

Fund Democracy  
Consumer Federation of America

September 8, 2008

FILED ELECTRONICALLY

Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Room N-5655  
Department of Labor  
200 Constitution Avenue  
Washington, DC 20210

Re: Participant Fee Disclosure Project

Dear Ms. Halliday,

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

In an earlier comment letter, we set forth the principles that should guide the disclosure of 401(k) fees,<sup>1</sup> and the Department's proposal substantially reflects key elements of those principles. For example, the Department proposes to require that all fees appear in a standardized, tabular format, which will be a significant improvement over fee disclosure for non-standardized investment options and the disclosure of plan expenses. The Department also proposes to require the disclosure of certain fees as a dollar amount and that this disclosure appear in participants' quarterly account statements. We applaud the Department for taking decisive steps to direct the attention of fee-insensitive participants to the impact of fees in a document that they are likely to read and in a way that is likely to draw their attention to the fees. As a whole, the proposal makes significant progress in increasing the transparency of 401(k) fees, promoting greater competition in the 401(k) marketplace, and, ultimately, helping to secure Americans' financial security in retirement.

---

<sup>1</sup> See Letter from Mercer Bullard, Founder and President, Fund Democracy, and Barbara Roper, Director of Investor Protection, Consumer Federation of America to Office of Regulations and Interpretations, Employee Benefits Security Administration, Department of Labor (July 24, 2007) available at <http://www.funddemocracy.com/401k%20fee%20letter%20final.pdf>.

In some respects, however, we believe that the Department's proposal can be improved. Our principal recommendations are as follows:

- Total Fee Disclosure: Investment option fees and administrative fees should be disclosed together in order that plan participants can evaluate the total cost of the 401(k) plan.
- Revenue Sharing: Fee disclosure should avoid misleading participants by suggesting false comparisons between investment option fees that include administrative fees (*i.e.*, that compensate plan administrators through revenue sharing) and investment option fees that do not.
- Comparative Fees: Comparative fee information should be disclosed across comparable asset classes in order to promote competition among service providers.
- Quarterly Statement Disclosure: The disclosure in the quarterly statement of fees in dollar amounts should reflect total plan fees paid by the participant and clearly segregate fees that are specific to the participant.
- Differential Compensation: In order to fully apprise participants of the adviser's potential conflicts of interest, fee disclosure should include a prominent description of any compensation received by an adviser in connection with providing advisory services to a participant that may vary based on the participants' decisions with respect to the plan.

We look forward to working with the Department toward a final proposal that will provide the 401(k) plan participants with the kind of fee disclosure that will help them receive as much of the performance of the market as possible and thereby achieve financial security after their retirement.

## BACKGROUND

As noted, we previously provided comments to the Department regarding 401(k) fee disclosure. Rather than restate these comments, we incorporate them by reference in this letter. To summarize, we have listed below the key policies that we believe that 401(k) fee disclosure should promote:

- Fee Insensitive Participants: Fee disclosure should target 401(k) participants who are less likely to be sensitive to the impact of fees on their investment returns by locating disclosure where fee insensitive participants are likely to review it and in a format that such participants are likely to understand.
- Total Fee Disclosure: Fee disclosure should clearly present the total cost of the plan in one place so as to facilitate comparisons and promote sensitivity to the

true impact of fees on participants' investment returns.

- Comparative Information: Fee disclosure should promote competition by providing or at least facilitating comparisons across products and services both at the investment option and plan levels.
- Differential Compensation: If differential compensation is allowed for those who advise 401(k) participants, then fee disclosure should include specific information as to the amount of and trigger for such compensation paid to advisers: (1) at or before the initiation of the relationship with the adviser, (2) at the time of each recommendation of an investment option in connection with which differential compensation is received, and (3) annually as long as the relationship with the adviser continues.

Like the Department, we believe that fees can have a significant impact on a 401(k) participant's account balance at retirement and that improving fee disclosure can help reduce fees. We especially appreciate the Department's unequivocal position on the relationship between fee disclosure and excessive fees. The Department found a wide dispersion in 401(k) fees that it attributes "to market inefficiencies"<sup>2</sup> and estimates – "conservatively" – that "plan participants on average pay fees that are higher than necessary by 11.3 basis points per year."<sup>3</sup> One form of market inefficiency is the confusing way in which 401(k) fees are currently disclosed. We strongly agree with the Department's expectation that its fee disclosure proposal will "result in the payment of lower fees for many participants. . . . as more fee transparency fosters more price competition in the market."<sup>4</sup>

#### FEE TABLE

The clearest example of how fee disclosure creates market inefficiencies is the current practice of providing investment option fees and plan fees in separate locations, and providing plan fees in a format that is difficult to understand or use for comparison purposes. Plan fees currently are required to be disclosed only in Form 5500 as a dollar amount on a plan-wide basis. Mutual fund fees (when they are the investment option) are disclosed in a fee table in the prospectus as a percentage of assets. Providing fee disclosure in the prospectus and Form 5500 makes it impracticable for participants to determine the total cost of their 401(k) plans. They cannot even compare fees of investment options because there is no standardized set of rules that applies across all

---

<sup>2</sup> Text accompanying note 11 (citing Investment Company Institute, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses* (2006)).

<sup>3</sup> Text accompanying note 13.

<sup>4</sup> Text accompanying notes 14 – 15 (citing James J. Choi, David I. Laibson, and Brigitte C. Madrian, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds," NBER Working Paper W12261 (May 2006) (finding "that presenting the participants with a comparison fee chart, and not just a prospectus, reduced the fees paid by 12% to 49% depending on the group studied"))).

types of investment options. Further, fees for certain services are included in investment option fees in some cases and in plan fees in others.

The Department's proposal to require disclosure of standardized fees for all investment options in a single fee table represents significant progress toward fee disclosure that will promote competition and reduce fees paid by 401(k) participants. The proposal will enable participants to compare the costs of different investment options and make a more informed investment decision. This will, in turn, promote competition among investment option providers and reduce fees. For example, participants will be able to compare easily the cost of an actively managed U.S. stock fund with the cost of a passively managed U.S. stock fund (if offered) and thereby make an informed decision as to which form of management provides a better value. Similarly, the proposed disclosure for plan fees will constitute a significant improvement over the Form 5500.

We are concerned, however, that the fee disclosure will be deficient – and even misleading – in important respects. One drawback of the proposal is that the investment option fees and plan fees would continue to be presented separately. We appreciate that it is important to encourage participants to compare the cost of different investment options within a 401(k) plan, but the separate presentation of investment option fees and plan fees effectively discourages the comparison of 401(k) fees with fees charged by other types of investment accounts. We recognize that, at one time, it would have been rare for an investor to be better off investing outside of their 401(k) plan, but changes in tax laws, the proliferation of tax-deferred investment vehicles, and the availability of low-cost mutual funds have created an environment in which many participants may be better off foregoing a high-cost 401(k) plan (although probably never to the extent of an employer matching contribution, if offered).<sup>5</sup>

We believe that the Department should design fee disclosure that facilitates not only comparisons within the plan, but also comparisons with investment options outside of the plan. Fee disclosure for 401(k) plans should show all of the costs of the plan in a single table that provides a total expense ratio for each option, including administrative expenses. Presenting the investment option fees and administrative fee separately will make it unlikely if not impracticable for participants to evaluate the total cost of the plan and compare it with non-plan investment options.

Another drawback of the proposal is that it encourages comparisons among investment options that are not truly comparable. The Department's Model Comparative Chart shows the fees for a Large Cap, International Stock and Mid Cap ETF option stacked one above the other in a single column. This is a false and potentially harmful comparison. Historically, large cap funds have been less expensive to operate than mid cap funds, which have been less expensive to operate than international funds. The Chart creates the impression that the international fund is more expensive relative to the others

---

<sup>5</sup> See Testimony of Mercer Bullard before the Senate Special Committee on Aging at 7 – 8 (Oct. 24, 2007) (chart showing larger balance after 20 years in taxable account than in 401(k) account) *available at* <http://www.funddemocracy.com/Senate%20Aging%20Testimony%2010.24.07.pdf>.

and this factor should count as a strike against it,<sup>6</sup> even if the international fund's fees were lower than the average for an international fund and the fees for the other two funds were above average relative to their peers. Thus, the investor might be inclined to choose the most expensive funds (relative to their class) while also failing to gain the benefit of diversification that investing in all three asset classes would provide. Most financial planners recommend that clients diversify their investments among different asset classes notwithstanding that this will mean paying higher fees for certain types of investments. The point of fee transparency is not to promote competition among different asset classes, but among providers of product offerings within a single asset class.

The appropriate fee comparison for the Large Cap fund would be fees charged by the average Large Cap fund or the average offered by 401(k) plans. This information would apprise participants of the cost of the Large Cap fund offered by the plan relative to its peers and promote competition among Large Cap funds and plan sponsors to provide lower cost alternatives. We recognize that there is no universally accepted standard for determining the appropriate average fee to use as the benchmark for a particular type of fund, but it should not be difficult to generate one. The fund management industry cannot credibly complain, as it has in the past, that an objective classification standard would be too difficult to implement or understand when it willingly identifies funds as belonging in particular asset classes and other categories for marketing purposes, a practice that certainly implies that funds have an objective basis for doing so. Third-party information providers such as Morningstar and Lipper also have provided comparative fee information on funds in the same asset classes that fund boards use to satisfy their fiduciary duty to ensure that fund fees are reasonable. The data are available; there is no excuse for not providing it to 401(k) participants.

As illustrated by our proposed fee table at Exhibit A to this letter, 401(k) fee disclosure should provide participants with direct comparisons to similar types of funds. The classifications for different types of funds exist. It only remains for the Department to require that plans use this information in a way that will shine a spotlight on investment options whose fees significantly exceed a reasonable average. It is frankly remarkable that regulators require that the performance of a benchmark investment be disclosed with the presentation of an investment option's investment performance, while not requiring the same type of disclosure for fees. Studies have consistently shown that past mutual fund investment performance has a weak (if any) relationship to future performance, whereas fees and their impact are, obviously, very predictable from year to year. Requiring disclosure of benchmark fees would actually provide participants with meaningful information with which to make investment decisions and, we believe, have a profound impact on competition. In contrast, the most appropriate accompaniment for one-year investment performance data generally would not be the performance of a

---

<sup>6</sup> The actual Chart does not do this because the illustrative fee amounts are unrepresentative. The Large Cap fee is 2.45% and the International fee is 0.79%. The Mid Cap fee is only 0.20%, probably because it is actually a passively managed fund (as of the date of the Department's proposal virtually all ETFs were passively managed).

benchmark, but rather a statement that the information reveals nothing about the relative merits of the investment.

A third drawback of the proposal is that participants, particularly fee-insensitive participants, will be inclined to assume that the fees that they see in one location reflect the total fees they will incur. If they review the investment option fee disclosure, they will tend to assume that those fees represent the total cost of the plan, and vice versa for those who review the administrative fee disclosure. This is not such an unreasonable assumption, for it seems counterintuitive to provide the fees for a single 401(k) plan in two parts in two separate locations. The Department has noted that the “lack of transparent fee disclosure in this market suggests . . . that individuals may underestimate the impact that fees and expenses can have on their account balances.”<sup>7</sup> The separate disclosure of investment option fees and administrative fees will often cause participants to underestimate the total cost of the plan. We believe that it is imperative that the total fees for a 401(k) plan be presented in a single location.

A final drawback of the proposal is that it does not account for the different ways in which fees are charged by different plans. Fees for certain services may be charged at either the investment option level or the plan level. Specifically, certain administrative fees such as those charged for recordkeeping, accounting and legal services can be collected by the plan’s third party administrator (“TPA”) or by the investment option. When the fee is collected by the investment option and the services are actually provided by the TPA, the investment option remits the fees to the TPA. This practice is commonly referred to as “revenue sharing.” When the administrative fees are charged at the investment option level, they will appear in the investment option fee disclosure and make the investment option fees seem higher and the plan fees lower. When they are charged at the plan level, they will appear in the plan fee disclosure and make the plan level fees seem higher and the investment option fees lower.

This diversity of practice has the potential to create confusion among participants who compare the investment option fees to investment options in other 401(k) plans or to investments in other types of tax-deferred and taxable accounts. The Department’s proposal does nothing to resolve that confusion. When the 401(k) plan investment option fees do not include administrative expenses that are paid to the TPA, then the 401(k) plan investment option fee will be artificially suppressed and seem lower, in comparison, than it actually is because the disclosure of the 401(k) plan’s administrative fees will be provided in a separate location. If all expenses were combined in one place, as illustrated in Exhibit A to this letter, the true total cost of the 401(k) plan option would be transparent and provide a meaningful comparison.

#### QUARTERLY STATEMENTS

We also agree with the Department’s decision to require the disclosure of fees in dollars in the quarterly statement, as opposed to disclosure only as a percentage of assets

---

<sup>7</sup> Text accompanying note 11.

and only in plan documents. The primary target of 401(k) fee disclosure should be participants who are less sensitive to the impact of fees on their 401(k) accounts. These fee-insensitive participants are less likely to review plan documents for the purpose of evaluating fees charged to their accounts, and they are less likely to appreciate the impact of fees expressed as a (small) percentage of assets. These participants are more likely to review their quarterly statements, and they are more likely to take note of fees expressed as a dollar amount, especially when presented in the context of the dollar value of the participant's account. To illustrate, a 2% fee might seem insignificant to a less savvy 401(k) participant, but the presentation of a quarterly fee of \$500 on an account with a \$100,000 balance is likely to increase the likelihood that the participant will consider whether their fees could be reduced by switching to another fund in the 401(k) plan or choosing a lower cost investment in a taxable account.

We are concerned, however, that the quarterly statement disclosure will be misleading because it will not show the participant's total fees. As discussed above, participants will be inclined to assume that the fees disclosed in their quarterly statement reflect all of the fees they paid for the quarter. In fact, unless the proposal is amended, the quarterly disclosure will not show the investment option fees and will further understate total fees when fees for administrative services provided by the TPA are charged at the investment option level. Quarterly statement fee disclosure should show the participant's total fees. As noted in our previous comment letter, this disclosure need not necessarily show the actual dollar amount paid by the participant (we recognize the potential expense of such disclosure), but rather could reflect a rough estimation based on the account's beginning, ending or average account size. The goal here is not the precision of the disclosure, but rather the dollar format and the prominent location. Even an estimate will provide more accurate information than the partial information proposed to be disclosed.

Another difficulty is that the fee disclosure in the quarterly statement will be inconsistent across different plans. As discussed above, certain administrative services can be charged at either the investment option level or the plan level. This means that the fees disclosed in the quarterly statement for one participant may include fees for these services, whereas the fees disclosed on his neighbor's quarterly statement might not and would appear (artificially) lower.

Further confusion may be created by the mixing of participant-specific expenses with plan administrative expenses. The Department proposes that the "amounts actually assessed" for individual expenses, such as expenses attendant to a qualified domestic relations order, a loan to a beneficiary or investment advisory services be disclosed, and permits such disclosure to be provided "in a quarterly benefit statement." We believe that it would be extremely confusing for the dollar amount of administrative (or total plan expenses, as discussed above) to be combined with the dollar amount of individual expenses as an aggregate number. Based on the wording of paragraphs (c)(2)(ii) and (c)(3)(ii) of rule 404a-5, we assume that the Department does not intend to permit such combining of these expenses and suggest that it clarify this position to avoid any doubt.

However, even if the dollar amounts for administrative (total) and individual expenses are presented separately, as the rule seems to require, we are concerned that participants might not appreciate the important differences between the two types of expenses. We recommend that the Department require that administrative (total) expenses be presented in the quarterly statement in a way that makes it clear that the former are plan expenses and that the latter are expenses incurred on account of individual services provided to the beneficiary.<sup>8</sup> We believe that similar explanatory disclosure should be provided where information about the individual expenses that might be assessed is disclosed at the time of the beneficiary's eligibility and annually thereafter pursuant to paragraph (c)(3)(i).

## CONFLICTS OF INTEREST AND DIFFERENTIAL COMPENSATION

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

Distribution compensation generally is paid out of other fees that already will have been disclosed to beneficiaries. This means that disclosure of the amount of distribution compensation is not needed to inform investors about the total cost of investing (although it would tell them how their fees were allocated among different services). Rather, disclosure of the existence and extent of the conflict is needed to inform beneficiaries about advisers' financial incentives.<sup>9</sup>

We recommend that the Department require that advisers prominently disclose the extent to which their compensation may vary based on the investment options selected by the beneficiary. In order to qualify as "prominent," the disclosure should be in separate document, email message or web page. The disclosure must be provided separately

---

<sup>8</sup> We agree that it is not necessary or cost-effective to "have administrative charges broken out and listed on a service-by-service basis." See Part B.2.

<sup>9</sup> See Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Rel. No. 26341, at Part II (Jan. 29, 2004) (explaining conflicts of interest necessitating requirement for point-of-sale of distribution compensation disclosure).



because otherwise it is likely to be confused with fee disclosure that is designed to highlight the costs of investing, rather than the economic incentives of the adviser.<sup>10</sup> The disclosure should focus on the amount of the adviser's differential compensation in order to permit the beneficiary to evaluate the objectivity of the adviser's recommendations.

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

Some may argue that disclosure of differential compensation is too costly and complex. Advisers who choose to create the conflict of interest that differential compensation disclosure would address should not be allowed, however, to avoid disclosure of differential compensation because of the complexity and disclosure costs they are responsible for creating. If, for example, a mutual fund charged dozens of different fees that depended on an investor's particular situation, the fund's sponsor should not then be heard to complain that the cost of fee disclosure far exceeded its benefits. In short, the cost of fee disclosure should be viewed not as a reason to permit conflicts of interest to be concealed, but as a natural market constraint on inefficient pricing practices. To the extent that investors reject complex fee structures, such as differential compensation arrangements, when they are fully disclosed, fee disclosure should be viewed as having operated successfully by promoting informed investor choice, competition and efficiency.<sup>11</sup>

## CONCLUSION

We applaud the Department for a forward-thinking, creative and decisive approach to the current rules for the disclosure of 401(k) fees. With the growth of defined contribution plans and the increasing importance of participants' individual decision-making role, it has never been more critical to Americans' retirement security that 401(k) fees be subject to the disinfecting light of full transparency and the benefits of unencumbered market competition. The Department's proposal takes a significant step

---

<sup>10</sup> See Investment Advisers Act Rule 206(4)-3 (requiring disclosure of solicitor's capacity and compensation in a separate document).

<sup>11</sup> Although the speciousness of arguments that fee disclosure is too costly due to its complexity is most applicable to differential compensation arrangements, it is not limited to such arrangements. The same analysis applies to all types of complex fee arrangements, such as the use of different types of account and activity charges that are in addition to a fund's expense ratio and plan expenses as disclosed in the Form 5500.

toward truly transparent, complete disclosure of 401(k) fees in a way that in the long term will save Americans billions of dollars in excess fees. We hope that the Department will capitalize on this opportunity to increase transparency and promote fee competition by addressing the concerns that we have discussed in developing its final proposal. Thank you for your consideration of our comments.

Sincerely,

Mercer Bullard  
President and Founder  
Fund Democracy, Inc.

Barbara Roper  
Director of Investor Protection  
Consumer Federation of America

cc by U.S. Mail:      Honorable Elaine Chao, Secretary of Labor  
                              Bradford Campbell, Assistant Secretary of Labor (EBSA)  
                              Andrew Donohue, Director, Division of Investment Management,  
                              SEC

## EXHIBIT A

Illustrative Fee table:

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

Additional Expenses:

Small Account Fee: \$2.50/quarter

Redemption Fee: 1.00%