational fiduciary would choose to do since the costs of this level of risk reduction would far outweigh the benefits. The rational fiduciary would choose the level of insurance where the marginal benefit of reducing liability equaled the marginal cost of it.

The disclosures of fee structures mandated by the proposed rule could assist in fiduciaries proving that they upheld their fiduciary duty and made prudent and reasonable decisions in their choices of service providers. If this is the case, it is possible that lawsuits against fiduciaries could decrease in number, with fewer claims being paid for breaches of fiduciary duty. A decrease in claims would be expected to lower fiduciary liability premiums, assuming that competition among insurance companies led premiums to be functions of expected claims. The reduction in fiduciary liability insurance premiums would thus mean that fiduciaries would be able to purchase the same amount of coverage against fiduciary liability risks for a lower cost.

Because the purchase of fiduciary liability insurance is a market transaction, changes in these premiums under the proposed rule as compared to the baseline could potentially be used to provide a measurement of benefits of the proposed rule. In addition to using reductions in the level of fees paid by plans, reductions in premiums for fiduciary liability insurance premiums could be another measure of better decisions by fiduciaries that result from the proposed rule.

### 3.2. *Secondary Benefits*

Apart from the primary benefits discussed above, we have identified potential secondary benefits that could arise from the proposed rule. These secondary benefits are possible higher rates of investment that could result from the proposed rule. These higher rates of investment could result from the increased plan efficiencies and better investment choices discussed above. Additionally these secondary benefits could arise more indirectly due to increased confidence in

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<sup>10</sup> Towers Perrin. 2004. *Navigating Today's Fiduciary Concerns: Executive Summary of the 2003 Fiduciary Liability Survey Report*. Available online at: [www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2004/200407/Navigating\\_Concerns.pdf](http://www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2004/200407/Navigating_Concerns.pdf)

plans by plan participants. In the baseline scenario, plan participants often have difficulty obtaining information about the fees they pay, and this may serve as a disincentive to invest in retirement plans. With increased transparency of fee structures, plan participants may have increased levels of confidence in their plan and the returns it would generate, and may feel in general that their investment opportunities are more attractive. This increased confidence and attractiveness of investments could thus result in a higher rate of investment in plans by plan participants.

The existence and magnitude of these secondary benefits would depend on the ability of the proposed rule to make investment opportunities more attractive to plan participants, and for the possibility of higher returns to encourage increased amounts of investment. At this point, it is not possible to estimate the extent to which the proposed rule will result in higher returns. To the extent it does, increased participation and contributions to pension plans will depend on the preferences of employees in trading current for future consumption. This issue is dealt with in more detail in Technical Appendix B.

Increased rates of investment would be a benefit to society if the rate of return on capital investment were greater than the social rate of time preference between current and future consumption. This issue is also covered in Technical Appendix B.

## **Technical Appendix B**

### **Secondary Benefits of Improved Pension Returns**

There are theoretical reasons to expect increased participation in, and contributions to, defined contribution pension plans if the proposed 408(b)(2) rule increases the efficiency of the plans. These increases in turn could lead to additional important benefits. We describe these additional benefits as secondary because they occur as an indirect consequence of the primary effects of the rule, as a result of its incentive effects.

The potential for secondary benefits is discussed in this section, but not quantified because of uncertainty about the magnitude of the primary benefits that would drive the secondary benefits. The theory underlying these potential benefits may still be worth exploring because it can be applied to many of EBSA's rules and other initiatives.

The theoretical discussion is divided into three parts: a simple model of intertemporal choice that could link plan efficiency to changes in pension participation and contributions for rational plan participants; an extension of the model showing how the results could be ambiguous; and a description of how changes in pension participation and contributions relate to social benefits, under different assumptions about the degree of rationality of the plan participants. The theoretical discussion is followed by a very brief note about empirical findings from the literature.

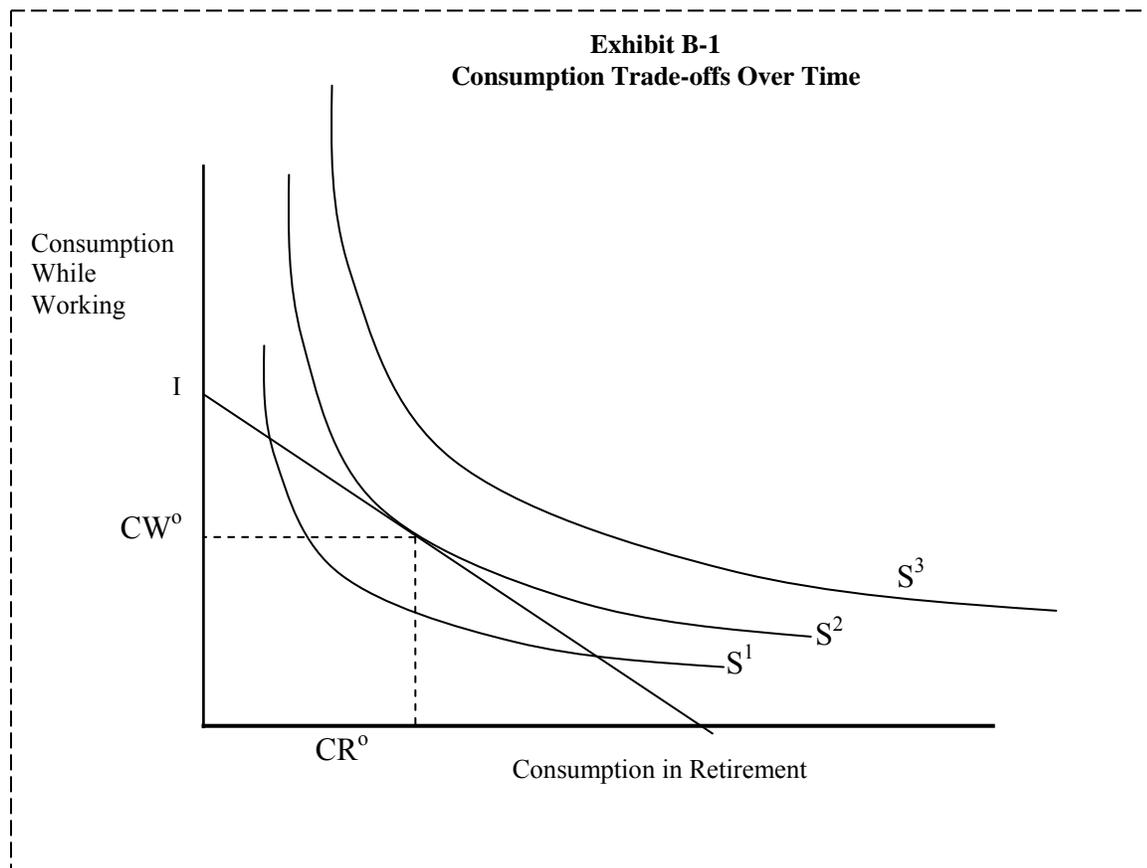
#### **A Decision Framework for Pension Contributions**

One way to look at the choice of pension contribution levels is to picture workers trying to maximize their own welfare over a life that has both a working phase and a retirement phase, with the latter period characterized by much lower (or zero) employment income. Without savings, spending in the latter period would be much lower than in the former, and under reasonable assumptions this unbalanced pattern would be distasteful: excessive consumption during the working years would not be worth the consequence of enduring poverty in old age. By saving and investing part of their employment income for spending during retirement, workers smooth out their consumption, leading to a preferable outcome.

This intuitively reasonable concept can be formalized or illustrated by defining a function relating consumption in the two periods to total well-being – the current value of the “utility” yielded by consumption over time. This concept is often displayed as an “indifference map” (see Exhibit B-1), on which the two axes can represent spending in two different time periods, and the curved lines (S1, S2, and S3) represent various fixed levels of satisfaction – each curve consists of consumption pairs that are preferred to points below or to the left, and inferior to point above or to the right. They are called “indifference curves” because consumers are indifferent between any two points on a single curve: higher consumption in one period is just offset by lower consumption in the other.

The downward-sloping straight line represents the potential for trading off consumption from one time period to another – i.e., reducing consumption now below (I), the employment income,

investing, and then using the proceeds of the investment to increase consumption in the future. The slope of the line is determined by the return on investment.<sup>11</sup>

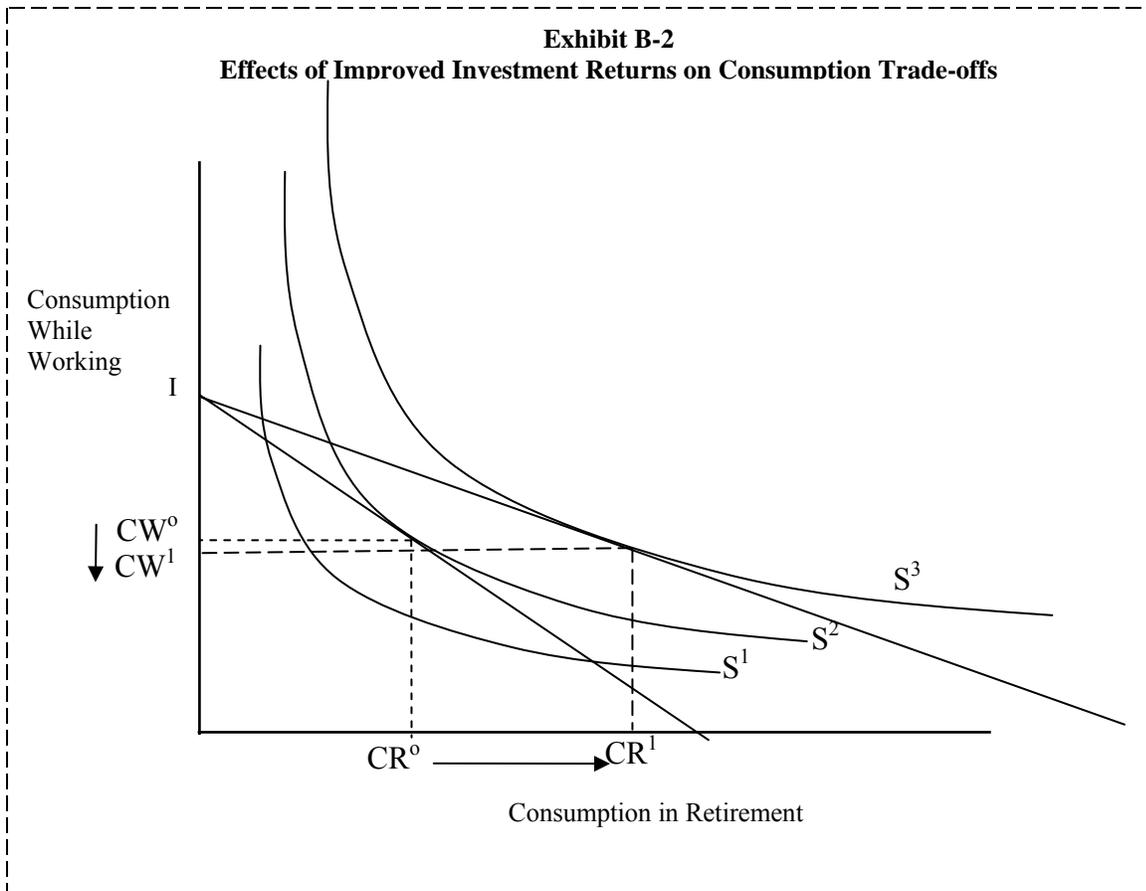


In theory, the consumer will be best off by choosing a pair of consumption points at which the consumption choice set is tangent to one of the indifference curves, because that curve is the highest one that can be reached with a given income. In the exhibit above, that pair is  $CW^0$  and  $CR^0$  (for consumption while working and consumption in retirement, respectively).<sup>12</sup>

If the rate of return on investment increases, the slope of the line flattens, and the tangency point is further out to the right, on a higher and thus “better” indifference curve. This change is shown in Exhibit B-2 below: a higher investment return allows the individual to reach the highest of the three indifference curves show, with a considerably higher level of consumption in retirement ( $CR^1$ ). Where this point is depends on the shape of the curves: the flatter the curves the more likely the new tangency point will be far to the right and lower down.

<sup>11</sup> Discounting of future consumption can also be included in that slope, leading to a net rate of return.

<sup>12</sup> If the choice set line is not tangent, it must be crossing an indifferent curve, and if so, a higher curve can be reach by moving further in one direction or another.



### Implications for Participation in Pension Plans

The change in investment of employment income can be seen by the change in the level of consumption while working, assuming total income ( $I$ ) is equal to consumption minus investment. In the example shown above, consumption while working drops, indicating that the increase in investment returns induced the worker to invest more.

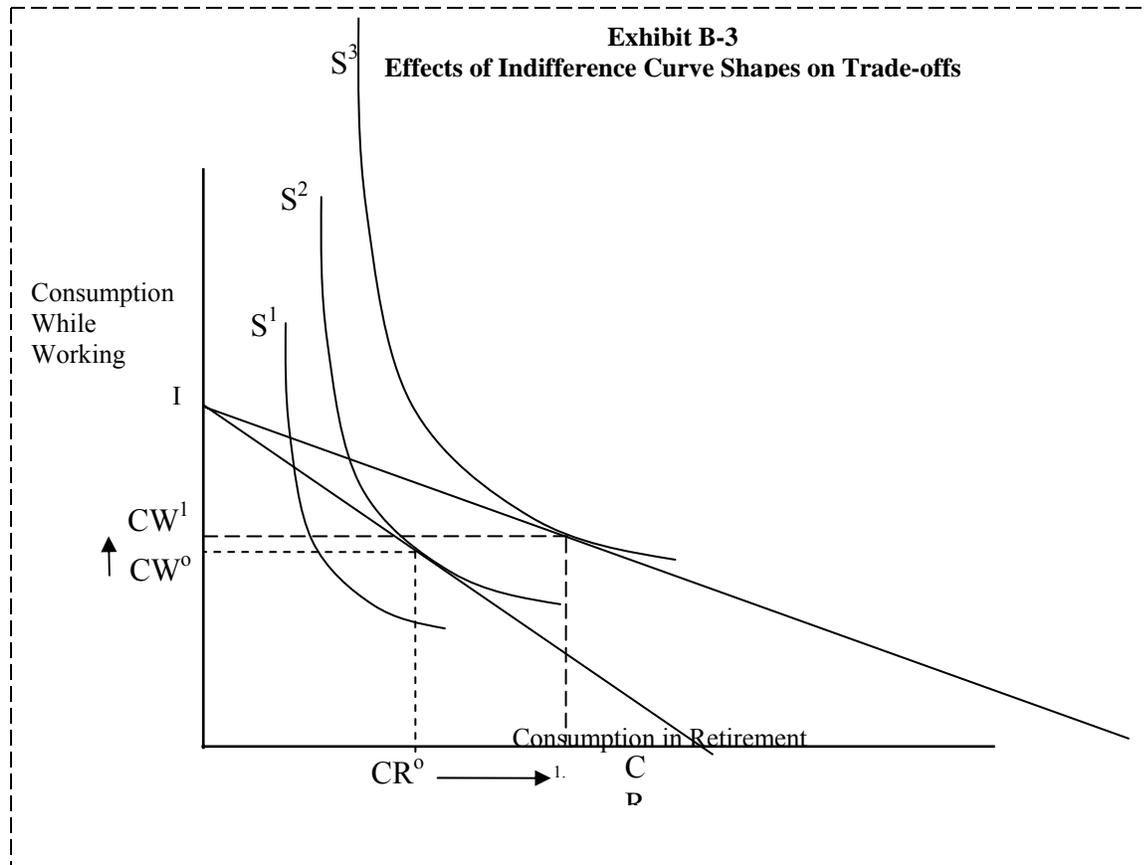
This result, though, depends on the shape of the indifference curves. With the more tightly bent indifference curves in Exhibit B-3, below, we see the opposite effect: better investment returns lead to higher consumption in the working years, meaning *lower* savings and investment.

The reason that better investment returns can lead either to more or less savings is that a better tradeoff between current and future consumption leads to two effects:

- (1) A desire to substitute future consumption for current consumption at a given level of well-being, and
- (2) A desire to consume more in both periods due to a higher overall level of well-being.

Economists refer to these effects as the substitution and the income effects, and they can often work in different directions. As a result of these competing effects on desired consumption during the working years, increased investment returns could induce small increases in saving or

small decreases in saving. Empirically, employer matches for 401(k) plans, which act like a major increase in investment returns, appear to lead to very small increases in savings, indicating that the substitution effect probably dominates.<sup>13</sup> Thus, if the rule leads to higher rates of return for participants, it might induce marginally higher contributions and participation.



### Evaluation of Changes in Investment from a Social Perspective

How increases in savings and investment should be evaluated from a cost/benefit perspective is another issue. Greater investment will lead to higher incomes in the future, but at the cost of lower current consumption. The rate at which investment provides returns in the future, compared to the rate at which we discount those future returns, will determine whether and to what extent increased savings are socially beneficial. The use of OMB’s recommended annual rates of seven percent for investment returns and three percent for the consumption discount rate could suggest that encouraging increased savings and investment is highly beneficial. Using these values, encouraging a worker to invest another dollar this year in order to realize higher consumption during retirement 20 years hence would yield an increase in consumption of  $\$1 * 1.07^{20}$ , or \$3.9, in 20 years. The present value of each dollar of increased future consumption, evaluated at 3 percent per annum, would be  $\$1/(1.03^{20})$ , or \$0.55. Thus, the present value of the \$3.9 increase in future consumption would be  $\$3.9 * 0.55$ , or \$2.14: each additional dollar saved

<sup>13</sup>“Employer Matching and 401(k) participation: Evidence from the Health and Retirement Study,” Gary V. Engelhardt and Anil Kumar, Research Department Working Paper 0601, Federal Reserve Bank of Dallas.

and invested for 20 years is worth more than twice as much, even after discounting to reflect our preference for current consumption. From this perspective, a penny saved is more than a penny earned.

From the perspective of the pension plan participant, however, the gains are less clear. Some researchers have expressed the belief that Americans have a tendency to under save.<sup>14</sup> One explanation might be that their discount rates are considerably higher than three percent. If this is indeed the case, from their perspective a small increase in savings may provide benefits that are almost entirely offset by the loss of current consumption. This is an issue that should be explored more thoroughly, in preparation for studies in which measurable changes in savings and investment are projected.

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<sup>14</sup> See, for example, Benzarti, S. 2006. "Implications of Participant Behavior for Plan Design" (available online at <http://www.alliancebernstein.com/investments/us/StoryPage.aspx?nid=5347&cid=29284>), and Madrian, B.C. and D.F. Shea. 2001. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *The Quarterly Journal of Economics*, 116(4):1149-1187.

## **Technical Appendix C**

### **Initial Regulatory Flexibility Analysis**

The Small Business Regulatory Enforcement Fairness Act (SBREFA) calls on rule makers to determine whether their actions will have a significant effect on a substantial number of small entities and to take certain actions if it cannot be certified that they will not have such an effect. In response to this request, the Department prepared an Initial Regulatory Flexibility Analysis (IRFA) of the proposed rule because, though the Department considers it unlikely that the rule will have a significant effect on a substantial number of small entities, the Department does not have enough information to certify to that effect. The Small Business Administration (SBA) provides detailed guidance on preparing an IRFA and lists the elements which the IRFA should include. This IRFA is structured around these suggested elements.

#### **1. Reasons Action is Being Considered**

Employee benefit plans have evolved over the past several years, resulting in changes to both the services provided to the plans and the compensation received by service providers. One result of these changes is that fee structures for service providers have, in some cases, become more complex and less transparent for plan sponsors, plan fiduciaries, or plan participants in terms of figuring out what is actually paid for services. With this increased complexity, it has often become more difficult to discern potential conflicts of interest which might exist between service provider arrangements. It has also become more difficult to determine the impacts of these potential conflicts of interest on the fees paid by, or the quality of the services provided to the plan.

The reasons the action is being considered are discussed in further detail in the preamble to the rule and in section 3 of the Regulatory Impact Analysis (RIA) (“Need for Regulatory Action”).

#### **2. Objectives of the Proposed Rule**

The primary objective of the rule is to help plan sponsors and fiduciaries get the information they need to accurately assess service provider arrangements. The Department believes the rule will thus promote the efficiency of plan sponsors and fiduciaries finding and using the information they need to search for service providers.

The objectives of the proposed rule are discussed in further detail in the preamble to the rule and in section 3 of the RIA (“Need for Regulatory Action”).

#### **3. Description and Estimate of Number of Small Entities**

The Department estimated the number of small entities that would potentially be affected by the proposed rule by examining 2002 Economic Census data for industries in North American

Industry Classification System (NAICS) codes for activities affected by the proposed rule. Firms would be affected by the rule if the activities they engaged in required them to make disclosures. According to the rule, firms must make disclosures when any of the following occur:

- They receive indirect compensation in connection with the provision of accounting, actuarial, appraisal, auditing, legal, or valuation services to the plan;
- They act as a fiduciary; or
- They provide banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other investment brokerage, or third party administration services to the plan.

From these affected activities, the Department identified NAICS codes for industries most likely to be affected by the rule. A listing of these NAICS codes, their meaning and a description of why the Department believes firms in these NAICS codes would be affected, are shown below in Exhibit C-1.

**Exhibit C-1. Affected Industries by NAICS Code**

NAICS Code	Meaning	Description of Affected Activities
523120	Securities brokerage	Firms in this industry provide securities brokerage services.
522320	Financial transactions processing, reserve, & clearinghouse activities	Firms in this industry may provide administration services related to financial transactions.
523920	Portfolio management	Firms in this industry include mutual fund platforms which receive indirect compensation. These firms also provide investment management services. <sup>15</sup>
523930	Investment advice	Firms in this industry provide investment advisory services and may be categorized as fiduciaries.
523991	Trust, fiduciary, & custody activities	Firms in this industry are likely to be categorized as fiduciaries.
524292	Third party administration of insurance & pension funds	Firms in this industry are likely to provide administration services.

While the Department believes that the NAICS codes listed above are a comprehensive listing of the industries most likely to be affected by the rule, it is important to note that firms in other industries may also be affected by the proposed rule. This could occur if firms are listed in the Economic Census under a NAICS code that is unaffected by the rule, but are also engaged in any of the affected activities. It is also important to note that not all firms listed in the NAICS codes shown above will be affected by the rule. This is due to the fact that some firms in these industries are not service providers to ERISA-governed plans, and they are thus outside of the scope of the proposed rule. This could also be due to the fact that some firms in these industries

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<sup>15</sup> ERISA provides that the investments made by a registered investment company are generally not deemed to be plan assets. Section 401(b)(1) states: “In the case of a plan which invests in any security issued by an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.], the assets of such plan shall be deemed to include such security but shall not, solely by reason of such investment, be deemed to include any assets of such investment company.”

do not contract directly with the plan and their compensation is included in the fees reported by another service provider.

Next, the Department used information on firms in the affected NAICS codes to estimate the population of affected firms. C- 2 below shows the total population of entities in the industries affected by this rule. The Small Business Administration (SBA) sets the threshold for small entities in NAICS code 523 at revenues of \$6.5 million per year.<sup>16</sup> Accordingly, Exhibit C-2 shows all of the entities with revenues below \$5 million as small and all of those with revenues of \$10 million or more as large. Half of those with revenues between \$5 and \$10 million are estimated to be small; though this is not an exact estimate, it is reasonable given that the SBA's threshold is closer to the bottom of the range and that the population within each size category is likely to be concentrated near the lower end.

Not all of the entities in these industries are involved in activities covered by the rule, however: as shown in section 5 of the RIA ("Characterization of Affected Entities"), a total of 15,600 service providers are expected to incur costs under the rule. Assuming the same size distribution among the firms incurring costs as in the industries as a whole, we can estimate that the number of small firms incurring costs is equal to 94 percent of the 15,600, or about 14,620 (15,600 x 0.94). The imputed breakdown of this number by size category is shown in the right-most column of Exhibit C-2.

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<sup>16</sup> U. S. Small Business Administration, "Table of Small Business Size Standards Matched to North American Industry Classification System Codes." Available online at: [http://www.sba.gov/idc/groups/public/documents/sba\\_homepage/serv\\_sstd\\_tablepdf.pdf](http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf)

**Exhibit C-2. Numbers of Firms in Affected Industries**

Revenue Category (1,000s)	Number of Firms, by NAICS Code						Average Revenues (1,000s)
	522320	523120	523920	523930	523991	524292	
Up to \$100	181	1,390	2,007	2,575	367	390	\$50
\$100 to \$249	251	2,169	2,087	2,703	393	426	\$163
\$250 to \$499	228	1,506	1,737	1,627	293	470	\$350
\$500 to \$999	180	893	1,351	1,063	238	510	\$693
\$1,000 to \$2,499	202	630	1,263	682	227	577	\$1,555
\$2,500 to \$4,999	95	245	607	243	72	298	\$3,464
\$5,000 to \$9,999	70	178	420	124	50	199	\$7,078
\$10,000 to \$24,999	64	138	322	77	31	128	\$15,638
\$25,000 to \$49,999	41	79	121	31	14	53	\$34,765
\$50,000 to \$99,999	23	33	68	13	8	26	\$70,972
\$100,000 to \$249,999	11	44	51	8	6	19	\$134,194
\$250,000 to \$499,999	10	22	12	4	8	7	\$272,172
\$500,000 or more	11	31	29	3	0	4	\$1,678,396
<b>Totals</b>	<b>1,367</b>	<b>7,358</b>	<b>10,075</b>	<b>9,153</b>	<b>1,707</b>	<b>3,107</b>	

**Exhibit C-2 (Continued). Numbers of Firms in Affected Industries**

Revenue Category (1,000s)	Total	Total Small	Estimated Small Entities Bearing Costs under 408(b)(2)
Up to \$100	6,910	6,910	3,292
\$100 to \$249	8,029	8,029	3,825
\$250 to \$499	5,861	5,861	2,792
\$500 to \$999	4,235	4,235	2,017
\$1,000 to \$2,499	3,581	3,581	1,706
\$2,500 to \$4,999	1,560	1,560	734
\$5,000 to \$9,999	1,041	521	248
\$10,000 to \$24,999	760		
\$25,000 to \$49,999	339		
\$50,000 to \$99,999	171		
\$100,000 to \$249,999	139		
\$250,000 to \$499,999	63		
\$500,000,000 or more	78		
<b>Totals</b>	<b>32,767</b>	<b>30,697</b>	<b>14,623</b>
	<b>100%</b>	<b>94%</b>	

#### 4. Estimating Compliance Requirements

As discussed in section 7 of the Regulatory Impact Analysis, the proposed rule will impose both initial and recurring costs. The initial costs are estimated to amount to \$56 for every small entity for rule familiarization, and \$2,544 + \$4,480 or \$7,024 for more in-depth review and changes to disclosure practices for small entities at the larger end of the range – those over \$1,000,000 in annual revenues. These costs, which are at most less than one percent of a single year's revenues, should be easily affordable for all small entities, and are therefore not considered in detail in this section.

As shown in Exhibit 7-3 of the RIA, recurring costs are estimated to total \$31,103,000, per year for about 15,600 firms, which is an average of just under \$2,000 per affected entity. This estimate was based on the projection that preparing a complex disclosure to a plan will take an hour and 40 minutes, at an hourly cost of \$56, which amounts to \$93 per complex disclosure.

The impact of this recurring cost on the small entities will depend on the number of plans served by each, and the fraction of them that are complex. The Department believes that only a fraction of all interactions between service providers and plans are likely to require complex disclosure. Of all disclosures, the Department estimates that 30 percent will be complex. Industry-wide, therefore, the average recurring cost is estimated to be 30 percent of \$93 or \$28.<sup>17</sup>

Furthermore, these complex disclosures are likely to be concentrated among large service providers, meaning that small service providers will bear relatively low recurring costs. Information gained from a discussion with a service provider supports the assumption used in this analysis that as plan size decreases, fee structures, and thus the disclosures required under the proposed rule, will generally become less complex. For example, there are very few medium-sized service providers; these firms tend to be either large operations or very small operations with fewer than 25 advisors. Firms at the small end of the market are also more likely to work with smaller plans. Industry sources suggested that it would be unlikely, for example, for a plan with \$20 million or more in assets to work with a small service provider, thus the plans handled by these small service providers are probably below \$20 million in assets.<sup>18</sup>

Service providers have a wide variety of ways in which they could be reimbursed for their services. Evidence from the industry suggests that larger firms would have more of these potential revenue streams and thus more complex disclosures to make under the 408(b)(2) rule. On the other hand, smaller firms are often compensated through a single revenue source, 12b-1 fees. Discussions with the service provider industry supported the Department's belief that the services provided to smaller plans are less complex than those provided to larger plans. This belief was also supported by an industry study which stated that larger investment firms such as Fidelity have created simpler "turnkey" programs for small plans which offer a reduced set of services.<sup>19</sup> Examples of the services that might be reduced or eliminated for small plans are in-

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<sup>17</sup> This cost estimate includes only labor costs and does not include the materials cost of paper and printing due to the trivial nature of this cost (\$0.55 per disclosure using the assumptions of \$0.05 per page for 11 pages).

<sup>18</sup> Neil Alexander, Hefren-Tillotson

<sup>19</sup> Jeff Benjamin, "An opportunity for advisers in the know" Investment News, August 19, 2002.

person visits from investment advisors, provision of marketing and educational materials to participants, and the ability of participants to use web-based portals to manage their investments. Another way in which services for smaller plans could be simplified is to have a “closed architecture platform” which offers participants a reduced choice of funds as opposed to an “open architecture platform” which offers participants a larger choice set of funds. Open architecture platforms also allow for the inclusion of funds outside of those offered by the particular mutual fund company with which the plan is contracting. The introduction of outside funds onto a mutual fund platform introduces additional complexity in fee structures. Therefore, the necessary disclosures for plans with closed architecture platforms are generally less complex than those necessary for plans with open architecture platforms.

It is not possible at this time to estimate quantitatively the degree to which complex disclosures and their attendant costs occur less frequently for smaller service providers. The Department is therefore assessing the costs of the rule on small entities on the conservative assumption that complex disclosures are just as common for small plans and small service providers as for the industry as a whole. Thus, recurring costs can be assumed for these purposes to average \$28 per year per plan served.

Given the assumption that recurring costs to small entities will average \$28 per plan served, the costs of the rule will depend on the numbers of plans they serve. At the present time, the Department does not know of data relating directly to this question. Though it stands to reason that service providers with low revenues serve relatively few plans, it is possible that they could serve just as many plans as other firms, with the main difference being that the plans they serve are very small.

In an attempt to determine the numbers of plans served by small service providers relative to large ones, the Department examined data from Form 5500 filings for plan year 2003. These data showed a strong tendency for smaller service providers (measured in terms of the total number of participants served, which is a reasonable proxy for revenues) to serve plans of smaller average size. Exhibit C-3 presents a summary of this analysis.

**Exhibit C-3. Relationship of Number of Plans Served to Service Provider Size, as Seen in Schedule C Data**

Size Categories of Service Providers, in Total Numbers of Participants Served		Number of Service Providers	Average Number of Participants served	Average Number of Participants per plan	Average Number of Plans	Log of Total Participants Served	Log of Number of Plans Served
3,000,000	& up	10	3,918,322	27928	140	6.59	2.15
1,000,00	3,000,000	52	1,582,169	28581	55	6.20	1.74
300,000	1,000,000	180	557,743	27390	20	5.75	1.31
100,000	300,000	320	169,376	17018	10	5.23	1.00
30,000	100,000	500	56,608	9512	6	4.75	0.77
10,000	30,000	500	17,801	6037	3	4.25	0.47
Up to	10,000	1700	5,827	2946	2	3.77	0.30
			Average= 78,243				

**Exhibit C-3 (Continued). Relationship of Number of Plans Served to Service Provider Size, as Seen in Schedule C Data**

Log of Total Participants Served	Log of Number of Plans Served	Log of Number of Plans Served as Predicted using Regression: $\log(\text{total plans}) = 0.0031 * \log(\text{total participants})^{3.4763}$
6.59	2.15	2.18
6.20	1.74	1.76
5.75	1.31	1.35
5.23	1.00	0.97
4.75	0.77	0.70
4.25	0.47	0.47
3.77	0.30	0.31

Because the data were limited to larger plans, they cannot be used to confidently predict the relationship between the smallest plans and their service providers. The general trends seen in the data, however, are strong: smaller service providers tend to work with smaller plans, and also with fewer plans.

The Department found that the relationship of the number of plans to the size of the service provider could be characterized accurately with a simple function:

$$\text{Log}(\text{Average number of plans served}) = 0.0031 * \text{Log}(\text{Total participants served})^{3.4763}$$

N= 7, R<sup>2</sup> = 0.998

This relationship, though not reliable over size ranges for which no data were available, can be used to suggest how many plans very small service providers might serve on average, relative to the number served by the average service provider.

The approach to using this relationship is to assume that an average-sized service provider is similar to an average-sized firm in the Schedule C data. Then, it is assumed that service providers with a fraction of the average revenue are like those that serve that same fraction of the average number of participants in the Schedule C data. With these assumptions, different fractions of the average service provider size can be substituted into the equation to obtain predictions of the equivalent number of plans that would be served, relative to the average number of plans served. Then, assuming annual costs to the service provider are proportional to the number of plans served, an estimate of the recurring costs to the service providers can be obtained.

For example, consider a service provider with revenues equal to half the industry average. The relative number of plans that service provider would be expected to serve would be found by substituting half of the estimated 78,000 (the average number of participants served by the service providers shown in the Schedule C data), or 39,000, into the equation. That yields 0.6206 as the log of the number of plans, compared to 0.7738 for the log of the number of plans using the industry average of 78,000. Translating these logs into estimated numbers of plans, and finding their ratio, yields the prediction that a service provider that is half as large as average serves  $(10^{0.6206})/(10^{0.7738})$  or 70 percent as many plans as average. Again, assuming that the costs of disclosure are proportional to the number plans served, this approach predicts that service providers that are half as large as the average will incur recurring costs that are 70 percent of industry-wide average costs. Multiplying the estimated average recurring costs of \$2,000 per service provider by 70 percent yields an annual recurring cost of about \$1,400.

Applying this approach to other sizes produces the projected recurring costs for different service provider sizes shown in Exhibit C-4. This exhibit also shows the results of assuming that there is no relationship between service provider size and the number of plans served, and hence equal recurring costs for every service provider.

#### Exhibit C-4. Projected Recurring Costs Compared to Revenues

Revenue Category (1,000s)	Average Revenues (1,000s)	Projected Cost Assumption		Equal Cost Assumption	
		Estimated Costs per Service Provider	Cost as a Percentage of Revenues	Cost per Service Provider	Cost as a Percentage of Revenues
Up to \$100	\$50	\$428	0.86%	\$2,000	4.00%
\$100 to \$249	\$163	\$520	0.32%	\$2,000	1.23%
\$250 to \$499	\$350	\$620	0.18%	\$2,000	0.57%
\$500 to \$999	\$693	\$753	0.11%	\$2,000	0.29%
\$1,000 to \$2,499	\$1,555	\$997	0.06%	\$2,000	0.13%
\$2,500 to \$4,999	\$3,464	\$1,404	0.04%	\$2,000	0.06%
\$5,000 to \$9,999	\$7,078	\$2,021	0.03%	\$2,000	0.03%
\$10,000 to \$24,999	\$15,638	\$3,257	0.02%	\$2,000	0.01%
\$25,000 to \$49,999	\$34,765	\$5,735	0.02%	\$2,000	0.01%
\$50,000 to \$99,999	\$70,972	\$10,293	0.01%	\$2,000	0.00%
\$100,000 to \$249,999	\$134,194	\$18,574	0.01%	\$2,000	0.00%
\$250,000 to \$499,999	\$272,172	\$38,794	0.01%	\$2,000	0.00%
\$500,000 or more	\$1,678,396	\$399,284	0.02%	\$2,000	0.00%
Average	\$6,943	\$2,000	0.03%	\$2,000	0.03%

Using either assumption, recurring costs as a fraction of revenue are higher for smaller service providers. Under the assumption that smaller providers serve fewer plans, and therefore face costs that are lower in absolute terms, costs are insignificant for every size of service provider. Even in the case of the very conservative assumption that large and small providers all serve the same number of plans, the costs are below one percent of revenues for all but the smallest service providers – those with revenues below the average for a firm with a single employee.

Still, it is possible that some very small service providers could serve more than the average number of plans, and could therefore bear higher costs relative to their revenues than shown in Exhibit C-4. To explore this possibility, the Department calculated the maximum number of small firms that could face recurring costs as high as one percent. This maximum was calculated under the extreme assumption that small plans are served only by small service providers, which would tend to concentrate the costs of the rule to the largest possible extent.

Using the assumption that small plans are served only by the smallest service providers, the Department found the plan size for which the average ratio of rule costs to revenues would just equal one percent, for all of the plans of that size or smaller. Finding this size necessitated calculating the cumulative recurring costs for plans up to each size, and comparing that cumulative cost to the cumulative revenues that could be generated by serving those plans. Because the on-going disclosure cost is \$28 per plan (0.3 x 1.67 hours x \$56 per hour), the Department calculated the cumulative costs for serving all plans up to a given number of participants by multiplying the cumulative number of plans by \$28. Assuming that the service

providers receive 1.5 percent annually of the total assets they manage,<sup>20</sup> and using the fact that the average assets managed for each plan participant for the industry is about \$58,000,<sup>21</sup> each participant could be expected to generate about \$870 ( $\$58,000 \times 0.015$ ) per year in fees. Multiplying \$870 by the cumulative number of participants yielded the total revenues generated by plans of no more than a given size. These calculations are shown in C- 5, in the fourth and fifth columns at the bottom of the exhibit. Comparing these columns, small service providers that served only plans with five or fewer participants could bear a total cost of \$4.6 million against revenues of \$466 million – which is barely below one percent.

The next step in determining the maximum number of small entities with costs exceeding 1 percent was to find the maximum number that could be sustained by the revenues of \$466 million per year. Clearly, if these revenues were divided among the service providers in the first two revenue categories shown in C-2, which average \$50,000 and \$163,000 in annual revenues, respectively, they would have an effect on the maximum number of individual service providers.

The total revenues of the affected service providers in the smallest revenue category are \$50,000 times around 3,300 firms, or \$165 million. Because this is less than \$466 million, it is conceivable that all 3,300 of the firms in that smallest category could face costs of one percent of revenues. The remainder of the \$466 million, or \$301 million, would be enough to sustain \$301 million/\$163 thousand, or nearly 1,850 additional service providers in the next smallest revenue category. Thus, if all plans with 5 or fewer participants are served by the smallest of the service providers, it is possible that up to  $3,300 + 1,850$  or about 5,150 small entities could face costs equal to one percent of revenues.

Comparing this maximum to the total number of small entities bearing costs under this rule, around 14,600, it is clear that on the order of a third of affected small entities could, possibly, bear ongoing costs equal to one percent of revenues. Because these magnitudes are above the thresholds commonly used to indicate a “significant impact on a substantial number of small entities” (or SISNOSE), and given the uncertainty of the underlying calculations, the Department considered it inappropriate to certify that the rule would not cause a SISNOSE.

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<sup>20</sup> The Motley Fool Mutual Fund Center. Available online at: <http://www.fool.com/school/mutualfunds/costs/ratios.htm>.

<sup>21</sup> Employee Benefit Research Institute/Investment Company Institute. “Participant-Directed Retirement Plan Data Collection Project, 2005 year-end data.” Available online at: [http://www.ici.org/stats/res/per12-01\\_appendix.pdf](http://www.ici.org/stats/res/per12-01_appendix.pdf).

### Exhibit C-5. Distribution of Plans and Participants for the Pension Plan Industry

Number of Participants	Number of DB Plans	Number of DC Plans	Total Pension Plans	Total Number of Participants
1	707	6,637	7,344	7344
2	5,645	38,983	44,628	89256
3	4,731	38,027	42,758	128274
4	3,332	34,199	37,531	150124
5	2,441	29,637	32,078	160390
6	1,778	25,890	27,668	166008
7	1,346	22,626	23,972	167804
Number of Participants	Cumulative Plans	Cumulative Participants	Cumulative Costs at \$28/Plan	Cumulative Revenues at \$870/Participant
1	7,344	7344	\$205,632	\$6,389,280
2	51,972	96,600	\$1,455,216	\$84,042,000
3	94,730	224,874	\$2,652,440	\$195,640,380
4	132,261	374,998	\$3,703,308	\$326,248,260
5	164,339	535,388	\$4,601,492	\$465,787,560
6	192,007	701,396	\$5,376,196	\$610,214,520
7	215,979	869,200	\$6,047,412	\$756,204,000

Clearly though, this estimate of the percentage of small entities that might bear a cost of 1 percent is very likely to overstate the true number of small entities that are substantially affected by the proposed rule. It is based on an assumption that the smallest plans are served only by the smallest of service providers.

The Department does not know of data specifically showing the distribution of the sizes of the service providers serving the smallest plans. The relationship between service provider size and plan size is almost certainly not absolute, however, Investment News reported that Principal Financial Group, a large business headquartered in Des Moines, Iowa, places a priority on small plans. Principal Financial Group is a leader in the area of small plans, serving over 25,000 with fewer than 500 participants.<sup>22</sup>

It is also likely that revenues per plan participant are higher than average for very small plans, due to the presence of fixed costs of plan management. One article reported that annual fees for small plans range from a minimum \$1,000 to \$2,500 per plan for the smallest plans, in addition to a small fee per participant, plus a percentage of the assets managed.<sup>23</sup> Higher revenues per plan served, measured against a constant cost, would greatly reduce the number of significantly affected service providers. Uncertainty about the structure of fees for very small plans, however, made it impossible for the Department to estimate the effect of these higher fees on the number of significantly affected small entities. Small service providers also are likely to have revenue

<sup>22</sup> Jeff Benjamin, "An opportunity for advisers in the know" Investment News, August 19, 2002.

<sup>23</sup> Virginia M. Kahn, "Bridging the Pension Gap" Business Week, June 21, 1999.

sources other than pensions and other benefit plans, which would dilute and mitigate the impacts of the rule.

Finally, as already noted, very small entities are unlikely to bear costs per plan as large as the industry as a whole. Because they appear to specialize in small plans, and because of the tendency for smaller plans to have simpler, standardized structures, small service providers are likely to be able to provide simple and routine disclosures in almost all cases.

In conclusion, the Department believes that the rule is very likely to result in costs that are insignificant in comparison to revenues for all but the smallest affected entities. This conclusion, however, is subject to considerable uncertainty, due largely to a lack of data on the lower end of the size distribution of both plans and service providers. It is at least possible for a substantial number of small entities to bear costs that could be considered significant.