The Case For Employer-Sponsored Retirement Plans

Fees and Expenses

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THE SPARK Institute, Inc.
SHAPING AMERICA'S RETIREMENT

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ABOUT THE SPARK INSTITUTE

The SPARK Institute represents the interests of a broad based cross section of retirement plan service providers and investment managers, including members that are banks, mutual fund companies, insurance companies, third party administrators and benefits consultants. Our members include most of the largest firms that provide record keeping services to employer-sponsored retirement plans, ranging from one participant programs to plans that cover tens of thousands of employees. The combined membership services more than 62 million employer-sponsored plan participants.

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INTRODUCTION

This white paper is the third and final planned installment in a multipart series developed by The SPARK Institute to demonstrate that employer-sponsored retirement plans,[1] particularly 401(k) plans, are the most effective, secure and viable way for American workers to save and invest to reach their retirement goals. This installment examines two groups of concerns regarding plan fees and expenses. The first group relates to claims that employer-sponsored retirement plans and their investments are expensive and may erode American workers' retirement savings. The second addresses concerns that employer-sponsored retirement plans and their investment fees and expenses are not adequately understood and disclosed.

The first and second installments of our white paper series[2] examined the "Benefits and Accomplishments" of employer-sponsored plans and "Coverage, Participation and Retirement Security," respectively. The SPARK Institute will release additional installments in order to address new issues and developments as appropriate.

[1] Employer-sponsored and workplace retirement savings plans are defined herein as any workplace retirement plan, including 401(k), 457, 403(b) or retirement savings plans offered through collective bargaining (e.g. Taft-Hartley). Employer-sponsored and workplace retirement savings plans, as used herein, do not include Individual Retirement Accounts.

[2] The first and second installments of our white papers are available on The SPARK Institute website at www.sparkinstitute.org/comments-and-materials.

EXECUTIVE SUMMARY

There are many myths, misperceptions and misunderstandings about the employer-sponsored retirement plan system and its accomplishments and effectiveness in helping American workers save and invest for retirement. Our series of white papers examines the myths and demonstrates the value, benefits, effectiveness, security and viability that make employer-sponsored retirement plans the best way for American workers to save and invest to reach their retirement goals.

The SPARK Institute believes that:

- The employer-sponsored retirement plan system is a fundamentally successful, sound, competitive and innovative system that (1) provides the best way for American workers to save and invest to reach their retirement goals, and (2) provides valuable services and good value for the cost, including more affordable investment options than retail investment products.
- Plan sponsors play a critical role in providing a valuable and cost-effective way for employees to save for retirement, including taking on the fiduciary responsibility of negotiating appropriate plan fees and expenses.
- Opportunities to improve employer-sponsored retirement plans remain, and improvements can be readily made, without abandoning the current system.

Recommendations

Improvements can and should be made in how fees and expenses are disclosed to plan sponsors and participants. Fee disclosure should be part of an overall assessment made by plan sponsors and participants. That assessment should include vetting such items as investment performance, fees and other plan-related services and information. Ultimately, the best approach to fee disclosure will be one that is flexible and concept-based. It should allow service providers to tailor disclosures with comparable information for each offered investment option, so that it ultimately provides the detail necessary for both sponsors and participants to understand the fees and expenses related to each option and make informed choices. A legislative and regulatory framework under which plan sponsors can make "apples to apples" comparisons of plan and investment fees and expenses is conceptually appealing, but creating a single solution for either plan sponsor or participant fee disclosure is not feasible or practical.

> ***Ultimately, the best approach to fee disclosure will be one that is flexible and concept-based and allows service providers to tailor disclosures with comparable information for each offered investment option.***

This document will examine and dispel the myths, misperceptions and misunderstandings about employer-sponsored plans. The SPARK Institute's recommendations for improving the current system are also discussed in greater detail.

DISCUSSION AND RECOMMENDATIONS

A. Fees and Expenses

Myth Employer-sponsored retirement plans and their investments are expensive and may erode American workers' retirement savings.

Fact Employer-sponsored retirement plans and the investments available in them are generally less expensive than their retail counterparts and have contributed greatly toward the retirement security of American workers.

One of the greatest misconceptions about the level of fees paid by participants in employer-sponsored plans is that they are expensive and overpriced relative to the fees that are paid by investors in retail or individual mutual funds and other retail investments. Employer-sponsored plans have been broadly and wrongly brandished as having "inadequate, and all too often, expensive investment options."[3] Additionally, many industry critics also incorrectly believe that retirement plan service providers are gouging plan participants and making unconscionable profits. In the following section, this paper will examine these criticisms and demonstrate that employer-sponsored retirement plans and their investments are not inherently more expensive than other retirement savings and investment vehicles. Accordingly, employers should continue to have the flexibility to choose the type of retirement plan designs and investment vehicles they offer and should be able to decide how to pay for the costs of such plans.

The fees paid by employer-sponsored plans are fair and reasonable when considering all of the services that are provided. Additionally, investments in employer-sponsored plans are generally less expensive than their retail counterparts.

Discussion

The misconception about the level of fees paid by participants in employer-sponsored plans has been expressed in different forums and venues, including newspaper and trade press articles,[4] and by policy makers, witnesses at hearings,[5] and other critics who have attacked the industry's fee practices. Some have made flawed claims about the 401(k) industry, such as that retirement plan participants would pay less and receive benefits that were at least as good if they contributed to mandatory payroll deduction IRAs, rather than a workplace 401(k) plan. The SPARK Institute believes that the fees agreed to by employers who sponsor retirement plans and charged to American workers who participate in those plans are fair and reasonable when considering all of the services that are provided. Due to economies of scale inherent in group plans, they deliver better value than comparable retail based investments such as IRAs. Furthermore,

[3] Letter from Congressman George Miller to *The Wall Street Journal*, November 17, 2008.

[4] *The Wall Street Journal*, January 8, 2009, "Big Slide in 401(k)s Spurs Calls for Change." "Many 401(k) plans don't give workers straightforward, low-cost investment options, such as funds that track markets indexes, which often beat stock-picking fund managers over the long haul." Rep. George Miller, a California Democrat who is chairman of the House committee looking into 401(k)s.

[5] See for example, Hearings of the House of Representatives Education and Labor Committee, "Strengthening Worker Retirement Security," October 7, 2008 and February 24, 2009.

in two recent lawsuits, the courts found in favor of employers who were alleged by plan participants to have breached their fiduciary duty by entering into arrangements in which the plans paid excessive fees to service providers/record keepers and investment fund providers. In one of the cases, the plan utilized retail mutual funds.[6]

1. **Myth** **Mandatory automatic individual retirement accounts (IRAs) are viewed by some as a less expensive alternative to employer-sponsored plans.**

   Fact **Automatic IRA accounts are a more expensive and less effective alternative to employer-sponsored retirement plans.**

   The SPARK Institute is aware that some policymakers and critics of the retirement plan industry have taken the position that mandatory automatic IRAs and other arrangements that utilize, almost exclusively, retail investment products are a less expensive alternative and that such arrangements will generate better investment outcomes than employer-sponsored retirement plans. The facts support a contrary conclusion, however.

   Ironically, in many instances, IRAs are invested in the same investment funds with the same expenses as employer-sponsored plans, except that participants receive more service, flexibility, education, and support through an employer-sponsored plan. Unlike retail IRA products where investors are left to fend for themselves when deciding which IRA provider to choose and then left with the daunting task of picking appropriate investments, employer sponsorship and engagement enhances the potential for workers to achieve sound investment outcomes by virtue of the employer's selection of service providers and a menu of high-quality investments from diverse asset classes that often reflect lower prices relative to retail investment options. According to research conducted by the mutual fund industry,[7] about 54% of the $3.0 trillion invested in 401(k) plans at the end of 2007 was invested in mutual funds. These funds, on average, charged less than their comparable retail class of shares. For example, the average total expense ratio incurred by 401(k) investors in stock mutual funds was .74% in 2007 as compared with the .86% industry-wide asset-weighted average and about half of the 1.46% simple average for all stock mutual funds.[8]

   In many instances, IRAs are invested in the same investment funds with the same expenses as employer-sponsored plans, except that participants receive more service, flexibility, education, and support through an employer-sponsored plan.

[6] In Hecker, et al. v. John Deere & Co., et al., the Seventh Circuit Court of Appeals said, in its opinion upholding summary judgment for defendants, "Importantly, all of these funds were also offered to investors in the general public, and so the expense ratios necessarily were set against the backdrop of market competition. The fact that it is possible that some other funds might have had even lower ratios is beside the point; nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)." In Taylor, et. al. v. United Technologies, et. al., the United States Federal District Court for the District of Connecticut granted summary judgment to United Technologies in a case also alleging that employers breached their fiduciary duty by entering into record keeping and investment management arrangements in which excessive fees were charged.

[7] Sarah Holden and Michael Hadley, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses 2007," ICI Perspective 17, no. 5, Dec. 2008.

[8] Ibid.

Lower employer-sponsored plan fees result from the convergence of market-based competition and employers' fiduciary duty to act in the best interests of their plans and participants. Competition among mutual fund and other service and investment providers drives down costs as service providers vie with each other for market share. Employers play a substantial role in negotiating with service providers to obtain the best possible deal for their plans and participants. Many employers hire financial consultants and search firms to assist them in negotiating their plan fees with service providers. Employers have a fiduciary responsibility to act solely in the interest of plan participants and are specifically mandated by the Employee Retirement Income Security Act of 1974 ("ERISA") to assure that the plan pays no more than reasonable compensation for the provision of services to the plan.[9] Research supports these conclusions. At the end of 2007, about three quarters of mutual fund assets in 401(k) plans were held in no-load funds, and about one quarter were in load funds that do not charge retirement plan participants front-end loads. According to the research, employers also regularly review the performance and level of fees of the funds that are offered under their plans: 64% of employers report that they had replaced a fund in the previous two years because they were dissatisfied with its performance.[10]

2. **Myth** **Service providers make too much money.**

Fact **Employer-sponsored retirement plans provide participants with significant and costly administrative and investment services which may not be fully understood or recognized by legislators, regulators, employers, and employees.**

Another concern is that the system enriches service and investment providers at the expense of American workers. This narrow perspective of the current system overlooks many valuable services provided to workers in connection with their plan participation and the need for employers, plans and service providers to comply with complex, sometimes overlapping, and voluminous regulatory requirements.

Many of the costs associated with providing plan administrative services and complying with legal requirements are significant, the scope of which may not be fully appreciated by policymakers. In addition to investment management, some of the services that commonly are provided to plans include:

- record keeping – including 24-hour access to account information
- participant transaction processing
- phone/call center support with representatives available to assist participants for at least 10 hours per day
- preparation and distribution of required disclosure materials and other plan communication
- employee enrollment and education
- plan document services
- plan discrimination testing
- benefit claim and payment processing
- tax reporting, and
- QDRO determination and processing

[9] ERISA Section 408(b)(2) - which states (inter alia.) that the prohibitions of Section 406(b)(2) shall not apply to the contracting or making reasonable arrangements with a party in interest for …services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore.

[10] Sarah Holden and Michael Hadley, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses 2007," ICI Perspective 17, no. 5, Dec. 2008.

Provision of these services is capital- and labor-intensive and involves substantial start-up and maintenance expenses, especially in light of the ever-changing employee benefit legislative and regulatory environment.[11]

Contrary to many claims that retirement plan service providers are getting rich at the expense of plan participants, the industry has been consolidating over the past 10 years as many providers struggled to maintain a level of profitability that would justify staying in the business. Costs in the retirement plan industry have risen significantly in recent years because of increased system demands due to regulatory and legislative compliance (e.g., Securities and Exchange Commission ("SEC") Rule 22c-2, Pension Protection Act of 2006 requirements, including implementation of the capability to offer Qualified Default Investment Alternatives), as well as increased distribution costs, among other reasons. Record keepers continue to provide more services to their customers despite cost pressures and fierce competition among service providers in the retirement plan industry.

As a result of increasing costs and competitive pressures, more than 60 companies have sold their businesses in the past five years alone and the industry's pre-tax profit margin is estimated to be in negative territory for 2009.

As a result of these increasing costs and competitive pressures, more than 60 companies have sold their businesses in the past five years alone. More than 20 additional firms exited the record keeping side of the business during that period by outsourcing that function to third party service providers.[12] For most of the firms making these decisions, the aforementioned escalating demands for investments in technology, and product and service improvements, plus the costs of compliance in a constantly changing regulatory environment, were not worth the potential benefit of remaining in the business.

In fact, the industry's pre-tax profit margin averaged 21% from 2005 through 2007, a period when the Dow Jones Industrial average was between approximately 10,800 and 13,400. However, the 2008 average pre-tax profit margin is estimated to be approximately 10%, and in negative territory for 2009, because of the market collapse.[13] As is discussed in the next section, the majority of service provider revenue is derived from asset-based fees. Therefore, the degree of profitability within the industry is largely dependent on performance of the financial markets and is also tied to participants' results. Because of fierce competition in the retirement and investment management industries, service providers cannot readily raise their fees but still must provide the same level of quality service. In fact, due to the market decline, they have taken substantial fee cuts.

[11] Since 1980, there have been 27 separate amendments to ERISA and/or the corresponding provisions of the Internal Revenue Code. Each change requires service providers to make operational and systems related modifications to assure compliance with these amended laws and resulting regulations. Source: ERISA The Law and the Code, 2008 Edition, published by BNA, edited by Sharon F. Fountain, Esq.

[12] The SPARK Institute data.

[13] Ibid.

3. **Myth** **Lower paid workers are charged too much for plan and investment services and would be better off without an asset-based fee system.**

Fact **Lower paid workers pay reasonable fees, and asset-based fees offer them a pricing advantage.**

During discussions about the shortcomings of the current employer-based system, concerns have been raised about the unfairness of the asset-based fee structure, including the allegation that it erodes the savings of lower- and middle-income workers. Among the claims is that the fees paid by such individuals are excessive and that they would be better off without an asset-based fee system. The following discussion dispels this myth and demonstrates that lower- and middle-income workers are not over-charged and, in fact, receive the same services as highly compensated plan participants, who are very often the plan decision makers.

Discussion

As discussed above, under existing retirement law, employers must ensure that the services provided to their plans are necessary and the cost of those services is reasonable.[14] Additionally, current law provides flexibility to the plan sponsor to determine how the fees and expenses of the plan are paid. In any plan, all participants, regardless of income level, will pay more or less in administrative and investment fees based on the extent to which the employer elects to pay the fees itself and subsidizes the plan's expenses. Although under some plans, employers may require participants to pay all of the costs and expenses for plan administration and investments, many employers match employees' contributions to the plan. The employer's matching contribution generally exceeds the fees paid by participants with lower account balances. Therefore, such participants are generally much better off than they would be in an IRA. Other factors affect the costs of the plan, including the size of the plan both in terms of number of participants and assets, the geographic dispersion of plan participants, the complexity of the plan, the services selected by the plan sponsor, the services selected by the participants (e.g., optional investment advice), and other factors.

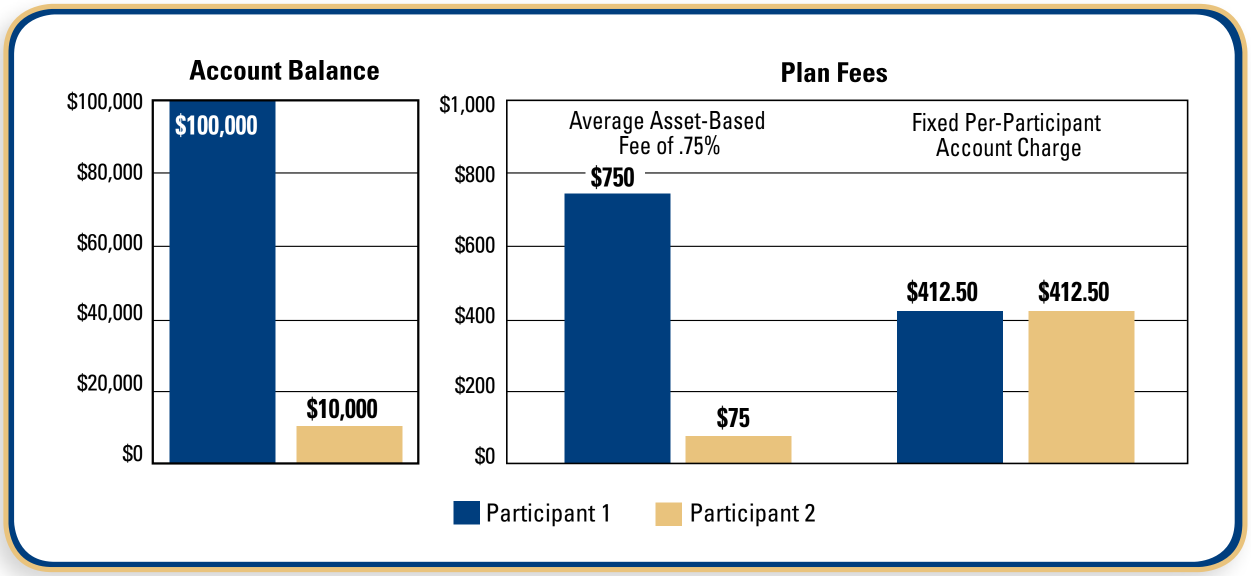
> ***In reality, the higher paid workers subsidize the lower paid workers' access to the same services and benefits, including, in many instances, lower cost investment options that the lower paid workers would likely not have access to anywhere else.***

Higher paid workers in plans with asset-based fees pay a larger share of plan expenses because they typically have larger account balances than the lower paid employees. For example, in a plan where the average asset-based fees are .75%, a participant with an account balance of $100,000 will pay $750 in fees and expenses, while a participant with a balance of $10,000 will only pay $75 for essentially the same services. Therefore, in reality, the higher paid workers subsidize the lower paid workers' access to the same services and benefits, including, in many instances, lower cost investment options that the lower paid workers would likely not have access to anywhere else.

[14] ERISA Section 408(b)(2).

An alternative to an asset-based system would be a fixed per-participant account charge. In the example above, assume the service provider needed the same total revenue of $825 ($750 + $75) to service both accounts. The fixed per-participant charge would be $412.50, which would create a disastrous result for the lower paid worker. This extreme example clearly demonstrates the fact that lower paid workers are generally better off under an asset-based fee system and that the claims of industry critics are not supported.

The chart below illustrates the examples discussed in the two preceding paragraphs.



4. **Myth** **The asset-based fee system provides a built-in fee increase mechanism for service providers that results in automatic annual fee increases.**

Fact **Service providers' fees fluctuate up and down based on market conditions, while fierce industry competition serves to keep fees low.**

The assertion made by critics of employer-based retirement plans that the asset-based fee system provides a built-in fee increase mechanism for service providers that results in automatic annual fee increases is inaccurate and misleading. This criticism assumes that the service provider is delivering a static level of service while the total assets in a plan are increasing. In fact, account balances may go up because new participants enter the plan and increase the demand for services that must be provided which, in turn, drives up providers' costs. Additionally, increases in revenue that result from higher total assets in the plan do not automatically result in increased profits. Fierce competition in the retirement plan service and investment management industries has not only prevented service providers from raising their rates but, to the contrary, has led to price declines while, at the same time, the industries continue to deliver and develop new, high quality products and services. So, while revenues may rise as the total account balance rises, the increased revenue merely allows service providers to cover the increased costs of providing their services. Furthermore, due to the rise and fall in the markets and the inflows and outflows from plans, asset-based fees tend to average out and mitigate any aberrational expenses and extreme market conditions. Simply stated, more profitable years or periods help the plan pay fees and the service providers to continue delivering services in years when profits are lower or when losses occur, such as in 2008 and as is expected for 2009.

Approximately 75% of revenues in the retirement services industry are generated by asset-based fees.[15] This fee structure has been almost universally accepted and is not inherently advantageous to service providers or detrimental to plan participants.

5. **Myth** **Smaller plans with lower total assets are overcharged by service providers.**

Fact **Smaller plans generally require more services and attention than larger plans relative to their size.**

There are certain fixed costs associated with operating all plans. Research validates that plan character impacts the costs that plan participants incur. It states: "Because there are some services that all plans must provide, plan size and average account size are important determinants of the cost of the plan relative to invested assets. For example, new plans with few assets likely will have higher costs per dollar invested than more mature plans with more assets and larger average account size."[16]

Due primarily to economies of scale, which result in down-scaling of fees once certain asset levels are attained, larger plans with higher total assets and more participants are more cost effective because there are more people and assets to share the costs. Larger plans from larger employers are also generally more efficient to service than smaller plans. Smaller plans from smaller employers very often require more attention and support relative to their size for a number reasons. Smaller employers tend to be more involved in running their own businesses and do not have internal staffs that are dedicated to supporting the plan. For example, small businesses generally do not have their own finance and human resources professionals to help operate their plans. Consequently, the business owners will rely on, and demand more support from, their service providers.

All plans have fixed costs that must be paid to ensure a basic level of service.

Plan fees are negotiated at the beginning of the service relationship and may also be renegotiated at any time by the plan sponsor. As noted above, certain costs are fixed and must be paid in order to ensure a basic level of service for the plan. Investment management fees are generally asset-based and vary according to the investments chosen by the plan sponsor, management style, asset class and other factors.

In summary, the fact that certain plans have fixed costs that must be paid to ensure a basic level of service, but have fewer employees and lower total assets to share those costs, does not mean that the plan or its participants are being overcharged for the services and benefits they receive.

[15] The SPARK Institute data.

[16] Sarah Holden and Michael Hadley, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses 2007," ICI Perspective 17, no. 5, December 2008.

6. **Myth** **If private sector employer-sponsored retirement plans were designed and operated like the federal Thrift Savings Plan, it would cost participants less in fees to participate in them and the services and features of the plans would be basically the same.**

Fact **Since the costs of maintaining the federal Thrift Plan get absorbed by federal administrative agencies and taxpayers and often cannot be quantified, cost comparisons with private employer-based plans are not reliable.**

Some critics of private sector employer-based retirement plans point to the federal Thrift Savings Plan ("TSP") as a model of success and cost efficiency. The fact is that the TSP is a unique plan that cannot be fairly compared with private sector employer-based plans for a number of reasons.

The TSP, for example, benefits from unmatched economies of scale. As the largest single DC plan in the U.S., it covers approximately 4 million workers and has over $200 billion in assets. By comparison, approximately 90% of 401(k) plans have fewer than 100 participants and about two-thirds have less than $1 million in plan assets.[17]

> ***The costs of maintaining the federal Thrift Savings Plan get absorbed by federal administrative agencies and taxpayers and often cannot be quantified, so cost comparisons with private, employer-based plans are not reliable.***

The SPARK Institute contends that the costs associated with operating the TSP are not fully known because many of the administrative and operational functions are performed by other government agencies. Also, the costs associated with those services (including government employees' compensation) are not known, are not taken into account in the analysis, or are not disclosed. Ultimately, such costs are paid indirectly by American taxpayers rather than the plan participants. Additionally, the TSP has lower compliance costs than private sector plans because the plan is not subject to the same rigorous and ever-changing laws and regulations as private sector plans.

Finally, costs are not the only factor in this analysis. The quality and flexibility of services provided, as well as innovations and advancements in products and tools for plan sponsors and participants, are also critical to the success of all retirement plan arrangements. The retirement plan and investment management industries have invested significant time, energy and resources into developing service models, products and features that have led to improvements in private sector plans as well as the TSP. For these reasons, The SPARK Institute does not believe that the TSP can or should be used as a basis for evaluating private sector employer-sponsored retirement plans.

[17] DOL, "Abstract of 2005 Form 5500 Annual Reports," February 2008.

7. **Myth** **The use of passively managed or index funds instead of actively managed funds would reduce the fees and expenses paid by participants for plan and investment services.**

Fact **Most administrative costs are fixed and pay for essential services, the provision of which is not dependent upon the type of investments offered by the plan.**

This argument can be broken into two parts. The first part is whether the use of index funds changes the economics of providing retirement plan services and whether that would reduce plan costs. In the following discussion, The SPARK Institute demonstrates that they do not. Some policy makers and industry critics propose the greater use of index funds in retirement plans as a "low cost" investment option alternative to actively managed funds. However, the use of index funds as a way of reducing plan costs relies on the misconception that doing so will change the economics of servicing a plan. Regardless of which funds are used in any plan, plan service providers must have a source of revenue to get paid. Plan sponsors and service providers can agree to fee arrangements that impose additional charges paid by participant assets invested in such funds in order to maintain the current revenue and economics of the plan. For example, additional asset-based fees can be charged against participants' accounts or paid by the plan sponsor, as the plan sponsor decides, outside of the index fund investment option in the plan. Accordingly, an index fund mandate will not change the economics of providing plan services, i.e. reduce the need to obtain necessary administrative services that would result in corresponding reductions in the costs associated with administration expenses.

The use of index funds as a way of reducing plan costs relies on the misconception that doing so will change the economics of servicing a plan.

The second part of the active versus passive investment management debate raises the issue of whether the incremental cost associated with active management can be justified by fund performance relative to appropriate benchmarks. This part of the debate is not unique to employer-sponsored retirement plans and is generally highly technical and beyond the scope of this white paper. Nevertheless, in the following discussion it is demonstrated that this ongoing debate should not be resolved by Congress or regulators in the context of saving for retirement through employer-sponsored plans.

Industry critics appear to want to unilaterally resolve the active versus passive management debate and declare passive management the winner. However, both types of funds are widely available and used inside and outside of retirement plans and have been for decades. Clearly, investors of all kinds, from the beginning investor to those who are seasoned, have voted with their investment dollars and created demand for both types of funds in a very competitive investment marketplace. If passive management was clearly and universally better than active management, and active managers were not providing value for the fees they charge, then it is hard to believe that active investment managers would have survived and thrived as long as they have.

So why has active investment management survived? To answer this question, the following information from the ICI is helpful: "[I]ndex funds are not necessarily a 'one-stop' solution for retirement investing. Index funds vary widely in their choice of index, which leads to widely varying risks and returns. [T]here is no one index fund that is right for all investors in all circumstances throughout all their investing life."[18] Index funds are hardly immune from market downturns. One of the largest indexed investments, the federal Thrift Savings Plan's C Fund, which attempts to track the S&P 500 index, was down 37% in 2008. The TSP's indexed I Fund, which attempts to track the Morgan Stanley Capital International EAFE Index, was down 42%.[19] Actively managed funds, like index funds, can be excellent investments. The returns that investors receive on either kind of fund will depend heavily on the mix of actively managed and index funds that are considered, as well as the period over which returns are measured. For example, the ICI examined the top 10 mutual funds (in terms of 401(k) assets) in 1997, which included some actively managed funds and some index funds. Over the 10-year period to 2007, an investment made at year-end 1997 in those actively managed funds would have earned a higher return (6.82%, net of fees) than a comparable investment made in the index funds (5.83%, again net of fees).[20]

The SPARK Institute does not believe that the wholesale use of passively managed funds by legal mandate will reduce plan fees and expenses and that policy makers should not unilaterally determine which approach to investing is better for American workers saving for retirement.

Based on the foregoing, The SPARK Institute does not believe that the wholesale use of passively managed funds by legal mandate will reduce plan fees and expenses or that policy makers should unilaterally determine which approach to investing is better for American workers saving for retirement.

B. Fee Disclosure

There has been considerable discussion, debate and criticism over the past two years regarding fee disclosure with respect to employer-sponsored retirement plans, particularly 401(k) plans. Industry critics claim that plan sponsors and participants do not understand their retirement plan and investment related fees and expenses because the information is not being adequately disclosed. Harsher critics go as far as to accuse the industry of active withholding of information in order to conceal alleged excessive fees. These criticisms by certain policy makers, trade groups, members of the media, plaintiffs' lawyers and academics have, in the opinion of The SPARK Institute, unfairly disparaged the entire employer-sponsored retirement plan system, as well as the retirement and investment services industries.

[18] "10 Myths About 401(k)s and the Facts," ICI, February, 2009.

[19] See http://www.tsp.gov/rates/annual-returns-tsp-indices.html.

[20] "10 Myths About 401(k)s and the Facts," ICI, February, 2009.

The fact is that the vast majority of retirement plan and investment providers offer substantial, detailed and understandable information about plan fees and expenses to plan sponsors above and beyond what is already required by law. However, The SPARK Institute believes that there is always room for improvement and changes and, therefore, supports the following:

Plan Sponsors – The SPARK Institute continues to support and encourage fee transparency that will help plan sponsors (1) understand the fees and expenses for retirement plan and investment products and services, and (2) make decisions on a fully informed basis. Any statutory or regulatory framework must be flexible and adaptable to the broad array of products and service structures, and must be able to accommodate the competitive and ever-changing nature of the retirement plan and investment industries.

Participants – The SPARK Institute believes that participants should be able to understand what they are paying for their workplace retirement plan. Fee disclosure should be part of an overall assessment made by participants that also covers investment performance and other plan-related services and information.

Greater fee transparency will ultimately benefit not only plan sponsors and plan participants, but also the retirement plan and investment management industries. In fact, most retirement plan service and investment providers already provide significant detailed disclosures about fees and expenses, and are ready, willing and able to facilitate reasonable and useful additional disclosures that may be required under new laws and regulations.

The following is more detailed discussion and comment on some of the specific claims made by industry critics and The SPARK Institute's views on them.

Discussion

The SPARK Institute is concerned that critics incorrectly blame the retirement plan and investment industries as a whole for plan sponsor misunderstanding or confusion about plan and investment fees and expenses. The fact is that the fees and expenses associated with operating a retirement plan and its investment options are complicated. Complexity derives from the diversity of investment products, the diversity of service provider business models, and the demands of plan sponsors to shift costs to participants. Additionally, the investment products available through employer sponsored-retirement plans are diverse and include mutual funds, insurance company annuities and separate accounts, bank collective trusts and other pooled investment products, brokerage windows, employer stock, and other investment vehicles. These products are regulated by varying and overlapping federal and state agencies (e.g., DOL, SEC, OCC, FINRA, and state insurance regulatory agencies) and are subject to many complex and often contradictory disclosure rules that do not consider the unique needs of retirement plans and their participants. A recent AARP commentary picked up on this issue and noted, "The unsatisfactory state of disclosure of 401(k) plan fees results in part from the fragmented regulation of both 401(k) plans and of the financial institutions that market and manage the asset classes in which participants invest."[21]

[21] "Determining Whether 401(k) Plan Fees are Reasonable: Are Disclosure Requirements Adequate?" AARP Public Policy Institute, September 2008

Service providers and investment managers have worked for many years to address these issues. Recent studies indicate that the majority of plan sponsors know more about the fees they pay providers, advisers and consultants than they did three years ago. Some 84% of respondents said they received written fee disclosure statements from their plan providers, and 88% received one from their advisers and consultants.[22] Another survey revealed that more than three-quarters of defined contribution plan executives are fully confident that investment fees and administrative costs associated with their 401(k) plans have been properly disclosed.[23]

The vast majority of plan service and investment providers recognize that it is good business to disclose fees and that fee disclosure helps them avoid potential misunderstandings by, and claims from, plan sponsors, plan participants and regulators. Additionally, most service and investment providers are already subject to rules and regulations that require them to provide and make available substantial amounts of information about their services, investment products and related fees and expenses.

The SPARK Institute Recommendation - The SPARK Institute believes that improvements can and should be made in how fees and expenses are disclosed to plan sponsors. The SPARK Institute supports transparency among all investment options, regardless of whether they are subject to securities laws, so that sponsors and participants have adequate and useful information to compare their investment options. However, because of the variety of investment options available and differences among them, not all of the same information for each option is applicable, available, useful or cost effective to gather and provide. Ultimately, the best approach will be one that is flexible and concept-based. It will allow service providers to tailor disclosures with comparable information for each offered investment option and ultimately will provide the detail necessary for both sponsors and participants to understand the fees and expenses related to each option and to make informed choices. Information about plan and investment fees and expenses should be more readily available in simplified formats that will facilitate fully informed decisions by plan sponsors. However, fee disclosure is not a one dimensional issue with a single solution. A legislative and regulatory framework under which plan sponsors can make "apples to apples" comparisons of plan and investment fees and expenses is conceptually appealing, but creating a single solution for plan sponsor or participant fee disclosure is not feasible or practical.

A coordinated legislative and regulatory framework should establish conceptual requirements for fee disclosure to plan sponsors by service providers.

A coordinated legislative and regulatory framework should establish conceptual requirements for fee disclosure to plan sponsors by service providers. The framework and requirements should establish the basic elements of required disclosure, but permit each service provider to meet its obligations in a reasonable format of its own choosing. Such flexibility will allow the retirement plan and investment industries to reasonably address the diversity and complexities of their products, business structures, and plan sponsor needs, adapt to changes in the future, and make the necessary disclosures in a cost-effective manner. Market forces, industry best practices, and the threat of regulatory enforcement actions should be allowed to drive service provider compliance through cost-effective and reasonable approaches.

[22] Spectrem Group online survey, October 2008.

[23] Mercer online survey, June 2008.

1. **Myth** **Plan participants don't understand that they may be paying the fees and expenses associated with the administration and investments of their retirement plan.**

Fact **Employer-sponsored retirement plans are a valuable and cost-effective way for American workers to save and invest to reach their retirement goals, even though many participants are unwilling to devote the time to review and understand the information provided to them about their plans' administrative and investment fees and expenses.**

Industry critics also blame the retirement plan and investment industries for plan participants not understanding that they may be paying the fees and expenses associated with the administration and investments of their retirement plans. Employers offer retirement plans to employees as an employee benefit, and many employees may assume that the plan is free or that the employer must be paying the costs associated with operating the plan. Most of what is written about fee disclosure to participants ignores the distinction between participants knowing and understanding that they are paying some or all of the fees and expenses associated with the plan, and the amount of such fees and expenses.

It has been pointed out elsewhere in this paper that retirement plan and investment fees and expenses are complicated for a variety of reasons, including the fact that employers have found it necessary to shift the cost burdens of offering retirement plans to plan participants. Ultimately, the plan sponsor determines whether it or the employees will pay the plan expenses, and in its capacity as a plan fiduciary, how those expenses are paid and disclosed to plan participants. The manner of disclosure varies depending on the type of fee and the investment product.[24] It is also the plan sponsor, not the service provider, that determines what information about plan fees and expenses is given and made available to participants. Service providers cannot, and should not, be expected to force or insist that plan sponsors provide information that the plan sponsor is unwilling to provide to participants, and that the plan sponsor is not otherwise required by law to provide.

The vast majority of providers already either provide or make available substantial amounts of information to help participants understand that they are paying some or all of the plan and investment fees and expenses and how much they are paying.

As noted above, the retirement plan and investment industries are subject to extensive rules and regulations. The vast majority of providers already either provide or make available substantial amounts of information to help participants understand that they are paying some or all of the plan and investment

[24] Investment and record keeping fees and expenses constitute the vast majority of total plan fees. Fees can be asset-based (i.e., a percentage of assets), account-based (e.g., certain dollar amount per participant account), or transaction-based (e.g., plan loan or distribution fees). Asset-based fees can be either embedded in an investment fund (i.e., meaning that the return of the fund is reported net of fees and expenses) or charged outside of the investment funds. Fees that are embedded in a fund (e.g., a mutual fund expense ratio) are inherently paid by the investor (e.g., the plan participant). Fees and expenses that are not embedded in an investment fund may be paid by the plan sponsor or the plan sponsor may elect to charge or allocate them among the plan participants. The plan sponsor elects how to report the account- and transaction-based fees and expenses to participants, and may include specific information on participant statements. Generally, with respect to fees and expenses that are not embedded in an investment fund, the plan sponsor has significant discretion regarding how to disclose such amounts to plan participants.

fees and expenses and how much they are paying. However, neither plan sponsors nor service and investment providers can force plan participants to devote the time and energy to review and understand the information they need to save, invest and prepare for retirement. It is harder still to get participants to think about plan fees and expenses. Many participants simply will not take the time or devote the energy to figure out plan and investment fees and expenses regardless of how much information is provided or made available to them. Even critics such as AARP acknowledge that "[m]ore complete dissemination of 401(k) fees by plan sponsors might not dispel [participants'] ignorance…."[25]

The SPARK Institute supports measured and reasonable changes in existing laws and regulations that would require plan sponsors to provide or make available to participants more information about the plan fees and expenses that the participants pay.

Considering these factors, The SPARK Institute is very concerned about the practice of some critics to blame the retirement plan and investment industries for participants' lack of understanding about these matters. A strong case can be made for the fact that it is a combination of simple human nature and the "do it for me" preferences of a significant number of American workers when it comes to retirement saving and investing. In fact, The SPARK Institute believes that workers who save for retirement through IRA arrangements do not understand their fees and expenses any better and, most likely, understand less about them because their employer is not involved. Employer-sponsored retirement plans are a valuable and cost-effective way for American workers to save and invest to reach their retirement goals, even though many participants do not understand, and do not try to understand, the details and complexities of the plans' administrative and investment fees and expenses.

The SPARK Institute Recommendation – As recommended in the previous section, The SPARK Institute believes that improvements can and should be made in how fees and expenses are disclosed. The SPARK Institute supports measured and reasonable changes in existing laws and regulations that would require plan sponsors to provide or make available to participants more information about the plan fees and expenses that the participants pay. Information about plan and investment fees and expenses should be more readily available in simplified formats that will facilitate fully informed decisions by participants without providing an abundance of details that do not materially help the participants' decision-making processes. The best approach will be flexible in allowing plan sponsors, service providers and investment companies to tailor disclosures to their participants' needs.

[25] Determining Whether 401(k) Plan Fees are Reasonable: Are Disclosure Requirements Adequate?" AARP Public Policy Institute, September 2008

2. **Myth** **Since plan participants rather than the plan sponsor may pay for the plan administration and investment fees and expenses, plan sponsors may not have an incentive to manage the plan fees and expenses.**

Fact **Existing laws and regulations that govern employer-sponsored plan fees create significant incentives for plan sponsors and service providers to manage the fees and expenses paid by the plan.**

The SPARK Institute is very concerned about claims that plan sponsors may not have an incentive to manage plan fees and expenses because plan participants may pay for all or part of the plan administration and investment fees and expenses. Some critics allege that plan sponsors have no incentive to ensure that plan fees and expenses are reasonable. These critics attempt to disparage the entire employer-sponsored retirement plan system by assuming that all plan fees and expenses are excessive and harming American workers.[26]

Under existing retirement plan laws and regulations, however, any fees and expenses charged against the assets of a plan must be reasonable.[27] Additionally, a plan fiduciary, typically officers and executive representatives of the employer, must independently review and approve such fees and expenses.[28] Moreover, any fees and expenses that are paid to a service provider that are not properly authorized by an independent plan fiduciary or that are unreasonable for the services provided would violate existing laws and are subject to forfeiture and penalties.[29]

Retirement plan laws and regulations do not require plan sponsors to hire the lowest cost service provider or to use the lowest cost investment options. Many factors go into the decision-making process regarding plan services, plan investment options and the related fees and expenses. When representatives of plan sponsors act unreasonably, imprudently or for the benefit of anyone other than plan participants and beneficiaries, they open themselves up to possible termination and potential corporate or personal liability as a result of litigation and regulatory enforcement actions. The SPARK Institute believes that the vast majority of retirement plan service and investment providers and plan sponsors act properly to manage plan fees and expenses and ensure that they are reasonable for the services being provided. As noted above, however, The SPARK Institute believes that, as with anything, there is always room for improvement.

The SPARK Institute Recommendation - The SPARK Institute believes that the existing laws and regulations that govern plan fees and expenses provide the necessary incentives for plan sponsors and service providers to manage fees and expenses. Additionally, the recent attention that has been devoted to plan fees and expenses has reinforced the importance of these matters to plan sponsors. The combination of heightened awareness with respect to these issues by all affected parties, increased fee disclosure, and the potential for litigation and enforcement actions, will continue to persuade plan sponsors and the retirement services and investment management industries to ensure that the fees charged for plan services are reasonable, regardless of whether such fees are paid by sponsors or participants.

[26] Rep. George Miller statement at Committee mark-up of H.R. 3185, 4/16/2008; Rep. Miller, Motley Fool interview 12/17/2008; "Determining Whether 401(k) Plan Fees are Reasonable: Are Disclosure Requirements Adequate?" AARP Public Policy Institute, September 2008.

[27] ERISA, 29 U.S.C. §§1001-1461.

[28] Ibid.

[29] Ibid.

3. **Myth** **Plan administration and investment service fees and expenses in a bundled service arrangement must be disclosed and broken out on an unbundled basis for the employer/plan sponsor and participants to make necessary decisions on an informed basis.**

Fact **The bundled versus unbundled fee disclosure debate detracts attention from the real issues of providing clear and understandable information for plan sponsors to evaluate the products and services necessary to operate their plans.**

The discussions about fee disclosure have also included debates over how to deal with and develop uniform disclosure among different product and service structures and business models such as "bundled" and "unbundled" service and investment arrangements. As a result of plan sponsor demand, it is now commonplace in the retirement plan industry for record keepers and third-party administrators ("TPAs") to make available to plan sponsors a menu of both mutual funds that it or an affiliate manages, as well as mutual funds that are managed and distributed by unaffiliated third parties (i.e., non-proprietary funds).[30] In addition to allowing plan sponsors to choose between proprietary and non-proprietary mutual fund options, generally referred to as "open architecture," the record keeper provides most or all of the record keeping and administrative services to the plan. Under these arrangements, which are sometimes referred to as "bundled arrangements," plan record keepers typically have a menu of non-proprietary funds for which they have trading agreements and arrangements in place in order to be able to make such funds available.

The bundled versus unbundled fee disclosure debate detracts attention from the real issues of providing clear and understandable information for plan sponsors to evaluate the products and services necessary to operate their plan.

The bundled versus unbundled disclosure debate is complicated by, among other things, the fact that these arrangements come in a variety of forms, continue to evolve in an ever changing market, and are not easily or adequately defined.[31] Unbundled providers argue that their products and services may appear to be more expensive to plan sponsors when compared to the same or comparable services that are offered

[30] The competitive forces in the retirement plan industry have dictated that plan service providers make non-proprietary investment products available as investment options to plans with at least $5 million in assets. For smaller plans (i.e., those with less than $5 million in assets), many plan record keepers may provide most or all of the administrative services but only offer their proprietary investment funds as investment options. The investment option limitation is a product design issue driven by the economic realities and costs associated with servicing smaller plans.

[31] The term "bundled arrangement" does not have a universally accepted definition in the retirement plan industry. A significant amount of confusion stems from the fact that there are several different types of bundled service providers and arrangements. Under arrangements typically found in smaller plans, a record keeper provides all of the administrative services and only offers its proprietary investment funds as investment options. The investment option limitation is a product design issue driven by the economic realities and costs associated with servicing smaller plans. Such arrangements are "fully bundled." In another type of bundled arrangement available to most plans with more than $5 million in assets, however, a record keeper provides comprehensive administrative services together with proprietary and non-proprietary investment options (i.e., open architecture investment options). Such arrangements are frequently included in references to bundled arrangements, a description that overlooks and creates potential confusion regarding the open architecture aspect of the arrangements. Under a third type of arrangement, a record keeper provides comprehensive administrative services, together with open architecture investment options using only non-proprietary investment options. This type of bundled arrangement is available from service providers that do not manage proprietary investments and are not affiliated with a mutual fund company or an investment manager. Such record keepers, however, usually consider themselves to be bundled service providers.

through a bundled service provider. Bundled service providers argue that they may not offer à la carte or unbundled services, may not have unbundled pricing or cost information available, and therefore should not be forced to provide cost or pricing information for each component service. Bundled providers add that any such unbundled pricing information is inherently arbitrary, hypothetical, unreliable, and potentially misleading, particularly when the service provider does not offer the individual services on an à la carte or unbundled basis. The DOL recognized that bundled providers should not be obligated to provide unbundled pricing information, nor to disclose the internal allocation of costs and fees among affiliated companies.[32]

The SPARK Institute Recommendation - The bundled versus unbundled fee disclosure debate detracts attention from the real issues of providing clear and understandable information for plan sponsors to evaluate the products and services necessary to operate their plan. Plan sponsors will have their own preferences toward either bundled or unbundled product offerings and have the ability and right to request information that they deem necessary in order to evaluate service providers. Similarly, service providers should have the ability to structure their products and services on an unbundled or bundled basis and price their products and services as they choose.

Plan sponsors have the ability to request information from prospective or existing service providers. Service providers have the option to comply with such requests in the hopes of winning new, or retaining existing, business. Alternatively, service providers can decline to provide information at the risk of losing new or existing business. Market forces, industry best practices, the threat of litigation, and the threat of regulatory enforcement actions should drive industry behavior instead of legislative and regulatory mandates to provide artificial pricing and cost information. The SPARK Institute believes that, ultimately, the bundled versus unbundled disclosure debate is more about companies with different product structures, service models, product and service capabilities, and pricing structures debating about market forces and competition than alleged defects in disclosure of employer-sponsored retirement plan fees. The SPARK Institute does not believe that new laws and regulations should attempt to resolve this business debate.

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[32] DOL Proposed Rule under 29 CFR Part 2550, Reasonable Contract or Arrangement under Section 408(b)(2) – Fee Disclosure, December 17, 2007.