ARE HIDDEN 401(K) FEES UNDERMINING RETIREMENT SECURITY?

HEARING

BEFORE THE

COMMITTEE ON EDUCATION AND LABOR

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C O N T E N T S

ARE HIDDEN 401(K) FEES UNDERMINING RETIREMENT SECURITY?

Tuesday, March 6, 2007
U.S. House of Representatives
Committee on Education and Labor
Washington, DC

The committee met, pursuant to call, at 11:02 a.m., in room 2175, Rayburn House Office Building, Hon. George Miller [chairman of the committee] presiding.

Present: Representatives Miller, Kildee, Payne, Andrews, Woolsey, McCarthy, Tierney, Wu, Davis of California, Sestak, Yarmuth, Hare, Courtney, Shea-Porter, McKeon, Petri, Ehlers, Kline, Marchant, Fortuno, Boustany, Davis of Tennessee, and Walberg.

Staff present: Aaron Albright, Press Secretary; Tylease Alli, Hearing Clerk; Jody Calemine, Labor Policy Deputy Director; Sarah Dyson, Administrative Assistant, Oversight; Carlos Fenwick, Policy Advisor for Subcommittee on Health, Employment, Labor and Pensions; Michael Gaffin, Staff Assistant, Labor; Jeffrey Hancuff, Staff Assistant, Labor; Ryan Holden, Senior Investigator, Oversight; Brian Kennedy, General Counsel; Thomas Kiley, Communications Director; Ann-Frances Lambert, Administrative Assistant to Director of Education Policy; Danielle Lee, Press/Outreach Assistant; Joe Novotny, Chief Clerk; Megan O'Reilly, Labor Policy Advisor; Rachel Racusen, Deputy Communications Director; Michele Varnhagen, Labor Policy Director; Michael Zola, Chief Investigative Counsel, Oversight; Mark Zuckerman, Staff Director; Robert Borden, General Counsel; Steve Forde, Communications Director; Ed Gilroy, Director of Workforce Policy; Rob Gregg, Legislative Assistant; Jessica Gross, Deputy Press Secretary; Taylor Hansen, Legislative Assistant; Victor Klatt, Staff Director; Lindsey Mask, Director of Outreach; Jim Paretti, Workforce Policy Counsel; Molly McLaughlin Salmi, Deputy Director of Workforce Policy; and Linda Stevens, Chief Clerk/Assistant to the General Counsel.

Chairman MILLER [presiding]. The Committee on Education and Labor will come to order for the purposes of conducting a hearing of whether or not hidden 401(k) fees are undermining workers' retirement security.

This is, again, one of a series of hearings where we are looking at the middle class and what we can do to strengthen and to cultivate the middle class.

And I think that this is a very important hearing, because it does deal with the ability of millions of middle-class workers, whether

or not they will have the ability to put together a plan for retirement security and for the maintenance of a standard of living that allows them to provide for themselves and their families.

If you earn your income from a paycheck, the chances are that one of the things you are concerned with is trying to put enough money away for the golden years. If you use a 401(k) or a similar plan to help you save some of that money for retirement, then you ought to have all of the information you need to make a well-informed decision about what plans and investment options will give you the best deal.

That is the purpose of this hearing: to examine the growing role of 401(k)-style plans are playing in helping people pay for their retirement and find out if hidden fees are eating into workers' retirement savings account balances without them even knowing it.

During much of the 20th century, two types of retirement plans—Social Security and traditional employment-based pension plans—helped to lift older Americans out of poverty and allowed American workers to maintain a decent standard of living when their working lives were over.

But now today, many of those traditional pensions, defined benefit plans, are no longer being created. New plans are being created or greater reliance is being placed on 401(k) plans, and clearly Social Security is now the sole source of retirement income for over half of the retirees and the primary source of income for two-thirds of all retirees.

Luckily, I would say, we have fended off the attacks on the program from people who wanted to privatize it, turning it into a gamble for retirees, instead of a sure thing. So we now have Social Security and 401(k)s.

The rub is that 401(k)s were never intended to be the primary source of retirement income, either. Today, the average balance among private-sector workers is just $28,000, and that is a pool of workers that struggle at the end of every month to be able to continue to invest in their retirement savings and in their ultimate retirement.

This morning, we will hear testimony about services that are being provided and the fees are being charged. Some of these fees are reasonable and necessary, but today we will also hear about a dizzying array of terminology, revenue-sharing, and wrap fees, finders' fees, shelf space, surrender charges, soft dollars, 12(b)(1) fees.

We have to ask whether or not all of these fees are necessary, and we have to examine whether they are undermining the workers retirement security. That is because even a seemingly small difference in the fees that workers pay can have an enormous difference in the overall size of their 401(k) balance.

As we will hear later today, a 1 percentage point difference in fees can reduce retirement benefits by nearly 20 percent. So you have a situation where people are struggling to put this money away every month, and making the sacrifices that go along with that, and yet we see just that 1 percentage difference.

As a way of an example, if you take one person participating in the Thrift Savings Plan, where people who are making the same contribution over a 30-year period of time, and the other is going

into an asset-based fees program, what you see here is that at the end of that time, the amount available is $175,000, if you had an asset-based fees or 3 percent, and $279,000, as you have in the Thrift Savings Plan.

Three hundred basis points is not unusual, I am told, but as we will hear that from the experts, it creates dramatic difference in what people can expect to draw on and how long they will expect these funds to last. And so this kind of difference insists that we pay attention to this matter.

Over the years, I have participated in a number of conferences on savings plans, on getting America to save more. How do we encourage savers to do this? With tax deductions, and tax credits, and all the rest of it, and those are all very, very important.

But if, in fact, what we see is, after workers with very limited resources make the very difficult decision to save their money,, the question is, what is the stewardship of that money?

We understand the laws of the fiduciary relationship and the responsibilities of trust to those individuals. But the fact of the matter is, it does not appear that that is always being honored.

The other thing here is that sometimes when people, delve into this subject, it is very complicated, as you will start to hear when the witnesses start to speak about it. Most of these explanations are not written in plain English. Most of these explanations are not presented in a matter in which participants can understand them.

If you go through this information packet for these fees, I am sure that either your head will be on your chest, your eyes will be glazed over, and you simply will not be able to decipher the information that you need as the saver.

Now, people will argue that this is for the plans, that the plans can look at this and make these determinations. The language is complicated; the language in many cases is unintelligible; the choices are unknown to the participant at many levels.

And so what we have is a situation where people work very hard, make the decision we want them to make, to set aside money for their retirement, and what they find out is there is a lot of people who are putting their hands into that money in the names of fees, commissions, all of the terms that I used before.

And what happens at the end of the year, what happens at the end of 10 years and 20 years and 30 years is that a remarkable amount of the assets that could have been available for retirement have leaked out of that fund to the benefit of others.

We will remember through the course of this hearing and of future hearings, the only source for all of the fees and the commissions is the hard-earned retirement dollars that these people have set aside and that their employers have contributed to, in some cases. All of the fees, all of the commissions are derived from that source of money.

And that is what makes, I believe, this hearing so critical, on what we might do, what we should consider, in terms of further disclosure, and further transparency, and certainly to make it more understandable for middle-class families, as they consider the choices that they have to build that retirement nest egg, using the 401(k) plan.

So I look forward to hearing the witnesses.

And at this time, I would like to recognize Mr. McKeon, the senior Republican on the committee, and then I will—hope springs——

[Laughter.]

I don't want you to characterize the hope I have. It is truly mine. But at that time, then I will introduce the witnesses.

Mr. McKeon?

Mr. MCKEON. Thank you, Mr. Chairman. And thanks for the reprieve.

As you know, this committee is no stranger to the issue of retirement security. And in fact, I would say we have proven ourselves the House's leader on this important issue.

In the long term, I believe the pension legislation we enacted last year will prove to be one of the most meaningful reforms of the 109th Congress. And the fact that we were able to do it in a bipartisan way, with 76 Democrats supporting the bill, and in an election year, no less, demonstrated what a bottom-line issue this is to workers, retirees and taxpayers.

We should not forget that those pension reforms were set in motion right there in this committee room. And though we did not have universal agreement at the end of the process or even as little as a comprehensive alternative plan from the other side of the aisle, we did produce what has become the most fundamental overhaul of the private pension system in more than a generation.

Indeed, the ground work for today's hearing and those that may follow has clearly and concretely been laid by our previous work. The issue before us is one that has become increasingly important, because defined contribution plans are clearly the future of our retirement security system.

In fact, in addition to the new safeguards we put in place last year to bolster the traditional defined benefits system, I believe two of the most important aspects of our pension reform bill focused on 401(k) plans.

First, we established new auto-enrollment procedures to increase the number of 401(k) participants. And, secondly, we fixed a flaw in outdated pension law that barred workers from receiving high-quality, independent investment advice as an employee benefit.

Years from now, I believe we will look back upon these reforms as a starting point or a turning point, placing more power than even before in the hands of workers, as they make decisions about their retirement.

This morning, as we look at potentially tweaking 401(k) rules, I will say what I said during the pension reform debate from the last Congress: Our first principle must be to do no harm. The pension bill we passed last year took years to get ready for the president's signature, and for good reason. We did not want to do anything that would force employers out of this voluntary system, nor did we want to take any action that would have discouraged retirement savings or investment, unintended consequences that we fought vigorously to avoid.

This should be guiding philosophy once again this time around. For example, if we are considering whether to place additional requirements upon plan sponsors on top of those we already established a year ago, we must do so with great caution, as the financial futures of millions of workers and retirees depend upon it.

At the outset of this hearing process, I also believe that it is vital to understand the delicate balance that exists within our retirement security system. For instance, workers do have a responsibility to make certain decisions involving their savings. Likewise, I believe we all must recognize that the topic of today's hearings, the 401(k) fees, are one of many factors, such as the historical performance and investment risk for each plan option, which plan participants do have responsibility to consider when investing in a 401(k) plan.

Now, do we want to or expect workers to be completely on their own? Of course not. No one believes that. But at the same time, we must resist the urge to simply overload workers with information. That little prospectus that you held up a while ago, one of the reasons that that is so thick and cumbersome is regulations and laws that we have passed here.

We must not mandate the distribution of out-of-context information that may lead participants to poor investment choices. A quick fix like that may help some of us feel good about ourselves, but it would do great harm to workers and retirees, which as I said is what we must seek to avoid.

Mr. Chairman, I believe our time together today will serve to start the process of deliberately and thoughtfully examining whether changes to federal law are necessary to provide greater information to plan participants. I enter it with an open mind, just as I am sure you and all of our colleagues do.

I appreciate our witnesses taking the time to be with us today, and I look forward to their testimony.

Thank you.

[The prepared statement of Mr. McKeon follows:]

Prepared Statement of Hon. Howard P. "Buck" McKeon, Senior Republican Member, Committee on Education and Labor

Chairman Miller, as you know, this Committee is no stranger to the issue of retirement security, and in fact, I'd say we have proven ourselves the House's leader on this important issue. In the long-term, I believe the pension legislation we enacted last year will prove to be the most meaningful reforms of the 109th Congress. And the fact that we were able to do it in a bipartisan way—with 76 Democrats supporting the bill, and in an election year, no less—demonstrated what a bottom line issue this is to workers, retirees, and taxpayers.

We should not forget that those pension reforms were set in motion right here, in this Committee room, and though we did not have universal agreement at the end of the process—or even as little as a comprehensive alternative plan from the other side of the aisle—we did produce what has become the most fundamental overhaul of the private pension system in more than a generation. Indeed, the groundwork for today's hearing and those that may follow has clearly and concretely been laid by our previous work.

The issue before us is one that has become increasingly important because defined contribution plans are clearly the future of our retirement security system. In fact, in addition to the new safeguards we put in place last year to bolster the traditional defined benefit system, I believe two of the most important aspects of our pension reform bill focused on 401(k) plans.

First, we established new auto-enrollment procedures to increase the number of 401(k) participants, and secondly, we fixed a flaw in outdated pension law that barred workers from receiving high-quality, independent investment advice as an employee benefit. Years from now, I believe we will look back upon these reforms as a turning point, placing more power than ever before into the hands of workers as they make decisions about their retirement.

This morning, as we look at potentially tweaking 401(k) rules, I will say what I said during the pension reform debate from the last Congress: our first principle must be to do no harm. The pension bill we passed last year took years to get ready

for the President's signature, and for good reason. We did not want to do anything that would force employers out of this voluntary system, nor did we want to take any action that would have discouraged retirement savings or investment—unintended consequences that we fought vigorously to avoid.

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At the outset of this hearing process, I also believe that it is vital to understand the delicate balance that exists within our retirement security system. For instance, workers do have a responsibility to make certain decisions involving their savings. Likewise, I believe we all must recognize that the topic of today's hearing—401(k) fees—are one of many factors, such as the historical performance and investment risk for each plan option, which plan participants do have the responsibility to consider when investing in a 401(k) plan.

Now, do we want to—or expect—workers to be completely on their own? Of course not; no one believes that. But at the same time, we must resist the urge to simply overload workers with information—or worse, to mandate the distribution of out-of-context information that may lead participants to make poor investment choices. A quick fix like that may help some of us feel good about ourselves, but it would do great harm to workers and retirees, which—as I said—is what we must seek to avoid.

Mr. Chairman, I believe our time together today will serve to start the process of deliberately and thoughtfully examining whether changes to federal law are necessary to provide greater information to plan participants. I enter it with an open mind, just as I am sure you and all of our colleagues do. I appreciate our witnesses taking the time to be with us today, and I look forward to their testimony.

Chairman MILLER. Thank you.

Our panel this morning is a distinguished panel with a long history in this subject.

And first witness will be Barbara D. Bovbjerg, who is the director of education, workforce and income security issues at the U.S. Government Accountability Office. At the GAO, she oversees evaluative studies on age and retirement income policy issues, including Social Security, private pension programs, and the operation and managements at the Social Security Administration, the Pension Benefit Guaranty Corporation, the Employee Benefits Security Administration of the Department of Labor.

Matthew D. Hutcheson is an independent pension fiduciary. He is the author of a text, "Retirement Plan Compliance and Reporting," at Texas Tech University's International Foundation for Retirement Education. He is also a member of the Board of Standards at the American Academy of Financial Management. His clients include the plans of Fortune 100, 500 and 1,000 companies, mid-and small-size companies, government and legal and accounting firms.

Mr. Robert Chambers is a partner in the Employer Services Practice Group, of the Charlotte-based law firm of Helms, Mulliss & Wicker. And his practice emphasizes executive compensation and employee benefit law. Mr. Chambers is a member of the taxation, business and law, and employment law sections of the American Bar Association and serves on several committees within those sections. He is the chairman of the American Benefits Council, an employee-benefit lobbying firm in Washington, whose members either employ or administer plans for more than 100 Americans, and a 1971 graduate of Princeton University.

Mr. Stephen J. Butler is the founder and president of the Pension Dynamics Corporation retirement plan administration firm in Pleasant Hill, California. In April 1997, Money magazine published

Mr. Butler's article entitled, "Beware: Retirement Plan Rip-offs." Mr. Butler has also written two books on 401(k) plans, the most recent being one titled "401(k) Today," published in 1999. For the past 7 years, he has been a weekly columnist covering retirement-related financial interests and has been quoted extensively in Fortune and Money, the Wall Street Journal, New York Times and numerous other publications.

So, Ms. Bovbjerg, we will begin with you.

And you know the rules here, but for the other witnesses, the green light will be on for 5 minutes, then it will turn to orange, which we will ask you to start summing in, and then red, if you can wrap your remarks so that we will have time for questions.

Thank you.

STATEMENT OF BARBARA D. BOVBJERG, DIRECTOR, HEALTH, EDUCATION, HUMAN SERVICES DIVISION, GOVERNMENT ACCOUNTABILITY OFFICE

Ms. BOVBJERG. Thank you, Mr. Chairman, Mr. McKeon, members of the committee.

I am pleased to be here today to speak about 401(k) plans. And in these plans, participating workers are responsible for choosing how much of their earnings to contribute, how to invest these contributions, and how to manage the resultant accumulation in retirement.

Today, I would like to describe trends in the use of 401(k)s and summarize our recent report about fees associated with these plans. Fees are one of the aspects of 401(k)s that workers should know about and understand in order to ensure adequate income from the plan when they retire.

First, the trends. 401(k)s are defined contribution, D.C., plans, meaning that benefits are based on contributions to accounts and investment returns that accrue. Historically, pension benefits were provided through defined benefit, D.B., plans, which provide a fixed level of monthly retirement income for life, based on salary, service and age of retirement.

Since 1985, the number of D.C. plans and participants has risen dramatically, while the number of D.B. plans and workers covered by them has fallen. Today, there are about 700,000 D.C. plans, covering 55 million workers, and D.C. plans now hold the majority of pension fund assets.

401(k) plans are an important part of this gross. Although they were once relatively rare, today they predominate among D.C.-type plans. In 1985, they were only about 7 percent of all D.C. plans, but now account for almost 95 percent. In 20 years, the number of participants in these plans has grown from 7 million to 47 million workers, and assets held by these plans rose from $270 billion to about $2.5 trillion.

401(k) plans are popular with many workers, in that they are portable, which D.B.'s are generally not, and they are easier to understand than typical D.B. plans. Yet 401(k)s also place responsibilities on workers that D.B. plans do not.

The majority of 401(k) plans are participant-directed. Because so much rides of workers' decisions with regard to their 401(k) saving,

it is crucial that workers have information to help them make wise choices.

There are many factors that a worker should take into account, one being the fees associated with the plan. So let me turn now to issues regarding fees.

Fees are important factors in 401(k)s because, in general, the higher the fee, the less savings will accumulate in the course of a working lifetime. Although various fees pertain to 401(k)s, investment fees account for the largest portion of the total. These pay for services including selecting the plan's portfolio of securities and managing the fund.

Plan record-keeping fees are the next largest. These are usually charged by the service provider to set up and maintain the plan. Whether and how participants or plan sponsors pay these fees varies by the type of fee and the size of the plan.

Investment fees are usually charged at the 6 percentage of assets and netted from investment return, while record-keeping fees may be charged as a percentage of assets, or as flat fees. These fees are increasingly being paid by participants, rather than by sponsors. ERISA requires that sponsors disclose a range of information about plans, but only limited information about fees.

Although plan sponsors may voluntarily provide information on fees, participants may not have a clear picture of all the fees they pay, because even the information that is provided may be offered in a piecemeal fashion, through plan descriptions, fund prospectuses, and fund profiles.

Not only do participants not necessarily know what they are paying in fees overall, they have no simple way to compare fees among investment options within their plan. The Department of Labor has authority under ERISA to oversee 401(k) fees and fee arrangements among plan service providers, but it lacks information sufficient to provide effective oversight.

Labor must ensure that fees are paid with plan assets, are reasonable, and that sponsors report information known about business arrangements involving service providers. But it is difficult for Labor to monitor fees that are netted out of returns and are not required to be reporter. Further, fee arrangements between service providers are sometimes hidden from the sponsor and can mask a conflict of interest that could affect the plan.

Labor has initiatives under way to improve the disclosure of fee information to participants, as well as in required reporting to Labor itself, and to spell out what information sponsors need to obtain from service providers.

In conclusion, 401(k) have emerged as the primary type of pension plans for American workers, yet requirements for reporting information workers should have to manage these types of plans has not fully caught up to the need. Fee information, in particular, needs to be more widely available, more comprehensive, and more clearly presented.

GAO has recommended that measures be taken by both Labor and the Congress to help make this information more accessible and, in so doing, help protect workers' retirement savings.

This concludes my statement, Mr. Chairman. I welcome any questions and hope that my full statement will be included in the record.

[The Internet link to GAO-prepared testimony, "Private Pensions: Increased Reliance on 401(k) Plans Calls for Better Information on Fees" follows:]

http://www.gao.gov/new.items/d07530t.pdf

Chairman MILLER. Thank you.

For all the witnesses, your statement, all your written material will be put in the record in its entirety.

Mr. Hutcheson?

STATEMENT OF MATTHEW HUTCHESON, PENSION CONSULTANT, INDEPENDENT PENSION FIDUCIARY

Mr. HUTCHESON. Chairman Miller, Congressman McKeon and members of the committee, from personal experience and research as an independent fiduciary, I believe the retirement income of America's workforce has been unnecessarily reduced due to confusion caused by blending fiduciary and non-fiduciary practices.

Many billions more should be available for health care and prescription drugs, home repairs, and basic living necessities. Instead, these sums line the pockets of others.

Conventional 401(k) plans now cost around 3 percent of plan assets per year to manage. Some are even as high as 5 percent. In my experience, that is 1.5 to 3.5 percent more than is reasonably necessary.

To put this into perspective, just 1 percent in excess costs to plan participants, having $2.5 trillion in 401(k) plan assets, represents a wealth transfer of $25 billion to others each and every year. A large portion of the costs of conventional 401(k) plans relate to services that have little or nothing to do with building and protecting the retirement income security and, hence, are excessive.

Take an average participant with a $30,000 account balance, contributing $150 per pay period. If this person earns an average of 8 percent over a 25-year time period, he or she will have accumulated over $500,000. However, add an additional 1 percent in annual fees, and the account balance drops nearly $85,000. Add 1 percent more, and the account balance drops $150,000.

This translates into approximately $540 per month in retirement income loss. This loss can be prevented, and it begins by enlightening plan sponsors about the realities of 401(k) plan economics. When we buy bread, we know exactly how much it costs: One dollar buys one dollar's worth of bread. However, when it comes to 401(k) plans, the sticker price is advertised at 50 cents, yet the actual cost may be closer to three dollars.

Fiduciaries simply cannot make good decisions when the costs of services are undisclosed. There are at least seven types of hidden fees or costs borne by plan participants. These range from brokerage fees, shared between the broker and an investment fund, to record-keeping subsidies between a mutual fund a third-party administrator.

Contrary to fiduciary principles, some of the fees borne by participants are for services they do not receive. It is costly and unnecessary to offer a wider variety of investment alternatives than is absolutely necessary to construct a prudent, low-cost portfolio.

The more fund choice is offered, the more mistakes participants make. Employees tinker with the investment within their accounts, incurring hidden trading costs that reduce their returns.

The current 401(k) environment encourages mistakes, for no good or necessary reason. The brokerage and investment fund industries understand and count on participants making imprudent investment decisions. They rely on fiduciary ignorance to generate revenue. This is a substantial and hidden cost about which participants are almost universally unaware.

An efficient, low-cost, market-tracking portfolio could easily and fairly be put in place for all participants. To my astonishment, the industry persists in the assertion that, without higher fees, they cannot deliver the desired services.

This is the heart of the matter: It is the services or plan options that are excessive, and those services or options are not always necessary for protecting participants' retirement income. Because 401(k) participants own stocks and bonds, constituting $2.5 trillion, it is essential that plans be managed by individuals who understand and uphold the standards of fiduciary care and loyalty.

In conclusion, it is incumbent upon us to be absolutely certain there are no unnecessary obstacles, whether intentional or unintentional, to the long-term success of our private retirement system. American workers deserve proper protections for the hard-earned savings they have set aside in their 401(k) plans, but these protections have been largely denied in the current state of the industry.

I believe in implementing simple solutions. Change will require exposing and confronting powerful economic interests that support the current system. It is daunting to tackle this vital issue, affecting millions now and in generations to come. Despite the forces arrayed against change, America's workers deserve better than they have received to date from the providers of 401(k) services.

Thank you.

[The statement of Mr. Hutcheson follows:]

Prepared Statement of Matthew Hutcheson, Pension Consultant, Independent Pension Fiduciary

Introduction

Very few matters of social importance are more complex than the one before you today. This particular issue is not only about uncovering obscure dollars unscrupulously extracted from the account balances of America's workforce, but it is also about correcting the culture that has permitted the problem to thrive in the first place. This written testimony will explain what the culture is, why it exists, how it has evolved over time, how it violates basic economic principles, the integrity of rules of fiduciary prudence, the exclusive benefit rule under ERISA, and other common sense practices that are critical for delivery of expected results from employer defined contribution retirement plans.

The American Worker Is Hurt by What He Can't See

"If we make a few rough calculations, the importance of the topic will be very clear. The SEC estimates in Concept Release 33-8349, that 1% of the average mutual fund's investment return disappears each year due to brokerage expense, execution costs, and transaction spreads. Other industry sources indicate that an additional .50% slips away via "revenue sharing payments." The impact on the average American is profound.

"Consider two thirty year old workers who each invest $3,000 annually into their 401(k) programs. American #1's 401(k) program is run according to stringent fiduciary principles and earns 7.5% annually. However, American #2's 401(k) is operated by conflicted, sales driven entities and only earns 6% annually after the aforementioned return erosion. The table below details the results.

Year	American #1—Fiduciary 401(k) Earning 7.5%	American #2—Hidden Fee 401(k) Earning 6%
10	$45,624	$41,915
20	$139,658	$116,978
30	$333,463	$251,405
40	$732,902	$492,143
47	$1,244,260	$766,694

"Even though both employees contributed the same amount and took the same investment risk, American #2 must work an additional seven years to make up for the lack of fiduciary oversight in his 401(k) plan."[1]

The difference in hidden fees costs American worker #2 nearly $500,000 during the illustrated period of time. This issue is about real people, real money, and the quality of their lives later in life. Consider the impact on American worker #2's ability to pay for health care, prescription drugs, home repairs or even groceries. If actuarial tables hold true, today's retiree may need to be prepared to live a quarter century longer than his grandparents did.

Background

A "401(k)" is a Qualified Retirement Plan

Qualified retirement plan assets pursuant to Internal Revenue Code ("IRC") section 401(a) are held in trust pursuant to IRC §501(a) exclusively for the future benefits of participants and beneficiaries. There are three types of "qualified" plans.

- Stock bonus
- Pension, and
- Profit sharing

A 401(k) plan, as we call it, is actually a profit sharing plan (in most cases)[2] that has a feature allowing employees to take wages and bonuses in cash, or defer them into the profit sharing plan, and hence are often referred to as "employee deferrals." However, those employee deferrals are technically "employer" contributions made pursuant to a "cash or deferred election." Deposits of all employer contributions, including employee deferrals, plus investment earnings of "401(k)" plans are subject to the same rules of trust administration, governance, and fiduciary prudence which apply to stock bonus and traditional pension plans.

ERISA—Employee Retirement Income Security

The purpose of a retirement plan, including 401(k) plans, is to provide future income for retired American workers. Those who are charged with the management of a qualified retirement plan must do so with an eye single to this purpose and none other. Such an individual is a "fiduciary."

Rules of Fiduciary Prudence

As it relates to the issue at hand, the following fiduciary axioms have consistently held true:

- Fiduciary based decisions secure future retirement income.
- Non-fiduciary based decisions diminish future retirement income.
- Hidden and excessive fees exist because both types of decisions (fiduciary based and non-fiduciary based) exist simultaneously within 401(k) and other similar plans, complicating and obscuring a fiduciary's ability to understand his duties and to properly discharge them.

This written testimony will focus solely on 401(k) and similar plan assets held in trust, pursuant to IRC §501(a). Therefore, rules of Fiduciary Prudence are a fundamental component of this discussion because trusts are governed and managed by fiduciaries. True prudent practices should deliver optimal results. Poor or partial fiduciary practices will deliver sub-optimal or even poor results.

Fiduciary principles and ideals are not obscure, nor are they difficult to learn and understand. In fact, modern rules of fiduciary prudence have existed for nearly two hundred years. However, in the United States, the primary way fiduciary responsibilities are taught to sponsors of retirement plans is through the financial industry. Since an important element of fiduciary governance is monitoring those who provide services to a retirement plan, strangely enough, we have accepted a system

where those being monitored are teaching those who are doing the monitoring, and doing so according to their philosophies and standards, with a particular objective in mind.

The current 401(k) culture essentially couples the "fox teaching the rooster how to guard the hen house" with a perceived governmental "get out of jail free card" (i.e. DOL regulation 404(c)). The effect of adopting these two "cultural" elements has, over time, caused 401(k) plans to be governed through the commingling of fiduciary and non-fiduciary practices and philosophies.

Therefore, resolving the issue of hidden, obscure, and excessive fees is wholly dependent on bifurcating fiduciary elements and practices from the non-fiduciary ones within the 401(k) industry. Then, logic will reveal that any fees paid for non-fiduciary services and practices are unnecessary, and hence excessive. Furthermore, these are the fees that are hidden because they simply cannot be justified when viewed through the lens of true fiduciary prudence. In short, if fiduciaries eliminate non-fiduciary practices in their 401(k) plans, they will immediately eliminate hidden and excessive fees. To argue otherwise would suggest that 401(k) plans are only "partially" subject to fiduciary prudence, and hence are only a "partially" qualified plan.

Conceptually, it is as simple as that—but in practice, it is far more difficult.

Complexity

The hidden fee problem in 401(k) and similar plans is actually a mysterious Gordian Knot consisting of trust law, tax law, public policy, doctrines of fiduciary prudence, financial principle, economic principle, and perhaps the lack of discipline to defer control and gratification until actual retirement. It is difficult to see the ends of the rope, and very few know how to unravel it. In addition, many who might discern how to unravel it have strong incentives not to do so.

It is widely accepted that 401(k) and similar arrangements are the way most Americans will invest for retirement. Therefore, it is incumbent upon us all to be absolutely certain there are no unnecessary obstacles (whether intentional or unintentional) to its long-term success. As it stands today, there is an imbalance between prudent practices aimed at efficiently securing the retirement income of America's workforce, and non-fiduciary services created for business purposes between competing service providers in the private sector.

Obstacles to a Clear Understanding

- Conflicting Governmental messages that confuse qualification rules under IRC §401(a) with rules of fiduciary prudence and process as defined by Department of Labor regulation, case law, and other regulatory pronouncements.
- "Exemptions" given to non-fiduciary firms or individuals to receive compensation from trust assets without being legally held to a fiduciary standard of conduct. In other words, non-fiduciary involvement in 401(k) plans has created a non-fiduciary operating environment.
- ERISA has imposed a federal fiduciary duty and responsibility on business executives and board directors who serve as "ERISA Fiduciaries" requiring them to act exclusively in the best interest of plan participants and beneficiaries. A growing chorus of benefit industry gurus believes that such executives and directors had a pre-existing fiduciary duty and responsibility to the owners of the business. Query: Has ERISA unintentionally imposed an incurable conflict of interest? That is, can any person faithfully serve the best interest of two conflicting masters? Plan participants may believe they are out of harm's way and protected, as fiduciary oversight is mandated by ERISA, but increasingly these fiduciaries appear to be like a sightless watchdog that doesn't bark.
- Fiduciary ignorance, fear, uncertainty, and doubt, which leads to non-fiduciary decisions and practices.

Identifying non-fiduciary practices, and their associated costs

Decisions and/or functions that are clearly fiduciary in nature include proactively monitoring costs, selecting a proper number of efficient investments necessary to construct an appropriate portfolio, and operating the plan in exact accordance to its purpose—which is to deliver retirement income to its beneficiaries.

Decisions and/or functions that are clearly imprudent include purchasing high cost funds when their identical match is available at perhaps less than half the cost, or turning a blind eye to obvious mishandling of trust assets by non-fiduciaries (i.e. the participants) and, at the same time, claiming for themselves protection from fiduciary liability under 404(c).

Fiduciary/Non-fiduciary/"The Gray Area" (Subject to discernment)

There are other decisions and/or functions that fall into a gray area. Such decisions or functions might be prudent, or they might not be.

The significance of this explanation is that some fees are obviously necessary and prudent. Some fees are hidden and imprudent and pay for excessive or unnecessary services. Finally, there are fees that could be improper in some plans, and acceptable in others, and it takes an experienced, discerning eye to recognize the differences.

Excessive is as excessive does

The following examples show the interplay between various imprudent, hidden, and excessive fees as influenced by the 401(k) culture described above.

Even at this time, a blatant non-fiduciary based feeding frenzy is taking place at the expense of American workers' 401(k) plans.

"The mutual fund industry is now the world's largest skimming operation—a $7 trillion (now $12 trillion) trough from which fund managers, brokers, and other insiders are steadily siphoning off an excessive slice of the nation's household, college, and retirement savings."[3] ($12 trillion update added)

Most experts agree that trust fiduciary laws are nominally default rules,[4] and hence should be simple to adhere to and operate under. However, managing 401(k) plans is anything but simple. It's a jumbled mess because non-fiduciary investment sales people have infiltrated, and now control what was intended to be a purely fiduciary function.

It would be simple to obtain optimal results. Then why isn't it happening?

For example, the S&P 500 Index consistently outperformed 98% of mutual fund managers over the past three years, 97% over the past 10 years ending October 2004, and 94% over the past 30 years.[5]

Recent studies reveal (and many more continue to substantiate), that a passive 60% stock, 40% bond portfolio outperformed 90% of the nation's largest corporate pension plan portfolios, "run by the world's best and brightest investment minds."[6] The average return on actively managed equity mutual funds over the past 35 years trails the S&P by 87 basis points per year, and 105 basis points on broader indexes. "Over long periods, this difference in return amounted to substantial differences in wealth."[7] This is an unnecessary waste of participant's hard earned money. "This is why most academic and many professional advisors recommend that the best investment strategy is to match the market's performance. You can do this by putting your money in a fund that holds all stocks in proportion to their market value. Since these index funds do no research and little trading, the costs of holding their portfolios are extremely small, some ranging as low as 0.10 percent a year."[8]

Then why do literally hundreds of thousands of 401(k) plan fiduciaries do just the opposite? It's because they are "guided" to particular decisions by non-fiduciaries (i.e. brokers, registered representatives, insurance agents, etc.) in pursuit of compensation which very frequently is in the form of hidden and excessive fees.

Making Sense of It All

Following are some of the usual hidden costs found in 401(k) plans.

Hidden Costs #1—Undisclosed Trading Costs

The assets held in account for the benefit of participants and beneficiaries do not belong to them. These assets are owned by an "entity," which is the trust. The participants are entitled to future benefits from the trust. This is an important concept in trust governance. In other words, if the investments belonged to the participants right now, there would be no need for fiduciaries. Therefore, the fiduciaries are charged with making decisions for the future benefit of others, based on what they deem appropriate for the participants and beneficiaries, in a similar way a member of the House of Representatives makes decisions for their constituents. The decision is based upon what they judge to be in their constituents' best interests.

"The new prudent investor rule directs the trustee to invest based on risk and return objectives reasonably suited to the trust."[9]

A major flaw in the 401(k) system, therefore, is allowing non-fiduciaries (in this instance, plan participants themselves) to control trust assets by choosing without skill from a large array of investment choices, carefully presented in such a way as to generate additional brokerage (trading) commissions by encouraging "active" trading within participant accounts. In other words, emotional reactions of participants who lack investment expertise trigger undisciplined and imprudent investment decisions in the trust, when a simple 60/40 portfolio described above is well within the reach of every single participant. The brokerage and mutual fund industries not only fully understand that participants are making imprudent investment

decisions, but are counting on participant ignorance to generate revenue. This is a substantial and hidden cost that participants are almost universally unaware, and have no concept of how it is reducing the future retirement income they would otherwise receive. The average actively traded mutual fund experiences approximately 80% turnover per year, meaning that 80% of the underlying stocks and/or bonds are sold each year. It is estimated that for every 1% in turnover, there is 1% in added brokerage commission cost. Hence, the average mutual fund has an added cost of .8% (otherwise known as 80 "basis points.") This is the first hidden and unnecessary cost.

It becomes easier to understand why so many 401(k) plans primarily offer (1) actively traded mutual funds, and (2) more funds than are necessary to construct a prudent, low cost portfolio. It also demonstrates rampant ignorance that exists in the fiduciary ranks—in plans large and small.

"TheStreet.com profiled a fund last year that had a 5 star rating, a 1% expense ratio, and 800 bps in brokerage expense."[10]

Reducing net returns through unnecessary and excessive brokerage expenses is a non-fiduciary and imprudent practice that runs counter to the principles set forth in ERISA, which is to secure the retirement of American workers. Consider the chaos that would result if Congress gave each citizen 15 laws to choose from. Individually, we might pick and choose those we deem appropriate for us and, in turn, adhere only to the particular laws we chose. The principle of fiduciary prudence is that fiduciaries make decisions for all individuals to whom they are responsible based upon what is in their best interest, whether they like it or not. As unpopular as this concept is, we must not equivocate on protecting participants and beneficiaries from their own ignorance, just as each of you protect your constituents from their ignorance on various matters.

The current 401(k) culture has eroded the principles of true fiduciary governance through the begging, pleading, lobbying, or through other ways and means, we have drifted from "protect and nurture their needs" to "give them what they want—in fact, let's give them even more than what they think they want."

Hidden Costs #2—SEC Rule 28(e) "Soft Dollar" Revenue Sharing

Hidden Cost #2 is symbiotic with Hidden Cost #1 above, and it violates fundamental fiduciary rules and significantly hurts participants. 28(e) Soft Dollars are generated by active trading within mutual funds and similar investment vehicles. Allowing "Soft Dollars" to go "un-captured" and credited back to the 401(k) trust is not a fiduciary practice, and the historical problems caused by soft dollars are self evident.

Shortly after the creation of the IRA, but before the creation of the 401(k) as we know it, a change occurred within the brokerage and mutual fund industry. As part of the Securities Acts Amendments of May 1975 (SAA '75), fixed commission rates on the purchase and sale of securities through brokerage firms were eliminated. The significance of the elimination of fixed commission rates would prove to be one of several core issues of debate regarding fees in retirement plans. This would ultimately allow brokerage firms to charge excess commissions, thereby creating "at play" revenue that actually belonged to the participants, which is commonly referred to as "soft dollar" revenue or "SEC Rule 28(e)" revenue. With hundreds of billions of securities trades each year, the revenue made available by SAA '75 would forever change the mutual fund and retirement plan industry. These soft dollars, coupled with the urgent need to compete in the 401(k) industry and the creation of the 12(b)-1 in 1980 created the "perfect fee storm," which until now has existed with little or no notice by Federal regulators, plan sponsors, participants, or the general public.

As a result of the Securities Acts Amendments of 1975, Section 28(e) was added to the Securities Exchange Act of 1934. With fixed commission rates no longer the law, Section 28(e) created a safe harbor for brokerage firms who exercise no investment discretion as defined under Section 3(a)(35) of the 1934 Act to be able to charge a mutual fund a commission that was more than what it costs to actually execute, clear, and settle a securities transaction without violating the law or fiduciary duties. This excess commission could be used to purchase additional services from the brokerage firm in the form of presumably valuable investment research. In order to receive protection under the safe harbor, the mutual fund must act in good faith to ensure the excess commission was "reasonable in relation to the value of brokerage and research services provided by the broker-dealer." Since a passive indexing approach requires no research and also consistently outperforms 90% of actively managed approaches that do require research, then what is the value of the research? The 10% that do outperform an indexing approach are temporarily fortu-

itous.[11] If you follow the money, modern investment research exists so 28(e) commissions can be captured, not to provide consistent market returns to participants.

Actively traded funds inherently have higher trading costs. In other words, every time a mutual fund manager buys and/or sells the underlying securities within the fund, the participants' return is decreased by the cost of those trades. Part of the reason for this lies in the fact that "excess" commissions are being charged for non-fiduciary purposes.

SEC rule 28(e) encourages turnover and the cost of trading because mutual fund managers receive revenue from the brokerage firms for clearing the Funds' securities trades. This explains why the intelligent approach so widely accepted by the world's most astute investing minds is thrown out the window in 401(k) plans. Brokerage and Mutual Fund companies work together to generate excess revenue at the expense of participants, because they believe they can indiscriminately do so, not because it is prudent, intelligent, or advisable.

Prior to ERISA, mutual funds used any "excess" commission on a securities transaction to buy additional goods or services from their chosen brokerage firm. For example, if a trade costs 3.5 cents per share (trade execution, clearance and settlement), and the brokerage fixed commission was 5 cents per share, the excess 1.5 cents could either be used to purchase additional goods or services from the broker that directly benefited the account holder, or be credited back to their rightful owners, the account holders. Excess brokerage commissions (28(e) soft dollars) were handled the same way for IRAs and qualified plans.

After ERISA, the practice of using such soft dollars in IRAs would remain the same, but with respect to participants and beneficiaries within a qualified 401(k) plan subject to rules of fiduciary prudence, a conflict clearly exists with ERISA sections 403(c)(1), 404(a)(1), 406(a)(1)(D), 406(b)(1) and 406(b)(3).

• ERISA 403(c)(1) states that the assets of a plan "shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." Significance: Using soft dollars for purposes other than for the exclusive purpose of providing benefits to participants and beneficiaries and paying operational costs of the plan itself is a fiduciary breach.

• ERISA 404(a)(1) states that a fiduciary must act prudently and solely in the interest of the participants and beneficiaries Significance: Using soft dollars to buy loyalty of brokerage firms, consultants or other parties-in-interest to the plan is a fiduciary breach.

• ERISA 406(a)(1)(D) states that a fiduciary shall not transfer to, or use by or for the benefit of a party-in-interest, any assets of an ERISA governed plan. Significance: Use of soft dollars could effectively be a transfer to a party-in interest, thereby creating a fiduciary breach.

Due to the lack of oversight of 28(e) Soft Dollar Revenue in qualified retirement plans, the Securities and Exchange Commission was compelled to address the issue before the Congressional Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services. This occurred on June 18, 2003, shortly after H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003" was presented to the House of Representatives by Chairman Baker, Ranking Member Kanjorski and other members of the Subcommittee. According to the testimony of Paul F. Roye, Director, Division of Investment Management of the SEC, the Mutual Funds Integrity and Fee Transparency Act would:

• Provide investors with disclosures about "estimated" operating expenses incurred by shareholders, soft dollar arrangements, portfolio transaction costs, sales load break points, directed brokerage and revenue sharing arrangements.

• Provide investors with disclosure of information on how fund portfolio managers are compensated.

• Require fund advisers to submit annual reports to fund directors on directed brokerage and soft dollar arrangements, as well as on revenue sharing.

• Recognize fiduciary responsibility and obligations of fund directors to supervise these activities and assure that they are in the best interest of the fund and its shareholders.

• Require the SEC to conduct a study of soft dollar arrangements to assess conflicts of interest raised by these arrangements, and examine whether the statutory safe harbor in Section 28(e) of the Securities Exchange Act of 1934 should be reconsidered or modified.

While it is commendable that the SEC has decided to act on this issue, 17 years earlier the U.S. Department of Labor issued ERISA Technical Release 86-1 notifying the public of this very issue. The nature of ETR 86-1 was to "reflect the views of the Pension and Welfare Benefits Administration (PWBA) with regard to 'soft dollar' and directed commission arrangements pursuant to its responsibility to administer

and enforce the provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA)."

An excerpt from ETR 86-1 states:

"It has come to the attention of PWBA that ERISA fiduciaries may be involved in several types of 'soft-dollar' and directed commission arrangements which do not qualify for the 'safe harbor' provided by Section 28(e) of the 1934 Act. In some instances, investment managers direct a portion of a plan's securities trades through specific broker-dealers, who then apply a percentage of the brokerage commissions to pay for travel, hotel rooms and other goods and services for such investment managers which do not qualify as research with the meaning of Section 28(e). In other instances, plan sponsors who do not exercise investment discretion with respect to a plan direct the plan's securities trades to one or more broker-dealers in return for research, performance evaluation, and other administrative services or discounted commissions. The Commission (SEC) has indicated that the safe harbor of Section 28(e) is not available for directed brokerage transactions."

Subsequent SEC investigations have shown that illegal "28(e)" revenues have been used by "non-fiduciary" consultants to make certain services available to mutual funds.

Among them:

- Conferences and other similar group meetings where the consultant invites both the "client" (i.e. a 401(k) plan sponsor/trustees) and representatives of the mutual funds who want to sell their funds to the client of the consultant. In other words, the mutual fund pays the consultant a significant amount of money to be invited to meetings where the consultant's clients will be in attendance.
- Sales and marketing support to the mutual fund's staff.
- "Objective looking" performance reports that paint the mutual fund in the best light, and facilitate the sale of that fund to clients of the consultant.
- Other "image enhancement" or "sales facilitation" services.
- Loyalty of consultant or brokerage firm.

28(e) revenue practices hurt plan participants and their beneficiaries, and violate ERISA Sections 403(c)(1), 404(a)(1) and 406(a)(1)(D). Illegal 28(e) soft dollars are the most difficult fee to uncover.

Hidden Costs #3—Sub-Transfer Agent Revenue Sharing

The following is a rather lengthy, but important illustration of the widespread practice of subsidized record keeping services through excess mutual fund management fees.

Envision a meeting among three individuals. An employer with 75 employees, wanting to design a brand new plan for their employees; a Registered Investment Representative; and a Record Keeper commonly referred to as a "Third Party Administrator." After the meeting, the employer requests formal proposals from the Investment Representative and the Record Keeper. They leave the employer's office and agree to work together to design a plan that works for all parties. The Registered Representative and the Record Keeper collaborate and develop two proposals for the employer to consider.

The first proposal recommends 6 mutual funds, 4 of which are actively traded mutual funds. As a portion/component of the Funds' Management Fees, the 4 actively traded mutual funds pay a .5% "finders fee" of each new dollar invested to the Registered Representative plus a .5% trail commission—referred to as a 12(b)-1 commission. (A more detailed discussion of 12(b)-1 commission will be forthcoming later in this testimony). The Record Keeper proposes a $4,000 base fee per year, plus $60 per participant per year, paid by the employer.

When the employer does the math, he discovers that if each of his 75 employees contributed $100 per semi-monthly pay period, the Investment Representative would earn $100 x .5% x 75 x 24 = $900 the first year, and every year thereafter, plus an additional .5% on the accumulating balance. This $900 doesn't seem like much, especially when compared to the record keeping fee $8,500 ($4,000 base fee plus $4,500 (75 participants x $60)).

SUMMARY OF PROPOSAL A

Cost item	Investment	Record keeping
Finders Fees	$900 per year	N/A
Ongoing Commissions	$900 and growing	N/A
Base Fees	N/A	$4,000
Per Head Charges	N/A	$4,500

The employer looks at the record keeping fees, squirms a little, and quietly questions whether the record keeper's services are really worth $8,500 per year. Then he requests Proposal B. Having experienced that reaction before, the Investment Representative and the Record Keeper are prepared to present something more palatable.

The second proposal consists of 12 mutual funds, 9 of which are actively traded. To the employer's delight, proposal B seems much better. The Investment Representative's compensation remains the same, but the Record Keeping fee is cut by 70%! The base fee is reduced to $800 per year, and the per-head charge is reduced to $25.

SUMMARY OF PROPOSAL B

Cost item	Investment	Record keeping
Finders Fees	$900 per year	N/A
Ongoing Commissions	$900 and growing	N/A
Base Fees	N/A	$800
Per Head Charges	N/A	$1,875

This proposal seemed like the best of both worlds. Twice as many mutual fund options for one-third the cost! The employer thinks participants will love it, and of course he loves it, too. It doesn't occur to the employer that he should question the economics, or whether there are fiduciary implications to going with one proposal vs. another. It seems like a no-brainer, so the decision is made to go with Proposal B.

Fast forward 10 years and the employer now has 150 employees, and $4 million dollars in the plan. As far as the employer is concerned, the economics are still the same as the first day the plan was adopted. However, there was an element the employer didn't understand. Remember the reaction to the $8,500 fee for record keeping fees? The employer wasn't certain if that was a fair fee for services rendered. Maybe it was fair, and if that was the case, the employer might have reduced or cut-back on various optional "elements" of the plan to arrive at a fee that seemed appropriate, all services considered.

The $2,675 in fees associated with Proposal B seemed about right. With the growth of the company and the plan, the fact that plan costs also increased went without saying. Looking back at the original "deal", the employer computes the fees and costs as he thinks it stands today. All things remain the same except for 150 participants instead of 75, and there are $4 million dollars in assets.

SUMMARY OF COSTS 10 YEARS LATER—PROPOSAL B

[The ''believed-to-be'' costs]

Cost item	Investment	Record keeping
Finders Fees	$1,800 per year	N/A
Ongoing Commissions	$20,000 growing	N/A
Base Fees	N/A	$800
Per Head Charges	N/A	$3,750

Paying the record keeper for such an extensive array of services rendered might even be perceived as being a little low. The employer intuitively knows the record keeper is worth more than $4,550, but is uncertain "how much more." If the record keeper needed more money, they would certainly ask for it, and if they don't request more they must be satisfied. The employer also notices the Investment Representative is now being paid over $20,000—and given all of the enrollment and investment education meetings—along with all of the reports, trustee meetings, and general education given to the fiduciaries, it might seem "about right."

Luckily for the employer and the participants, the employers' niece happened to be a student of fiduciary prudence and retirement plan economics and something seemed "fishy" to her.

After looking into the economics of "Proposal B" today, the employer's niece reluctantly brought the bad news. Something has gone terribly wrong, and the employer is stunned beyond words. Here's how the true economics look:

TRUE ECONOMICS

Cost item	Investment	Record keeping
Finders Fees	$1,800 per year	N/A
Ongoing Commissions	$20,000 growing	N/A
Base Fees	N/A	$800
Per Head Charges	N/A	$30,150

How could the record keeper be making more money than the Investment Representative? Ten thousand dollars more * * * and growing!

Remember the "collaboration" the Investment Representative and Record Keeper originally entered into? Proposal B involved the payment of Sub-Transfer Agent fees (Revenue Sharing from the Mutual Funds). The increase in funds was not an added benefit to the employer or employees as initially believed. Rather, it was a carefully calculated design element to capture a particular type of revenue sharing based upon two things: (1) The number of funds offered multiplied by (2) the number of participants with assets in those funds.

Assume in this case 8 of the 9 actively traded mutual funds are being utilized by participants. Also assume that the mutual funds each pay $22 per participant per year. The true economics are therefore 150 participants x $22 Sub-Transfer Agent Revenue Sharing x 8 Funds = $26,400. When the existing "per head" fee paid by the employer ($3,750) and the base fee ($800) are added to the Revenue Sharing number, the new total is $26,400 + $3,750 + $800 = $30,950.

The employer is angry for four reasons. First, he feels deceived because he didn't understand the true economics of the plan. Second, he feels his ability was impeded to prudently judge whether the services rendered were worth what the Record Keeper received in actual compensation. Third, he understands now that the "extra" funds had nothing to do with helping participants build a better portfolio. It had everything to do with multiplying the potential revenue sharing—and that has not helped the participants at all. Fourth, the realization that the employer has allowed assets to be improperly spent on services with skewed economics might place him squarely in the cross hairs of an effective litigator.

Such is the nature of hundreds of thousands of 401(k) and similar retirement plans across the United States even as you read this.

What is a Sub-Transfer Agent? (and Sub Transfer Agent Revenue Sharing?)

A transfer agent is usually a bank or trust company (or the mutual fund itself) that executes, clears and settles a security buy or sell order, and maintains shareholder records (i.e. accounts for "title" of the ownership of the shares). When certain functions of the transfer agent are sub-contracted to a third party, that third party becomes a "sub-transfer agent." Within the context of this paper, a sub-transfer agent would be one of the following entities:

1. A third party administrator.
2. A bank or trust company performing recordkeeping services.
3. Some other entity tracking the number of shares held for the benefit of a specific participant within an individual account plan.

Payment to these parties for this sub-contracted service has come to be known as "Sub-Transfer Agent fees." Sub-Transfer agent fees exist solely to support the participant directed account culture in actively managed mutual funds.

Sub-transfer agent fees are generally paid as a flat dollar, per-participant, per fund. For example, many funds will pay a third party administrator $10 per participant, per fund. Other funds will pay a percentage of assets—such as 5 to 10 basis points. However, some funds pay up to $22 per participant, per fund or 35 basis points. The problems with sub- transfer agent fees is not how much is being paid to the service provider. Rather, the problem is being unaware who is receiving the payments, and whether or not the payments fairly represent the value of the service being rendered. The Department of Labor has made it very clear that a plan sponsor must understand the value and associated compensation of each individual servicing company, thereby making the cost of the parts more important than the cost of the whole.

An estimated 100 million shareholder accounts, or approximately 40 percent of all mutual funds, are in sub accounts at financial or record keeping intermediaries at this writing. Approximately $2 billion dollars per year is paid to third parties for sub-accounting services. There are potential costly and ERISA-violating problems inherent in omnibus accounts with underlying participant directed sub-accounts which are beyond the scope of this testimony.

Hidden Costs #4—Non-Fiduciary Compensation (12(b)-1 commissions)

There are two types of 12(b)-1 fees:

1. Sales commission 12(b)-1—paid to a registered representative for selling mutual funds for an individual or within a plan.

2. Servicing 12(b)-1—paid to a person or entity who services an account after the sale.

SEC Rule 12(b)-1 was enacted in 1980. It is partially responsible for the proliferation of mutual funds in individual account plans. Again, referring to the mutual fund relationship with the distribution medium (sales force) of the brokerage firm, it creates a conflict of interest between the brokerage firm and the mutual fund, thereby rendering each unable to devote their loyalties to the plan participants. It permits mutual funds to increase their internal fund expense ratio by up to 1% in aggregate.

The combination of these two commissions may not exceed 1%. For example, the sales 12(b)-1 could be 50 basis points (.5%) and the service 12(b)-1 could also be 50 basis points.

It is common to refer to both sales and servicing revenue as "12(b)-1" fees, not differentiating between the two. More than half of all mutual funds have a 12(b)-1 feature. These commissions are disclosed in the prospectus, but very few plan sponsors understand their significance to the plan, the participants, and the trustees.

The 12(b)-1 commissions are a concern because non-fiduciary sales people carefully place products with high 12(b)-1 commissions within 401(k) plans without the full understanding of the plan sponsor or trustees. Conversely, a Fiduciary Investment Advisor would be obligated to disclose fees in writing, invoice the plan sponsor or plan for those stated fees, and credit any 12(b)-1 fees back to the trust. This clear difference in behavior and reporting shows the crisis that exists in the industry. Plan sponsors don't know there is a difference; mutual funds are simply mutual funds to them.

Another seldom considered 12(b)-1 issue is that of unfair subsidy disparity. Fee subsidy disparity is often referred to by the fiduciary community as the "Hidden Tax" paid by participants with larger than average account balances because 12(b)-1 commissions pay for non-fiduciary services.

Illustration

Let's compare two hypothetical plans, Plan "A" and Plan "B." Let's say each has $50 million in assets, both have identical mutual funds and service providers, each paying 3% (1.50% in trading costs, and 1.50% in fund management fees). Further, assume that 40% of the fund management fee pays for revenue sharing arrangements (brokers, record keepers, insurance agents, and others), and 60% is kept by the fund manager. Let's also say that Plan "A" has 500 employees and Plan "B" has 2,500 employees.

Are costs consistent for all employees as a percentage of their account balances? Yes, of course. But what are the real economics? Take a look at the following example of a comparison between two hypothetical plans:

Fee/Cost element	Plan A	Plan B
Gross fund fees and commissions	$1,500,000 ($50,000,000 x 3%)	$1,500,000 ($50,000,000 x 3%)
Revenue sharing	$300,000 (1.50% x 40% x $50,000,000)	$300,000 (1.50% x 40% x $50,000,000)
Revenue Sharing borne by each participant	$300,000 ÷ 500 participants = $600 per participant	$300,000 ÷ 2500 participants = $120 per participant

In this example, the participants of Plan "A" are subsidizing the overhead of Plan "B."

Hidden Costs #5—Variable Annuity Wrap Fees

A Variable Annuity is an investment contract between a plan and an insurance company where (normally) a series of ongoing deposits are made to accumulate resources sufficient to pay a future benefit. Variable Annuities can be sold by insurance agents who have little or no formal investment or fiduciary training. Variable Annuities are separate vehicles that invest in mutual funds—they are not mutual funds in and of themselves.

Variable annuities offer a variety of investment options that are typically mutual funds investing in stocks, bonds and cash. Gains on variable annuities are tax deferred whether held in a qualified trust or not, and there are costs associated with this "built-in" tax deferral. The fee associated with obtaining this tax-deferred benefit is an insurance component. Therefore, one must ask whether or not putting a variable annuity in an ERISA-governed vehicle is necessary, or even wise. In other words, you could buy a lower cost mutual fund using the inherent benefits of a 401(k) and still get the deferral of tax. Paying the insurance company for the tax deferral may not be prudent. Variable annuities generally have higher expenses than comparable mutual funds, and these fees are assessed in such a way that each component service is "wrapped up" into one aggregate fee. Accordingly, this aggregate fee is called a "wrap" fee. The wrap fee hides individual component fees and services, which are:

- Investment Management: Management fees of the mutual fund that is contained within the variable annuity. (Note that trading costs are in addition to the investment management component, and are extremely difficult to discover in variable annuity contracts.)
- Surrender Charges: If withdrawals are made from a variable annuity within a certain period of time after units are purchased within the annuity, the insurance company will assess a surrender charge. The charge is used to reimburse the insurance company for the commission payments they paid to a broker or insurance agent upfront. The surrender charge usually starts out higher, and decreases over the length of the surrender period.
- Mortality and Expense risk charge: This charge is equal to a percentage of the account value, typically 1.25% per year over the investment management fees—but could be more or less depending on who is purchasing the annuity.
- Administrative Fees: The insurer may deduct charges to cover record-keeping and other administrative expenses. It is common to see fees of $25 or $30 per year, or a percentage of each participant's account value, typically in the range of an additional .15% per year.
- Fees and Charges for Other Features: Stepped up death benefit, a guaranteed minimum income benefit, long-term care insurance etc. These fees are stated in the annuity contract, and are actuarially computed based on age, health, etc., and hence differ from participant to participant.
- Bonus Credits: Some insurance companies offer bonus credits, which is a credit back to the account of percentage of each purchase—e.g. 3% of each deposit. These types of accounts often have higher expenses, and the expenses can be larger than the credit. Bonus credits are generally "purchased" with higher surrender charges, longer surrender periods, higher mortality and expense risk charges.

Hidden Costs #6—Administrative "Pass Throughs"

An unfortunate and yet almost universally common in 401(k) plans is an expense borne by all participants for unnecessary services demanded by a vocal minority. A fiduciary is obligated to protect and treat all participants equally. It is a violation of ERISA's exclusive benefit rule that millions of participants unknowingly pay for the undisciplined urges of others to immediately wrest benefit from their retirement plans. Three examples are:

- Easy loans taken against a participant's vested balance
- Open brokerage options
- Investment "advice" services

While some may argue that these plan features are available to all participants equally, we must not confuse matters of coverage and non-discrimination in benefits rights and features (pursuant to IRC §401(a)(4)) with fiduciary prudence. Plan assets should not be used to pay for services that all Participants do not collectively receive or benefit from plan assets. In hundreds of thousands of companies across the U.S. there are assertive individuals, who are the vocal minority, that want various bells and whistles in their 401(k), and the unsuspecting end up having to pay for it. This subtle violation of the exclusive benefit rule is rampant and costly. Plans with optional benefits that increase the overall cost of plan operation should be paid for by the individual users or by the plan sponsor, not by the plan. These amounts vary from plan-to-plan, but they can be substantial, especially if the fees are "translated" into an asset based charge that goes un-examined year after year.

Hidden Costs #7—Non-Fiduciary Mish-Mash

To wrap up this discussion, it's important to highlight a few remaining hidden costs. The following is not an all-inclusive list, because there are dozens of variations to each of these items, and even a few other costs that are highly complex and difficult to explain. These are beyond the scope of this hearing, but might be

examined as part of a subsequent hearing. Some of the remaining fees and costs employers of all sizes are struggling to grasp are:

• Share class variances based upon plan size. (i.e. high load share classes in large plans. Common share classes include A, B, C, R, etc.)[12]

• Shadow Index Funds. These are basically funds that closely track passive indexes, but have "actively managed" prices. In other words, they are overly priced index funds, some overpriced by 200% to 300%.

• Suspected Inter-Fund pricing discrimination. (Evidence that this practice is now coming to light, but this is so new that independent fiduciaries are still trying to grasp the full nature and extent of this particular issue.)[13] This is where a mutual fund cuts "deals" with preferred investors, and increases fees to non-preferred clients so that the total fee balances out to what is disclosed in the prospectus. For example, a prospectus of a two hundred million dollar fund might state that the fund management fee is 1% of assets. The fund manager then "discriminates" against clients 2—6 by cutting a deal with preferred Client 1 that reduces their fee by half.

	Assets	Actual fee
Client 1	$100,000,000	.50%
Client 2	20,000,000	1.10%
Client 3	20,000,000	1.10%
Client 4	20,000,000	1.10%
Client 5	20,000,000	1.10%
Client 6	20,000,000	1.10%
Total	$200,000,000	1.00%

Clients 2 through 6 are paying for the backroom "deal" between the fund manager and client 1, and will experience lower returns at the same time, a clear example of investment return and cost discrimination. Also, other suspected violations of fiduciary prudence are coming to light where the "deal" isn't with a preferred client, but with the Investment Representative. This has even more serious implications when proven to be true.

Expert fiduciaries are still trying to get their arms around this issue. It's such a startling revelation that independent fiduciaries don't want to believe it, and hence are trying to find other reasonable explanations for their findings, hoping it simply isn't so. However, the economics of 401(k) plans are so defiant, entrenched, and arrogant, that it might very well be happening more often than one would like to think. Like Andrew Fastow, the former CFO of the complex ENRON "special purpose entities," maybe the industry thought no one would ever figure it out.

There is more that can and should be shared with legislators about other activities in the final markets that adversely affect participants and beneficiaries. I hope this testimony provides sufficient background to assist in grasping the issues at hand and comprehending the necessity of diligently considering possible solutions.

Possible Solutions

• Require full disclosure of all financial service provider costs and expenses. Create stiff monetary sanctions for any person, entity, or institution to withhold information from named fiduciaries for any qualified plan. This would require full transparency of all service provider activities and costs. It would enable fiduciaries to better understand the basis for their decisions regarding plan operations and investments. With improved understanding, the retirement income security of millions of Americans would be enhanced.

• Require fiduciaries to itemize any and all fees and expenses extracted from plan assets at any level, including trading commissions, spreads, management fees, soft dollar arrangements, finders fees, transfer agent fees, and other expenses, and to disclose those directly to participants on the Summary Annual Report. This will demonstrate to participants that fiduciaries are aware of the costs the plan is bearing, and that they are taking responsibility for those costs.

• Hold all individuals or companies who are paid from plan assets to a fiduciary standard. This includes brokers, insurance agents, record keepers, actuaries, and others. Those individuals or professionals unwilling to assume fiduciary responsibility could negotiate payments directly from plan sponsors.

• Require all mutual funds held in a qualified trust (within the meaning of Internal Revenue Code section 501(a)) to be "revenue sharing free" which would include barring 28(e) soft dollars, 12(b)-1 marketing or servicing commissions, and sub transfer agent fees. This would force the industry to price services based upon what

knowledgeable fiduciaries determine to be reasonable and appropriate and are willing to bear.

• Eliminate Department of Labor Regulation 404(c). Plan sponsors and service providers have hidden behind this regulatory allowance as a perceived shield from fiduciary liability while ignoring the plight of workers who desperately need guidance and oversight for their investments. Rule 404(c) is non-fiduciary at its core, and it encourages other decisions that are not in the interests of securing the retirement incomes of American workers.

Conclusion

Thank you for the invitation to testify before this committee. It is my earnest belief that the workers of America deserve proper protections for the hard earned savings they have set aside in their 401(k) plans—protections which they are denied in the current state of the industry. I also believe that the problems with the industry can be solved rather simply, though it will require confronting powerful economic interests that support the current system. But America's workers deserve better than they have received to date from the providers of financial services. Finally, thank you for beginning the daunting task of tackling this very important and relevant social issue that will affect millions in the coming decade. I look forward to elaborating on this written testimony in more detail during the question and answer period.

ENDNOTES

[1] Randy Cloud, founder of CNMLLC. Accredited Investment Fiduciary Auditor and a member of the Revere Coalition, a non-profit fiduciary advocacy group of independent investment fiduciaries.

[2] Stock bonus plans may also have a 401(k) feature.

[3] Statement by Senate Governmental Affairs Subcommittee on Financial Management, The Budget, and International Security. November 3, 2003, Senator Peter G. Fitzgerald (R- IL)

[4] *http://papers.ssrn.com/abstract—id=868761*

[5] *http://www.ifa.com/Book/Book—pdf/overview.pdf*—"Step 5"

[6] Dimensional Fund Advisors, Basic 60/40 Balanced Strategy vs. Company Plans 1987-2003. FutureMetrics, 2004.

[7] *http://finance.yahoo.com/expert/article/futureinvest/6953*—"The Truth About Money Management"

[8] Ibid—"The Birth of Indexing"

[9] *http://papers.ssrn.com/abstract—id=868761* page 2

[10] "Fee Forensics, The impact of brokerage expense and trade execution in mutual fund portfolios." 2005 Annual Conference of the Center for Fiduciary Studies. Santa Fe, New Mexico.

[11] *http://www.efficientfrontier.com/ef/997/tough.htm*

[12] *http://www.nasd.com/InvestorInformation/InvestorAlerts/MutualFunds/UnderstandingMutualFundClasses/NASDW—006022*

[13] The following is a startling quote from an actual Independent Fiduciary fee review: "We find it noteworthy that the funds in the Plan are paying out more than half of the revenue they receive for 'investment management'. In fact, one fund (fund name deleted) is paying out 150% of the revenue that it discloses by prospectus. Several other funds (mostly name deleted / name deleted funds) pay out more than 70% of their receipts. Obviously, this indicates that they may be making up their lost revenues in some other manner. We spot checked the SAIs of a couple of the Plan's funds and found hidden expenses in excess of .50% for transaction expenses. Some portion of this money goes back to the manager in one form or another (research services, commission rebates, etc.). We estimate that the true investment and recordkeeping cost of the plan is significantly greater than the .94% that is revealed by the basic plan expense ratios."

Chairman MILLER. Mr. Chambers?

STATEMENT OF ROBERT CHAMBERS, ESQ., PARTNER, HELMS, MULLISS & WICKER, PLLC; CHAIRMAN, AMERICAN BENEFITS COUNCIL

Mr. CHAMBERS. Good morning, Chairman Miller, Ranking Member McKeon, members of the committee. My name is Robert Chambers, and I am a partner in the Charlotte, North Carolina-based, law firm of Helms, Mulliss & Wicker. As was noted earlier, I am also the chairman of board of the American Benefits Council, on whose behalf I am testifying today.

The council very much appreciates the opportunity to present testimony with respect to 401(k) plan fees. Our goal, like yours, is that the 401(k) system remains fair and equitable, that it functions

in a transparent manner, and that it provide meaningful benefits at a fair price.

Our members have been successful in obtaining fee information and using it to sponsor less expensive and more efficient 401(k) programs, and yet, at the same time, we think that there is room for improvement through more universal disclosure of both fee and other information to both fiduciaries and to plan participants.

There are three pieces to the fee disclosure puzzle that we will be discussing today: one, disclosure by service providers to employers and other fiduciaries; two, disclosure by those fiduciaries to participants; and, three, disclosure by the fiduciaries to the government.

Now, this comports with the GAO's recommendations in its 2006 report, as has previously been mentioned, and with the three-part project that the Department of Labor is currently pursuing. Admittedly, we have some concerns with some of the details in the department's proposals, but we absolutely agree with their general approach.

Now, I would like to take the rest of my time to raise five points that we think, at the council, bear consideration this morning.

First, the 401(k) plan system in the United States is voluntary. It depends on the willingness of employers to offer plans and the willingness of employees to use them. Whatever fee disclosure reform efforts evolve, they must not undermine these basic building blocks.

If a new regiment is overly complicated, overly costly, some employers will drop their plans. Others will comply and pass the costs onto participants, either in the form of plan expenses, or perhaps reduced employer contributions.

Further, and perhaps most important, many employees will be confused by the overemphasis on fees. Compared to equally valuable investment consideration, such as diversification, actual investment performance, and risk factors, and they will either make unbalanced investment decisions or, even worse, a decision not to participate at all.

Investment education is based on balance, and neither Congress, the Department of Labor, nor plan fiduciaries should counteract that concept through a disproportionate focus on plan fees.

Second, every new feature that is added to a 401(k) plan adds new costs. There are mandatory bells and whistles, such as the benefit statement rules that are new, and permissive bells and whistles, such as automatic enrollment. But they are all bells and whistles; they have all been adopted by Congress; and they all cost money to administer.

Additional fee disclosure will also result in additional cost. Therefore, we must carefully measure the value of what may be gained against the cost of the annual disclosure. Let's make sure that our efforts to reduce costs do not, in the end, actually reduce savings.

Third, in our system of commerce, it is the quality and features of a product or service that permit one manufacturer or service provider to charge more than a competitor. Some cars cost more than others, as do computers, and, unfortunately, my plumber.

Similarly, 401(k) plan fees should not be evaluated independently from the product or service that is provided. Every participant would be willing to pay higher fees if the total net return on the investment were increased. Enhanced disclosure will enable participants to determine whether the quality of the product or the quality of the provider warrants it cost. The two are inextricably tied to one another.

Fourth, we acknowledge that fee levels differ among differ plans, just like cable TV service. Some people want only basic service; some employers want to provide only a basic 401(k) plan. But other folks want hundreds of channels, providing, they expect, an even wider spectrum of entertainment. And many employers want to provide a similarly broad span of retirement plan features for their participants.

More bells and whistles, more costs. Enhanced disclosure will help participants to make decisions among the choices presented.

It is also true that many smaller employers pay higher 401(k) plan fees. This is usually attributable to fewer lives over which to amortize fixed costs. We believe that increased disclosure will exert downward pressure on fee levels in the marketplace.

Fifth, and finally, some maintain that revenue-sharing is wrong and should be prohibited. People with this view, we think, misunderstand how the 401(k) system works. They also probably think that Toyota manufactures cars. It does not. It assembles cars.

No one expects Toyota to manufacture all of the glass, all of the seats, all of the computer components for its vehicles. They subcontract. And revenue-sharing in the 401(k) context is simply a way of paying for subcontracting.

One service provider delegates a function to another, who is able to perform the function more efficiently and at less cost. Revenue-sharing reduces the overall cost of the plan for both employers and employees.

So, in conclusion, we are very supportive of enhanced disclosure of plan fees, but fee disclosure must be addressed in a way that does not overemphasize fees relative to other factors in the investment decisionmaking process, nor should it undermine confidence in the retirement system, or create new costs that, in turn, could decrease retirement benefits.

I would be happy to answer any questions that you may have.

[The statement of Mr. Chambers follows:]

Prepared Statement of Robert Chambers, Esq., Partner, Helms, Mulliss & Wicker, PLLC; Chairman, American Benefits Council

My name is Robert G. Chambers and I am a partner in the Charlotte, North Carolina law firm of Helms Mulliss & Wicker. I have advised clients with respect to 401(k) plan issues since 401(k) was added to the Internal Revenue Code in 1978. In that regard, my clients have included both major employers that sponsor 401(k) plans as well as national financial institutions that provide services to 401(k) plans.

I am also chair of the board of the American Benefits Council ("Council") on whose behalf I am testifying today. The Council's members are primarily major U.S. employers that provide employee benefits to active and retired workers and that do business in most if not all states. The Council's membership also includes organizations that provide services to employers of all sizes regarding their employee benefit programs. Collectively, the Council's members either directly sponsor or provide services to retirement and health benefit plans covering more than 100 million Americans.

The Council very much appreciates the opportunity to present testimony with respect to 401(k) plan fees. With the decline of the defined benefit plan system, 401(k) plans have become the primary retirement plan for millions of Americans. Accordingly, it is more important than ever for all of us to take appropriate steps to ensure that 401(k) plans provide those Americans with retirement security. In that regard, our goal is an effective and fair 401(k) system that functions in a transparent manner and provides meaningful benefits at a fair price in terms of fees.

We Support Enhanced Disclosure And Reporting Requirements

With respect to 401(k) plan fees, we believe that this Committee would be pleased by what our member companies are doing. Our members—both plan sponsors and service providers—report to us that plan fiduciaries are taking extensive steps to ensure that fee levels are fair and reasonable for their participants. Plan fiduciaries are asking hard questions regarding the various plan services and fees, and the fiduciaries are obtaining answers that give them the tools to negotiate effectively for lower fees and to provide meaningful information to participants. In the case of small plans with less bargaining power, plan fiduciaries are using additional fee information to shop more effectively for service providers.

Are there exceptions to this rosy picture? Of course there are. No system functions perfectly. So we need to strive to make the system even better. How can we achieve those improvements? The answer is conceptually simple: through even more universal disclosure of meaningful information. We need to ensure that all plan fiduciaries and service providers follow the practices we are hearing about from our members. Those practices include disclosure to plan fiduciaries of direct and indirect fees that service providers receive from the plan or from unrelated third parties. Those practices also include clear, meaningful disclosure to participants.

In this regard, we commend the Department of Labor and the Government Accountability Office ("GAO"). The Department of Labor has been working on a three-part project to enhance transparency that is conceptually the same as the enhanced regime we are recommending. This three-part approach is very similar to the recommendations made by GAO. One part would require the type of disclosure by service providers to plan fiduciaries that I refer to above. A second part would require clear, meaningful disclosure to participants. And a third part would require plans to report fee information to the Department. We have concerns regarding certain specific points with respect to the Department's proposals, but conceptually we are in agreement with the general approach. We look forward to a constructive dialogue with the Department as its proposals move forward.

As described in its letter to GAO regarding plan fees, the Department of Labor has already taken a number of steps to improve awareness and understanding with respect to plan fees. The Department makes available on its website important materials designed to help participants and plan fiduciaries understand plan fees. These materials include "A Look at 401(k) Plan Fees for Employees", which is designed to assist participants in selecting investment options. For employers and other plan fiduciaries, the Department makes available "Understanding Retirement Plan Fees and Expenses", "Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan", and "Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries". In addition, the Department makes available a model form—called the "401(k) Plan Fee Disclosure Form"—that is designed to facilitate the disclosure of plan fees by service providers to plan fiduciaries and the comparison of these fees. Finally, the Department has been conducting educational programs across the country that are designed to educate plan fiduciaries about their duties.

In short, we believe that the Department of Labor and GAO are making, and have been making, important contributions to improving the 401(k) plan system. In this regard, we are also proud of our own efforts to improve fee disclosure, which include working in a constructive manner with the Department to help it improve disclosure and transparency. For example, recently, a group of associations submitted to the Department of Labor an extensive list of fee and expense data elements that plan sponsors can use to discuss fees effectively with their service providers. (The associations were the American Benefits Council, the Investment Company Institute, the American Council of Life Insurers, the American Bankers Association, and the Securities Industry Association (now the Securities Industry and Financial Markets Association).) We view disclosure enhancement as a critical part of our mission to strengthen the 401(k) plan system and we are committed to continuing to offer our help to this Committee, other Committees, and the agencies.

Addressing Concerns And Questions

So far, I have been talking about positive things that can be done to improve the 401(k) plan system. Now I would like to touch on concerns that I know are shared by this Committee and answer some questions that have been raised.

We Must Not Undermine The Voluntary System

The success of the 401(k) plan system is dependent on many things, including very notably the willingness of employers to offer these plans and the willingness of employees to participate in the plans. It is critical that any reform efforts not inadvertently undermine these key building blocks of our system. Clear, meaningful disclosure is needed; overly complicated and burdensome disclosures would only push employers and service providers away from the 401(k) plan system. In particular, burdensome rules would be yet another powerful disincentive for small employers to maintain plans. Overly complicated disclosure would also confuse rather than inform participants; participants need clear meaningful information that is relevant to their decision-making.

In addition, employee confidence is critical to their participation in the system. If the huge number of employees participating in well-run efficient 401(k) plans hear only about the 401(k) plan problems and do not hear about the strengths of the system, their confidence will be eroded, their participation will decline, and their retirement security will be undermined.

We Must Not Inadvertently Increase Fees In The Effort To Reduce Them

Every new requirement imposed on the 401(k) plan system has a cost. And generally it is participants who bear that cost. So it would be unfortunate and counterproductive if a plethora of new complicated rules are added in an effort to reduce costs, but the expense of administering those new rules actually ends up adding to those costs. The Department of Labor has explicitly raised this exact concern. In its letter to GAO regarding the GAO plan fee report, the Department noted that its own fee disclosure project must be designed "without imposing undue compliance costs, given that any such costs are likely to be charged against the individual accounts of participants and affect their retirement savings."

In this regard, it is important to recognize a key point noted in the GAO report. In the course of numerous plan fee investigations conducted by the Department of Labor in the late 1990's, no ERISA violations were found with respect to 401(k) plan fees. Moreover, the Department of Labor receives enforcement referrals from various entities, such as federal and state agencies. The GAO report notes that "only one of the referrals that the [Department of Labor] has closed over the past 5 years was directly related to fees" (emphasis added). In the context of these facts, imposing burdensome new rules and costs to be borne by participants would be even less justified.

Fees Can Only Be Evaluated In The Context Of The Services They Pay For

Another critical point to bear in mind is that we must not examine fee amounts out of context. Any specific fee can only be effectively evaluated in the context of the quality of the service or product that is being paid for. For example, some actively managed investment options may logically have higher than average expenses, but it is the net performance of the option that is critical to retirement plan sponsors and participants, not the fee component in isolation. We must avoid studying fees in a vacuum. Fees are very important, but they are only one component of performance; with respect to investments, other key components include minimization of risk, diversification, relative peer group performance, quality of the investment organization, and, of course, investment return. Our objective should be excellent performance and service at a fair price.

Another example of this point is that increased fees generally reflect increased services. In the past several decades, there has been enormous progress in the development of services and products available to defined contribution plans ("DC plans") such as 401(k) plans. For example, many years ago, plan assets generally were valued once per quarter—or even once per year—so that employees' accounts were generally not valued at the current market value. Participants generally were not permitted to invest their assets in accordance with their own objectives; the plan fiduciary generally invested all plan assets together. Today, 401(k) plans generally value plan investments on a daily basis, and permit participants to make investment exchanges frequently (often on a daily basis) to achieve their own objectives. Other new services include, for example, internet access and voice response systems, on-line distribution and loan modeling, on-line calculators for comparing deferral options, and investment advice and/or education services.

In addition, the legal environment for DC plans used to be simpler, with far fewer legal requirements and design options. New legal requirements or options can require significant systems enhancements. For example, system modifications were needed to address catch-up contributions, automatic rollovers of distributions between $1,000 and $5,000, Roth 401(k) options, redemption fees and required holding periods with respect to plan investment options, employer stock diversification requirements, default investment notices, automatic enrollment, and new benefit statement rules. Today, 401(k) plans have become the dominant retirement vehicle for millions of American workers. With this change has come the need to help participants adequately plan for their retirement. Service providers have responded by developing investment advice offerings, retirement planning and education, programs to increase employee participation in plans, and plan distribution options that address a participant's risk of outliving his or her retirement savings.

Naturally, the new services and products and the needed systems modifications have a cost. In this regard, we also want to emphasize that the disclosure rules need to be flexible enough to take into account the ever evolving 401(k) plan service market. For example, the rules need to be consistent with the current trend toward reducing the size of the plan investment menu as well as the trend toward offering a brokerage account option.

On a related point, we see enhanced plan fee disclosure as another important step with respect to participant education. And we look forward to working with this Committee on further participant education initiatives.

Why Do Fee Levels Differ So Much Among Different Plans?

Different workforces need different services. Accordingly, the 401(k) plan market has attracted a number of different service providers that have developed numerous service options for plans, often with different fee structures and different services available for separate fees. This structure avoids forcing plans to pay for services that they do not want or use, and increases the options available to plan sponsors wishing to find providers and services that meet their and their employees' unique needs.

Concerns have been raised about the higher level of fees for smaller plans. Many plan fees vary only slightly (if at all) based on the number of participants in the plan. Accordingly, on a per-participant basis, plan costs can be much higher for small plans than for large plans. On a similar point, many costs do not vary with the size of a participant's account, so plans with small accounts will often pay much higher fees—on a percentage of assets basis—than plans with large accounts. These effects are most often a function of the nature of the services rendered: for example, plans must meet the same regulatory requirements without regard to whether a plan has 100 participants or 100,000 participants, and without regard to whether the average account size is $5,000 or $50,000.

Who Pays DC Plan Fees?

By law, the employer must pay certain fees, such as the cost of designing a plan. But there are a wide range of fees that are permitted to be paid by the plan and its participants, such as fees for investments (which generally constitute the vast majority of a plan's total fees), recordkeeping, trustee services, participant communications, investment advice or education, plan loans, compliance testing, and plan audits. Many employers voluntarily pay for certain expenses that could be charged to the plan and its participants, such as recordkeeping, administrative, auditing, and certain legal expenses. On the other hand, investment expenses, such as expenses of a particular mutual fund or other investment option, are generally borne by the participant whose account is invested in the fund.

Why Does One Service Provider Sometimes Receive Fees From Another Service Provider? Is This "Revenue Sharing"? Is This A Problem Area?

Some maintain that "revenue sharing" is wrong and should be prohibited. That view reflects a misunderstanding of how the 401(k) plan system works. Let me explain.

It is not uncommon, for example, for mutual funds or other investment options to pay other plan service providers for services needed by the funds. For example, assume that participants of a plan invest some of their assets in Mutual Fund A. If these were retail investors in Mutual Fund A, Fund A would need to: maintain separate accounts for each investor; provide a means for investors to interact with Fund A (e.g., internet access, voice response systems, telephone service representatives); make certain that investors receive statements, investment confirmations, and any statutory notices; and prepare the appropriate tax reporting for any distributions. When a participant invests in Fund A through a retirement plan, the plan's recordkeeper generally assumes these responsibilities and bears the cost of

performing them. It is not uncommon for Fund A to pay the plan's recordkeeper for performing the services that the fund would otherwise have to perform in the retail environment.

Such "inter-service provider" fees arise because different service providers cooperate in providing a total service package to a plan. "Revenue sharing" is the term often used to described these types of inter-service provider fees. In fact, fund companies typically designate a portion of their overall expense ratio as "shareholder servicing fees", and it is this expense stream that is typically used to pay other providers.

There is nothing inherently problematic regarding inter-service provider fees and the current-law prohibited transaction rules preclude inter-service provider arrangements that would create conflicts of interest. For example, assume that a plan pays Mutual Fund A $100 for investment services and the plan pays unrelated Service Provider B $50 for recordkeeping services. Assume further that Mutual Fund A pays Service Provider B $10 to provide shareholder services so that A receives $90 net and B receives a total of $60. Assume further that B discloses the receipt of the extra $10 to the plan fiduciary so that the plan fiduciary can evaluate the fee and the relationship between Mutual Fund A and Service Provider B. If $100 is a fair price for investment services, why does it matter whether A performs shareholder servicing itself or subcontracts with Service Provider B to perform those services? In other words, if Mutual Fund A performed the services itself, the cost to the plan would be the same $150, but A would keep the full $100, instead of paying $10 of its $100 fee to B. And if $50 is a fair price for recordkeeping services provided to the plan, why does it matter if B receives an additional $10 for services rendered to A? This example illustrates how an efficient subcontracting relationship works among service providers.

We are not suggesting that disclosure of the inter-service provider fees is not important. On the contrary, as discussed previously, we are very supportive of such disclosure. But the existence of these arrangements is not indicative of an inherent problem or a sign that 401(k) participants are paying excessive fees. If fully disclosed, these subcontracting arrangements can, on the contrary, be quite efficient and the current-law prohibited transaction rules are already in place to preclude conflicts of interest.

Are Plan Fees Too High?

Competition among investment options and service providers is intense, which exerts downward pressure on fee levels. For example, as noted above, investment expenses are generally the largest plan expense. These expenses are reviewed in the context of reviewing the performance of investment options. Plans routinely review such performance: a 2006 survey by the Profit Sharing/401(k) Council of America indicates that 62% of plans review plan investments at least quarterly and substantially all plans conduct such a review at least annually.

In fact, plan investment fees are much lower than fees outside the context of plans. For example, a 2006 study by the Investment Company Institute found that in 2005 the average asset-weighted expense ratio for 401(k) plans investing in stock mutual funds was .76%, compared to a .91% average for all stock mutual funds.

Conclusion

We are very supportive of enhanced disclosure of plan fees. But fee disclosure must be addressed in a way that does not undermine participant confidence in the retirement system and does not create new costs that have the counterproductive effect of increasing fees borne by participants. We are committed to working with the government to make improvements in the fee disclosure area, including reporting to the Department of Labor. We believe that the best approach to the fee issue is through simple, clear disclosures that enable plan sponsors and participants to understand and compare fees in the context of the services and benefits being offered under the plan.

Chairman MILLER. Thank you.
Mr. Butler?

STATEMENT OF STEPHEN J. BUTLER, PRESIDENT AND FOUNDER, PENSION DYNAMICS CORP.

Mr. BUTLER. Chairman Miller, Congressman McKeon and members of the committee, my name is Steve Butler. I am the founder

and president of the Pension Administration Firm in Pleasant Hill, California.

My company is one of the largest independent administration firms in Northern California, and we have operated well over a thousand retirement plans over the past 30 years.

I have written two books on the subject. The first was "The Decisionmaker's Guide to 401(k) Plans." The second was entitled "401(k) Today." Both books identified hidden costs and offered a formula for making an effective comparison between the total costs of different vendors and vendor combinations.

This led to some national publicity focused on what we called the Butler Index. This is an index of total costs, employee and employer, on a same plan, which was then the subject of a New York Times article. The article compared about a dozen major vendors in the 401(k) industry, and the results were shocking. Money magazine then wrote a feature article based on the Butler Index.

A persistent lack of disclosure leads many plan decisionmakers to purchase 401(k) plans that careful analysis of costs would show to be a poor value for participants.

A number of academic and industry studies show that just an extra 1 percent of assets charged to a plan will reduce retirement account balances by roughly 20 percent over a 30-year period. This means that someone retiring will have 80 percent of what they otherwise would have had, if fees had been reasonable and competitive.

The need for full disclosure of 401(k) fees should be as obvious as the reasons for any consumer protection laws. Throughout the history of these plans, a subset of the financial services industry has advertised free 401(k) bundle services to sponsoring employers, while the actual costs were billed to plan participants. And if costs were disclosed at all, a breakdown of these costs has not been offered to those participants.

In many cases, they were not disclosed to or fully understood by the company decisionmakers. To date, the Department of Labor has still not required bundled 401(k) vendors to fully disclose all the real fees associated with these plans.

Today, American workers have what I estimate to be $3 trillion in 401(k) plans. To pay for the record-keeping and money management services, they are paying somewhere between 1 percent and 2 percent, $30 billion to $60 billion a year. And, of course, that will only increase.

Charges for these basic functions can differ by as much as 600 percent for essentially the same range of services from different providers. This says that, while some plan participants are receiving good value, others are being grossly overcharged.

By comparison in the automobile industry, there is the manufacturer suggested retail price, commonly known as the sticker price, a legal requirement that the price be emblazoned on the window of every car sold in this country, with the component costs of each option listed separately.

There is nothing that should stand in the way of an equivalent, simple, and elegant solution to a problem that is otherwise costing American retirement savers as much as 20 percent of their ultimate retirement nest egg.

The approach of the Butler Index was to identify and breakdown all costs of either a bundled plan or combination of vendors. It was not rocket science. Anyone smart enough to operate a 401(k) plan today is smart enough to be able to go one step further, to identify and disclose the fees it is charging and what those fees are for.

Anyone asking for an exemption from these disclosure requirements because they say it can't be done is insulting our intelligence. Are they really trying to say that they have no way of determining the extent to which they are making a profit on a 401(k) plan client?

Any 401(k) is better than no 401(k), even if it an expensive one. However, company owners and managers owe it to themselves and their employees to make informed decisions about the plans they purchase on behalf of their fellow employees. In fact, the failure of corporate plan sponsors to have adequate disclosure of 401(k) fees and a breakdown of what those fees are for has been the subject of recent class-action lawsuits brought by participants, alleging that the plan sponsors breached their fiduciary duties under ERISA.

Full disclosure of 401(k) plan fees to corporate plan sponsors and participants will allow for cost comparisons. Give the number of players in the 401(k) marketplace, this will create competition, ultimately leading to reduced costs, to the benefit of participants.

In the absence of full disclosure, we see the equivalent of the fog of war. The battle for extremely valuable retirement plan money is so intense that the industry cannot resist any steps that enhance the perceived value of their product. The simplest of these enhancements has been to bury the total cost and fees charged to participants and then fail to disclose them.

As I see it, this is the problem that needs to be addressed with disclosure legislation and/or appropriately crafted Department of Labor regulations.

Thank you.

[The statement of Mr. Butler follows:]

Prepared Statement of Stephen J. Butler, President and Founder, Pension Dynamics Corp.

A Brief History

The 401(k) phenomenon is an accident in legislative history that has changed the face of America's retirement system. Voluntary pre-tax contributions from employees have generated substantial financial resources that provide a comfortable retirement for many. Considering the average American employee, early projections indicated that these plans would generate roughly five times the asset value at retirement than would have been received from the continuation of what was then a combination of qualified profit sharing, money purchase and defined benefit plans. Current statistics for the average employee who has been a participant for at least twenty years (and who is in their early 60's) support this original projection. The $3 trillion now accumulated in 401(k) plans offers a testimonial to their success.

The fact that pension laws have evolved to provide what amount to "portable" pension plans is critical in a country where the average employee changes jobs every seven years. The Bureau of Labor Statistics recently determined that the average employee born between 1957 and 1964 has had 10.5 different jobs between ages 18 and 40. Twenty-one percent of this group have had 15 jobs. Only fifteen percent have had fewer than four jobs. Those with college degrees had no better statistics regarding job stability than those without degrees.

To the extent that the traditional retirement plan system (that which preceded the 401(k) era) failed to meet expectations, its failure was largely attributable to the practical reality of employee turnover. Traditional pension benefits were designed

to create a form of "golden handcuffs" with vesting schedules that rewarded only those employees who remained with a company long enough to become vested in their retirement benefits. In the early '70's, this could have required as much as ten years of service. A direct quote from President Reagan at the time was that he wanted to create "portable pension programs." Over 70% of working Americans work for companies having less than 100 employees. A large percentage of these employees work for companies with less than 25 employees. In the past, small, relatively unstable companies rarely offered traditional retirement plans when employer contributions were the only source of funds. Today, many offer some variation of a 401(k) plan or the small-company equivalent in the form of SIMPLE 401(k)'s.

The complicated laws requiring 401(k) plans to pass non-discrimination tests has compelled company owners and highly-compensated managers to spend time and money promoting plans to all rank and file employees. Without substantial contribution percentages from these non-highly compensated people, the managers were limited to contribution amounts below the legal maximums. This has prompted management to do everything in their power to promote the plans. Matching contributions, company discretionary contributions, employee meetings, individual financial advice and careful selection of investments are all a part of this promotional effort leading to the success of these plans.

Cost to Participants in General

The costs to 401(k) participants struggling to save for retirement is a detriment that has marred what would otherwise have been the unqualified success of the 401(k) phenomenon. Excessive fees, just over the past twenty years, have reduced participant account balances by an average of 15%. On a projected basis, excessive fees charged to participants will have reduced retirement "nest-eggs" by 20% according to a wide variety of organizations conducting research on the subject.

Understanding the Fundamentals of 401(k) Costs

Fees taken from plan assets to pay for administration and/or money management are paid with funds that could otherwise be earning and compounding on a tax-deferred basis. The "Magic of Compound Interest" works against employees to dramatically magnify the loss of these missing dollars. The business term for this condition is "opportunity cost"—the calculated cost in dollars of a lost opportunity.

Example:

The best illustration of the cost of excessive fees is to project a flow of 401(k) contributions over time at percentage returns that reflect the difference of 1% (a typical amount of an "excessive fee.") Choosing $10,000 as an employee contribution amount is reasonable considering that we are looking well into the future. The median income today is $71,000 and the average contribution amount is 6-7%. In many cases, both members of a married couple are contributing, so $10,000 per year is not unreasonable. The returns for the American stock market have averaged 10% per year over a long historical period.

THE OPPORTUNITY COST OF A 1% EXCESS COST—$10,000 ANNUAL CONTRIBUTION

Percentage annual return	Account value 10 years	Account value 20 years	Account value 30 years
10%	171,178	641,491	1,925,836
9%	162,568	566,549	1,570,441
Cost of 1% fee	8,610	74,942	355,395

For the 20-year period through the 1980's and 1990's, the stock market averaged a 16% rate of return. Looking at what might be higher underlying rates of return going forward, the opportunity cost of the missing 1% is much higher. By 2000, many employees in expensive plans who had been participating for twenty years effectively paid the following amounts in opportunity costs as a result of high fees during that 20-year period.

THE OPPORTUNITY COST OF A 1% EXCESS COST—$10,000 ANNUAL CONTRIBUTION

Percentage annual return	Account value 10 years	Account value 20 years	Account value 30 years
15%	232,057	1,279,641	6,008,782
14%	215,656	1,079,734	4,541,874
Cost of 1% fee	16,401	199,907	1,466,908

After twenty years, this illustrates the actual cost for what might have been a single employee contributing $10,000 a year (or two people contributing $5,000 each) in the twenty years ending in 2000. Multiply these single-participant detrimental effects times the $3 trillion now in 401(k) plans and we can understand why the fee issue is critical.

Stop and recall for a moment the "Rule of 72" which states that money earning 7.2% doubles every ten years, and money earning 10% doubles every 7.2 years. Today's $3 trillion can be reasonably expected to double twice to $12 trillion in the next 14 years, thanks to reasonable investment returns and annual contributions. Excessive, undisclosed fees scheduled to cost participants as much as $2 trillion dollars is the problem we are here to try to correct.

Where the Abuse Begins

The greatest abuses are seen in the small-company environment where the average company owner is not a mutual fund or retirement plan expert. Large companies, by comparison, have reasonably sophisticated decision-makers. Xerox, for example, operated its own mutual funds and charged participants just 3/100ths of one percent per year. Participants in many small-company plans can be paying as much as 3 full percentage points—exactly 100 times more for the same level of services.

Technically, all fees charged to participants are disclosed today to plan sponsor decision-makers, but not all fees are disclosed to participants. In the insurance industry, for example, the practice of non-disclosure was justified by the rationale that "fees didn't matter—net investment results were all that participants needed to see." This was an actual quote from the marketing Vice President of a major insurance company when interviewed by MONEY magazine in 1998.

Fees charged to participants may be stated in the investment materials, but they remain effectively hidden on an ongoing basis because participants never receive a bill and never see a separate line item outlining what their costs, in dollars, have been.

According to FORBES magazine, the mutual fund industry is the world's most profitable as it earns a consistent 30% pre-tax profit. Investors are not fee sensitive because they are focused on returns. Generally this means "chasing last year's best performing mutual funds."

In today's seamless electronic financial services arena, the hard-dollar cost of administering a mutual fund with at least $50,000 is 6/100ths of one percent per year—approximately $30. Virtually all 401(k) plans are administered in pooled accounts where the investor is the plan itself—not the individual employee. As a result, virtually all 401(k) accounts, on a fund-by-fund basis, meet this $50,000 benchmark, meaning that the profit on the account is anything beyond the 6/100ths being charged. If the average mutual fund charge in a 401(k) investment is 1 full percentage point per year, the profit on those accounts might be as high as 94%.

In all discussions regarding fees, we have to take as a given that no single mutual fund or fund family can show that that they have consistently earned a higher rate of return (to justify higher fees) for any sustained length of time. The money management industry is a "zero sum game" in which all players revert to the norm at some point. Moreover, even when we can review past performance, there is no way to know prospectively whose performance might compensate for an excessive fee going forward. Over longer periods of time, a difference in performance among funds of the same type can be largely attributed to the difference in their costs to investors.

How 401(k) Plans are Structured

Most 401(k) money is maintained today in a "daily-valued" electronic environment managed by the mutual fund or insurance companies themselves or the transfer agent industry that services the mutual fund industry. Plan participants can dial up their account information on an 800 voice-response number, but by far the most popular access is through the Internet. The raw cost of providing this seamless, electronic recordkeeping function is approximately $50 per year per participant. This is referred to as the "recordkeeping fee." It is the cost of maintaining the accounting of the participant's account.

Apart from the money management, there is the cost of complying with the layers of retirement plan regulations dictated by ERISA. This work is concentrated immediately after the end of every year when the discrimination testing must be completed. Later in the year, the government reporting form (Form 5500) for the plan must be completed and submitted. It is essentially a balance sheet and income statement for the plan. The cost of this compliance testing and administration is typically about $35-$60 per participant with a base company fee of $1,000- $1,500.

An Illustration of Fees in a Typical Plan

We can use an example a plan with 50 participants and $3,000,000 in assets. This is typical of an engineering or professional firm that has had a plan for twenty years.

The record keeping and compliance cost for these 50 employees should be roughly $130 per employee. If the true cost of money management is only 6/100ths of a percent, the money management cost for $3,000,000 would be $1,800. The total cost of the plan would be $7,800. By comparison, a typical vendor in the industry today would be charging an average of $36,500 for this plan. Some have scheduled fees that would amount to as much as $60,000 or 2% of assets.

While a plan sponsor (the company) might be happy to pay for the administration cost, it will never pay total fees of this magnitude. Asset-based money management fees will always be charged to participants where they will be largely ignored. After all, no participant ever receives a bill or writes a check for these costs. They are automatically deducted from what would have been earnings—or from principal in years when earnings may be negative.

Techniques that Obscure the Magnitude of Fees

Having established that hidden excessive costs are a guaranteed detriment to optimizing savings results over time, it is generally easy to identify them when we know where to look. Some of the more difficult hidden costs, however, are those that are buried in the process and that will never show up in any stated cost to participants.

Non-disclosure at Participant Level in "Bundled Plans"

In the 401(k) marketplace, participants are told the annual expense ratios of the mutual funds offered by the plan, but administrative fees charged to their accounts are typically disclosed only in an annuity contract signed by the plan sponsor. This percentage amount is referred to as the "wrap fee" and it is typically one or two percent in a small company environment. The insurance industry is not legislated by federal laws, so the normal disclosure requirements demanded of the fund industry do not apply to insurance companies legislated only by state governments. In the mutual fund industry, the cost of administration, if presented as being "free," is usually imbedded in the expense ratios of the funds. Comparable funds, if not priced to support administration, could generally be found that would be less expensive for participants.

These plans that combine investment products with administration all provided by one company are referred to as "bundled" plans, and the providers of such plans are suggesting that "bundled" plans be exempt from any disclosure requirement to come out of these hearings. With what I estimate to be 70% of all 401(k) plans provided in this "bundled" format, making them exempt would emasculate any new disclosure requirements.

Mutual Fund Industry—Proprietary Fund Requirement

In the mutual fund industry, the fees to participants are disclosed because they are the normal annual expense ratios of the funds. They are spelled out in the prospectus of each fund and today are universally summarized in the employee promotional literature. The mutual fund industry does not add a wrap fee. Instead, a company such as Fidelity will insist that at least half of the funds selected for the plan include their own proprietary funds. Remembering that the profit from a 401(k) account can be as much as 94% to the fund family, the insistence that at least half of the funds come from the fund family's proprietary list ensures that the plan will be profitable. A refinement of this technique is to require that the so-called "core funds" will be proprietary. These are the large-company or balanced funds that traditionally attract as much as 70% of the money in the plan. So, while the fund requirement based on the number of funds may only be half of the offerings, the percentage of employee money in those funds can easily be 70% or more.

The balance of the funds offered in the plan may come from other fund companies as part of an effort to create a "veneer of objectivity" for marketing reasons. These other fund families will typically be limited to just those funds that charge enough to pay the primary fund family 25/100ths of one percent and possibly some additional funds to buy "shelf space" on the "platform" offered by the primary fund family selling and administering the plan.

What does this practice cost the participant? No single fund family offers superior funds across the entire spectrum of the industry. Common sense would tell us that selecting from a vast universe of choices will generate better fund selection than a limited universe from just a single fund family. Here, we are selecting funds for the convenience and pricing demands of the vendor—not with the sole purpose of im-

proving the outcome for the participant. Knowing that this is the case explains why major mutual fund companies in the 401(k) industry refuse to be construed as fiduciaries of the plan. Selling their own funds would be a prohibited transaction and would violate the requirement that fiduciaries make decisions based upon the "sole interests of participants."

In the sample plan above, (50 employees and $3,000,000) most vendors today would offer to do the administration and record keeping at no cost to the plan sponsor. A quick review of the arithmetic would explain why. Those administrative costs would have been about $7,000 and the plan is charging participants $30,000.

Barring the Exit—Back-end Charges for Plan Sponsors who Want to Leave

The most egregious examples of excessive fees today are found in plans that are using share classes or annuity products that pay commissions up front and then have high ongoing fees to participants to offset, over time, the commission that was paid up-front. If a plan sponsor chooses to leave one of these plans there will be a "contingent deferred sales charge" otherwise known as a "back-end load." Eventually, the load grades down and disappears after five to seven years, but in the meantime, the plan sponsor can not leave without subjecting participants to an exit charge that can be as high as 5% of their assets. Moreover, the law specifically bars a plan sponsor from paying that cost as a company expense, because plan contributions can only be made as a percent of compensation—never as a percent of assets. These are the plans that can be charging participants as much as 3% per year. Once introduced, they are locked in by exit charges for at least five years.

The insurance industry and the subset of the mutual fund industry selling through the NASD brokerage industry are selling these 401(k) packages with back-end loads. The pure no-load sub-set of the fund industry does not offer this format. The back-end-load phenomenon occurs only in an environment where a mutual fund sales person or insurance agent requires a sales commission that has to be charged to the plan.

Funds as a "Feeding Trough" for the Brokerage Industry

As yet another example of a hidden fee, FORBES magazine published an article entitled, " What's the Matter With Brokers' Funds?" The fact that these funds generate relatively poor performance is well-established, and the reasons have to do with two facts. The article stated that "* * * the whole psyche of a brokerage firm is built around selling, not buying * * * Analysts at wire houses get ahead by helping underwriters, not by being skeptical." This is essentially saying that the brokerage-sponsored funds are used as a resource for investing in the kind of companies that the firm was underwriting. High turnover of assets in the funds also generated trading fees for the brokerage firm. I was once told by a Prudential-Bache retirement plan representative offering a "free" plan to a plan sponsor that "once we have the assets, we don't have to worry about making money." The FORBES article went on to say, "Another problem is that broker-sponsored funds tend to have steep expense ratios."

How an Expensive Plan Can Be Marketed

Thanks to the benefit of hindsight, a classic marketing ploy involves a presentation of funds from a new vendor candidate that have substantially out-performed the incumbent selection of the existing vendor. The current vendor, of course, is saddled with a selection of funds that were chosen three years previously in most cases. There are the problems of logistics and inertia that stand in the way of making changes in plans unless performance has fallen off a cliff. Of course, in this environment, a new set of fund choices will always look substantially better. The average plan sponsor rarely thinks to ask for examples of what the proposed new vendor's investment selections might be for a plan that they have operated for three years. There would typically be no improvement shown by this comparison.

This is symptomatic of how the consultants and marketing personnel in the industry can appear to be offering improvement when, in fact, they are simply rearranging the deck chairs and adding to the level of hidden fees in many cases. Representations of superior performance are a major tool used to take the focus away from participant fees.

Misinformed Decision-making on the part of Plan Sponsors

Section 404(c) is a U.S. Department of Labor regulation establishing requirements for plan sponsors that reduces their liability for making poor decisions with regard to the plan. Employees must be able to change investments and receive statements at least quarterly. They must be offered three basic fund types including a money market or guaranteed fixed income option. Finally, the plan must have a written

investment policy statement, and employees should be provided with investment education (the latter being undefined and unspecified.)

Ironically, Section 404(c) proved to be a solution looking for a problem which then created a far more serious disadvantage for the employee participant. Since 1980 or the earliest days of the 401(k) phenomenon, virtually all plans offered quarterly statements and investment changes and a selection of different investment types. Remember that senior executives were major beneficiaries of these plans and they were inclined to want investment quality and flexibility. Virtually all plans operated under what was essentially an investment policy statement because decision-makers wanted decent investment choices for themselves.

The financial services community seized on Section 404(c) as the reason for hiring them to monitor the plan and therefore reduce liability. In fact, there was no practical liability for reasons having to do with 404(c). At industry conferences, lawyers were quick to point out that there were no lawsuits anywhere in the country brought by employees or groups of employees offered a selection of name-brand mutual funds and a rudimentary investment education and plan promotional effort.

The law of unintended consequences quickly created a "create the need" opportunity for the financial services community. An army of qualified and experienced "advisors" fanned out across the 401(k) Plan Sponsor community and talked about the potential liability of not using professional help and advice with regard to operating the plan. What this universe of advisors did not point out was that a.) there was no practical legal problem stemming from the way plans were typically being operated, and b.) the cost of this advisory service was going to be, at a minimum, one half percent to one full percentage point charged to plan participants—a cost that guaranteed a loss of up to 20% of retirement assets for each participant.

Meanwhile, there have been some lawsuits successfully filed against plan sponsors. The first that I am aware of was against First Union Bank settled for $25 million in behalf of the bank's employees. The bank was operating a collection of mutual funds, (Evergreen Funds which they owned at the time) and these funds were charging bank employees substantially more than 401(k) investments the bank was selling to its bank customers.

In the same vein, the recent class action suits against Fortune 500 companies such as Caterpillar, Boeing, Kraft and International Paper are all centered on fees—not a lack of reporting, investment choice or investment education.

Avoiding Compliance Responsibility

While the financial services industry has seized upon Section 404 (c) and the scare tactics it can foster, they have deliberately avoided responsibility for most of the other IRS and Labor Department Regulations that they should be upholding when representing themselves as providing 401(k) administrative services. A typical service contract will have hold harmless language such as "the design and ongoing operation of your retirement plan needs to be reviewed by your tax and legal advisors." The "bundled provider" contract of one of the nation's largest mutual fund companies says the company will perform the 401(k) test and coverage test, but all other tests are the responsibility of the plan sponsor. In effect, the financial services industry is saying that they will do the work, but they are not offering a guarantee that it will be done correctly or completely. A plan failing an audit can cost the plan sponsor a substantial amount of money in legal fees and corrective measures. In an indirect way, this misrepresentation could be construed to be a hidden fee. The average plan sponsor assumes that the major financial institution handling their plan has taken responsibility for its compliance with all government regulations. In my experience, however, the immediate response when compliance problems arise is the voice on the phone saying, "read your contract."

The Search for a Solution

To identify a solution, a process would involve working back from a perfect, if admittedly impractical, model.

Ideally, the best 401(k) plan would be one that charged nothing to the plan. All fees, even those associated with managing the mutual fund, would be charged to the company and paid with tax-deductible corporate dollars. A typical employee would be better off electing to have his or her taxable salary reduced slightly to help defray all or a portion of these costs. This would be far better than having the same costs deducted from plan assets that could be compounding on a tax-deferred basis.

Here's an actual example of that positive arithmetic. Over 800 dentists use a money management firm to manage retirement assets at their respective practices. The firm charges 1% of assets and routinely levies this charge against plan assets. In one actual case, I pointed out to a dentist that the firm was free to bill his practice for what, in this case was $15,000 per year on $1.5 million of assets. The net

cost to the dentist billed directly, considering his 50% marginal state and federal tax bracket was $7,500. Instead, the dentist was paying that year's $15,000 with money in his plan that in 7.2 years (at a 10% annual return) would have doubled to $30,000. In 14.4 years, it would have doubled again to $60,000—in 22 years, $120,000 etc. Obviously, the dentist asked to be billed directly and then started wondering if 1% might be little high for mediocre investment management that failed to beat basic benchmarks. The financial services industry will always opt to bill the plan directly because they do not want fees to become an issue. The arrangement outlined above had persisted for over twenty years. The billing format had a projected cost for the dentist and his employees of well over one million dollars of opportunity cost—a cost that was reduced to a fraction of that amount in future years with the stroke of a pen.

Xerox charged just 3/100ths of one percent to its employees. Vanguard, on large amounts of money, can charge as little as 6/100ths of a percent and still make a profit. DFA is yet another mutual fund company renowned for its Vanguard-equivalent low fees. These organizations offer mute testimony to the fact that it doesn't have to cost what most of the industry charges to invest pools of money. An oligopolistic situation exists thanks to buyers who are unaware of the impact of fees. With few exceptions, nobody in the financial services industry wants to see this condition change.

The Solution

A simple but impractical solution would be to bar any organization that manages money from actually selling and administering 401(k) plans. The industry selling plans would be barred from receiving any revenue-sharing from the money management (mutual fund) industry. This would end the hidden fee elements seen in the brokerage industry and mutual fund industry where the sale of 401(k) plans is an engine for selling proprietary funds and generating trading commissions. There are 3,500 third party administrators across the country today who are independent of major financial institutions and that perform recordkeeping services and compliance work for retirement plans. Some of these companies, such as Hewitt Associates and Milliman and Roberts, are substantial and equipped to handle the nation's largest plans. Without this separation between product producers and 401(k) administration and sales, it is difficult to see how some of the more subtle examples of hidden costs can be avoided. Considering the foothold that mutual fund companies have in the industry, however, it is difficult to envision this as a practical solution. The horse is out of the barn.

The next option would be to have a national standard fee disclosure form required of any 401(k) presentation and require that it be renewed to reflect any change in investment mix. This standard would require that the cost in dollars and compound earnings over ten and twenty year time periods would be based upon the average fee charged to participants, assuming an even mix of investments across the entire spectrum of fund offerings. This would be stated on the front page of the 401(k) presentation and as part of the Summary Plan Description. In other words, a 401(k) vendor would have to show what the average opportunity cost would amount to over ten and twenty years based upon the average fee charged to a $10,000 per year contribution. It would be reasonable to assume a 10% rate of return as the starting point or gross return on investments assuming no fee. Fees would then be subtracted from this percentage amount, and the compound results would be illustrated. Using an average contribution of $10,000 per year would be simple (and inspirational.)

This comparison would illustrate the dramatic difference in costs over time between different vendors. It would offer a reality check for the average decision-maker who might otherwise have chosen a hidden-cost but expensive plan for his or her company. It is critical to require that the comparison use an example in dollars as I have suggested. To just require a stated percentage cost is too abstract. Even investment professionals have a hard time grasping the magnitude of opportunity cost presented by just a fraction of a percent in excess costs.

The Outcome and Benefit to Those Saving for Retirement

Saving fees increases retirement benefits, in the aggregate, by as much as 15%-20%. How can this not be important enough to enact disclosure standards demanded of every company in the industry? Decision-makers may still purchase expensive plans for their employees, but not without hearing from the "self-styled mutual fund experts" that manage to find a voice in every company. An army of retirement savers have now deposited $3 trillion in their 401(k) plans. They are rapidly becoming a nation of reasonably sophisticated investors. For the most part, they know how to diversify investments, and they have lived through the volatility of stock market

performance. This is a clear case where the glass is half full. The financial services industry can be commended for getting us this far. Going forward, however, we can improve results by insisting on an educational tool (comprehensive cost disclosure) that the industry acting on its own is inclined to avoid.

Chairman MILLER. Thank you very much to all of you for your testimony.

Mrs. Bovbjerg, toward the end of your testimony, you said that one of the problems was that many of the fees are hidden from sponsors and might mask conflicts of interest. Could you elaborate?

Ms. BOVBJERG. What we are talking about there is when a sponsor may contract with a pension consultant or a service provider, who then has, unknown to the sponsor, a business relationship with, say, a fund manager, and then recommends to the sponsor, "You should use this, you should go with this fund manager."

Chairman MILLER. And that may be without regard to performance or cost?

Ms. BOVBJERG. It may not be in the best interest of the plan.

Chairman MILLER. You also said that the Department of Labor did not have resources to adequately—fill in the—to do what? I didn't catch the last part of your testimony there.

Ms. BOVBJERG. Well, the Department of Labor doesn't get the information that they would need to enforce fee responsibilities. They don't get a total fee reported to them in the Form 5500, the primary way that they get information from plan sponsors. We think that they should make that more clear, that they need all of the fees in one place.

Chairman MILLER. You think that should be corrected?

Ms. BOVBJERG. We have recommended that to them, and they are pursuing several initiatives in the area.

Chairman MILLER. What is the status of that, do you know, since this report?

Ms. BOVBJERG. Of our recommendation?

Chairman MILLER. Yes.

Ms. BOVBJERG. They are considering it.

Chairman MILLER. Yes?

Ms. BOVBJERG. They haven't done anything yet, but they are considering it.

Chairman MILLER. Okay, thank you.

The example that you just pointed out, a few months, there was a story in one of the business journals talking about this arrangement, where money was between sponsor and a fund. And it was one of the worst-performing funds and had been one of the worst-performing funds for multiple years, like among the worst, and yet they kept paying out money to get, you know, recommendations of deposits of funds in that fund.

So is that what you are talking about, that kind of conflict of interest? I am not necessarily saying of that magnitude, because this was——

Ms. BOVBJERG. Well, we are talking about some of the things that came up in the SEC report a couple of years ago. They looked at 24 pension consultants and found that about half of them had undisclosed relationships with other types of service providers.

Now, that is not to say that there was necessarily a conflict or that it harmed the pension fund, but it was not disclosed, and they felt that was problematic.

Chairman MILLER. Mr. Hutcheson, in your testimony, you suggest that that is not that unusual.

Mr. HUTCHESON. No, sir, that is very common. That is a very common practice. In some cases, the term "directed brokerage," which is now a banned practice with mutual funds, an explanation of that is where a fund manager would speak with a brokerage firm and say, "I will bring all of the trades of the underlying securities of our mutual fund to you if you will then recommend my fund to your sales force."

And what would happen is, is the sales force would get a recommendation for a particular fund, and they would go out and sell it to plan sponsors.

Chairman MILLER. That is a now banned practice, you are saying?

Mr. HUTCHESON. In mutual funds, it is.

Chairman MILLER. In mutual funds.

Mr. HUTCHESON. There are some other types of investment pools, where it is not a banned practice, but the egregious problems happened in mutual funds, and now that is a banned practice.

Chairman MILLER. Thank you.

Mr. Chambers, you suggested that people think that Toyota builds cars, but they assemble them. But at the end of the day, they are buying a car which can be—is rated over time. People say that this is what it costs to drive this car for this year, this is the maintenance, this is the miles per gallon, and all the rest of it.

They can find out information and make a decision between that Toyota and the Chevrolet Impala, if they want. They can make that decision. My concern is here is that people are being asked to make decisions or decisions are made for them, and the assumption is that that is better or that is different.

Because what we see is that, you know, day in and day out, it is very hard for fund managers to beat the S&P index, right?

Mr. CHAMBERS. If you would elaborate on a particular fund——

Chairman MILLER [continuing]. Mr. Hutcheson's testimony, I think it was—it is obviously used many times by index funds. But, for example, the S&P 500 index consistently outperformed 98 percent of the fund managers over 3 years, 97 percent over 10 years, and 94 percent over the past 30 years.

Recent studies reveal—and many more continue to substantiate—that the passive 60 percent stock, 40 percent bond portfolio outperformed 90 percent of the largest corporate pension plan portfolios, "run by the world's best and brightest investment minds."

Mr. CHAMBERS. And the source for that, sir?

Chairman MILLER. It is in Mr. Hutcheson's testimony, but we see this remark all of the time at the end of the year or the quarter, where they match and compare actively managed funds against index funds and other such funds. And it is very hard for those managers to beat those index over any period of time.

Mr. CHAMBERS. Well, I think, in given periods, you are absolutely right.

Chairman MILLER. Well, 10 years.

Mr. CHAMBERS. But I also think—and if I may, I also think——

Chairman MILLER. Thirty years is a pretty good given period, since that is the time most people work.

Mr. CHAMBERS. Possibly. It depends upon which fund it is, of course. I can tell you, for example, that the funds——

Chairman MILLER. Well, it beats 94 percent of the active funds, so you can pick the other 6 percent of the funds, and I hope I could find them.

Mr. CHAMBERS. Well, I can tell you, sir, that, for example, in our retirement plan, at our law firm, we get this information every quarter. And over 5 years, which is a measurement—our law firm has not been in existence for 30 years, so we don't have that information.

But over the last 5 years, we have outperformed—if you take all of the funds that we make available, about 10 funds, we have outperformed the appropriate market index for each one of those funds an average of 3.05 percent over 5 years.

Do I think that—and if you take a look at the peer performance reviews of the investment managers who we retained and the funds that we retain, they are not necessarily in the top 5 percent or 10 percent of their peer group every year. I think it depends upon the way that you are looking at the statistics.

I don't know that I necessarily agree with Mr. Hutcheson's statistics, not knowing what his basis is.

Chairman MILLER. I would say that Mr. Hutcheson is one of among many—and I am not vouching for his statistic, I am just saying that this is a comparison that is made in every economic journal at the end of every quarter and the end of every year, when they put in a special section on mutual funds, and they compare how it is done.

Mr. Butler, I don't know if you want to chime in on this, but——

Mr. BUTLER. Well, I would just refer to the Stanford professors about 30 years ago who threw darts at the Wall Street Journal and proved that a randomly selected group of stocks would beat 85 percent of all efforts to manage money over any rolling 10-year period of time.

It led to five different Nobel Prizes for research coming out of that original dart-throwing exercise. So I think it is pretty well-established that, at the end of the day, low fees are the primary determinant factor for investment results that are optimal.

Chairman MILLER. If I might, I would just like to take one minute of the committee's time here. The question here, I think, is the transparency and information available and the value of that. And, you know, you have what we get in our TSP, the Thrift Savings Plan, in a relatively simple form at the very bottom, it has cost to participant. And it is fixed basis points across all of the funds, except for the L funds, and those are variable funds, so, as of this date, that was not available to them.

You have the vanguard approach, which is, again, a one-page, very simply laid out cost to this. And this is to the plan, not to the participant. This is to the plan. And then you have what, I believe, that ING reached an agreement with Attorney General Spitzer on this, where you have to charge—one is the end-year balance without fees, end-of-year balance after the fees.

So I don't know whether these are the right things to do or not, but the point is, there does appear that there can be a simplification of explanations, both to plans and to the participants, in those plans. And that is the quest of this committee, to see whether or not some of these might make sense, in terms of helping the participants and the plans make these decisions.

And with that, I will yield to Mr. McKeon.

Mr. MCKEON. Thank you, Mr. Chairman.

Ms. Bovbjerg, in the colloquy that you had with the chairman, you talked about the Department of Labor has received input, and you don't know where they are in the process of coming out with regulations or proposals?

Ms. BOVBJERG. Well, they have three initiatives in process right now. And I believe that they told us that the regs would be forthcoming later this year. They have been collecting a lot of comments on those initiatives.

Our recommendation to them was a little different than those initiatives. We would have recommended that they require sponsors to provide a total of the fees associated with the plan by type, in the Form 5500, and they have not taken action on that yet, but they also hadn't said they wouldn't. They are considering it.

Mr. MCKEON. How much do you think could be done by the Department of Labor, versus what we should try to do in legislation?

Ms. BOVBJERG. Well, some things, for example, with regard to the 5500, can be done by regulations in the Department of Labor. Other things, you are so right, have to be done through statute.

We had recommended in our recent report on fees a couple of things that Congress might consider. Both would require amendments to ERISA. One was to require service providers to provide information on their financial relationships to sponsors. And the other—and that would be an explicit requirement. Now it is not a requirement. Some sponsors know; some sponsors don't.

And another would be to require sponsors to provide participants information on fees that would allow them to make comparisons across funds.

Mr. MCKEON. It sounds to me like all of you are in agreement that something should be done for disclosure simplification.

Ms. BOVBJERG. I think we are.

Mr. MCKEON. Well, that is what I heard in the testimony. The concern I have is one that I addressed in my opening statement, is unintended consequences. And how do you simplify without making it much more complicated?

It seems like every time we try to simplify—not our committee, but the Ways and Means, when they try to simplify the tax code, pages upon pages are added to the tax code. And that is a concern I have.

The prospectus that the chairman showed—well, they are all familiar with them, as we are. They are very complicated. I have bought stocks for my life, and I am sorry to admit that I usually don't read every word in those things. And it would be nice to have a little summary or something to go with them, but a lot of that is a result of laws that have been passed or regulations.

So I am really sympathetic to the need to simplify. I am just concerned of, once we start trying to simplify, what we end up with

at the end of the road. You know, if we sat down with these four people in a room—a few of us—we could probably work something out that would be good and be profitable. And I am concerned as we move forward that we just don't make things worse at the end of the day.

So, Mr. Chairman, what I would like to ask all of them and others, as we go through this process, to keep involved. And if you will watch where we are skewing things one way or another, please try to bring it back. I don't know if you are planning on moving forward with legislation on this, but that would be my big concern, is that we——

Chairman MILLER. I am thinking about it now.

Ms. BOVBJERG. Could I chime in for a minute? I perceive that part of it is the concern about not overburdening sponsors, and another part is the concern about plain English, which is something that we at GAO worry about across a lot of different programs, and something that the Social Security Administration has to worry about, with the benefit statements they send out to a much wider ranger of Americans than people who actually have pensions.

It is something that I think any disclosure of initiatives that we as a government take in this area, we might consider some language about plain English, making it accessible.

Mr. MCKEON. Like the things that the chairman just showed, I think were good, simple. The problem is, we pass laws, the president signs the law, regulators write what they think that we meant when we passed the law. And by the time it all gets done, plain English is totally gone.

And, I mean, we did that—when we go to the doctor's now, we all have to sign a new form. And I am a little chagrined every time I go in the doctor's office and have to sign that, because it was federal legislation that required that. And it just gets put somewhere in a file, nobody ever reads it, nobody ever does anything with it, but it just was a result of some legislation.

So I would be happy to join with you, if you think that is an approach——

Chairman MILLER. I appreciate the comments. I hadn't smoked out what we would do yet. I would like to think about it. But when I read much of this testimony, it along with the GAO and its make a fairly compelling case that inaction is probably not an option for the committee.

And I appreciate your concerns and your willingness to work on this and to, certainly, use these witnesses as resources.

And we always know that, when the law leaves here, it is clearly written, so it is not open to ambiguous interpretation. But we know we can start with a clear statement of purpose.

Mr. Kildee?

Mr. KILDEE. I will be brief. I think we have a vote on the floor.

But, Mr. Butler, what do you think it would take to get the 401(k) industry to move towards a simple, one-page fee disclosure that captures all the fees?

Mr. BUTLER. Well, I think it would be very simple. First of all, you have to appreciate that the entire industry today operates in a seamless, electronic environment. So those of us who are actually keeping track of this money—I won't make it too absurdly simple,

but I would almost say that, with a few keystrokes, we can determine what the actual costs are and report them very effectively.

I see it being a de minimis additional effort and probably not something that would increase costs in any way.

Mr. KILDEE. You think it is not rocket science to do?

Mr. BUTLER. It is not rocket science.

Mr. HUTCHESON. Could I, Congressman Kildee? I agree. I believe that the solution is very simple. I believe in letting the markets work and letting competition drive prices. And I do not believe that this would impair, or impede, or discourage employers from maintaining plans. I believe that it would greatly increase confidence in letting that competition go, unencumbered and unimpeded.

And I just wanted to share and elaborate on something. William Sharpe, who won the Nobel Prize in Economics, said that the market generally is supposed to be efficient. And when you start actively managing investments, whether at the mutual fund level, or at the plan level, or at the sub-plan level, the participants level, the fees start to be added, and there is a direct correlation, an exact correlation between the returns of what the participants receive and the costs.

So active-managed funds and index funds are the same before costs. You add costs and fees, and there becomes the disparity.

And what happens is, is that when a participant receives their participant statement, they show that their funds and their plan are meeting the benchmarks or matching this index or that index, but that is for the fund. That is for the fund itself.

Those statements do not show what that particular participant's return was. And that has to be corrected, because, with all due respect, a good-manned firm may have great performing funds at the fund level, but once you start adding in various costs, the actual participant returns are very different. And that is an important clarification that I wanted to make.

But coming back to this, I believe strongly that it is simple. If we strip out all the ambiguity, all the obscurity, and let the market work based on fully transparent, fully disclosed information, the fees will go down. There will be good competition. There will be confidence in the system.

Plan sponsors will appreciate it. I don't see plan sponsors bailing out of this. I see them embracing this. And it is in the best interest of American business to shore up the economic security of its workforce, because 20 years from now, we have got a big pool of baby boomers who are going to be retired who won't have enough money to meaningfully participate in the economy.

And a lot of businesses are going to wonder why they are struggling. It is because a whole segment of the economy was removed because they didn't have enough money. There is no money to spend.

And so it behooves plan sponsors to deal with this. It is in everybody's interests.

Mr. KILDEE. And they are going to be in the 401(k)-type rather than the defined benefit-type, so we have a large number of people who will be affected by this then.

Mr. HUTCHESON. That is correct.

Mr. KILDEE. Ms. Bovbjerg, can we learn anything from the Thrift Savings Plan that we have in the federal government that can help us in the 401(k)s?

Ms. BOVBJERG. The Thrift Savings Plan discloses information in a clear way, as Chairman Miller was showing. I think it is important to remember that the Thrift Savings Plan is somewhat different from 401(k)s, in that their administrative costs are exceedingly low compared to other forms of—you know, other types of plans, that some of that has to do with the way that that plan is administered throughout the government.

It also has to do with—they have been very effective in keeping their costs low, I have to acknowledge that. I just think it is difficult to make that comparison, because you are dealing with a less diverse group of people. We are dealing with federal employees. They can all read; they all speak English. You know, it is quite different than a much broader type of plan coverage.

Mr. KILDEE. Thank you very much.

Thank you, Mr. Chairman.

Mr. BOUSTANY. Thank you, Mr. Chairman.

We would all agree that disclosure and transparency are very good things. Mr. Chambers, is there a danger in oversimplifying, when providing information to participants, that could lead to poor choices? Could you elaborate on that and what sort of problems that that might create?

Mr. CHAMBERS. Surely, thank you.

Despite some of the comments that have been made earlier today about fees being the most important—and, perhaps—I am not suggesting anyone has said the only important, but the most important factor here—a large number, certainly in my experience, the predominant number of financial advisers have indicated that there are many different things that should be put into focus as you are making an investment decision. Clearly, fees are one of them.

The gentleman to my right, Mr. Hutcheson, I think just mentioned the fact that, you know, you look at total return. That is generally going to be net of some fees, perhaps all fees, depending upon what is being paid out of the funds.

Risk is an issue. Diversification is an issue. There are many, many issues that need to go into an investment decision. Perhaps that is why Mr. McKeon is no longer investing in stocks, because of all of the different things that you have to consider when you are making an investment decision.

So I think that the big problem with oversimplification here is an overemphasis on fees. Yes, they are important. Yes, they should generally be disclosed. But they can—just looking at that and that alone can lead to some very bad investment decisions.

Mr. BOUSTANY. I thank you for that answer.

Ms. Bovbjerg, in looking at ERISA, Section 404, could you basically state what it requires and what was its intended purpose? And in the view of GAO, is it really meeting that purpose?

Ms. BOVBJERG. I don't know if I can do all that right here and now. I can talk a little about 404(c), which is particularly relevant——

Mr. BOUSTANY. 404(c) is particular, yes.

Ms. BOVBJERG [continuing]. To this topic, that plans that fall under 404(c) are essentially seeking freedom from liability for investment choices that the participants make. In return, they have to disclose certain things beyond what other plans would have to do.

We had a little trouble trying to figure out what proportion 401(k)s sell under 404(c). We thought it was 50 percent to 60 percent, somewhere in there. Those are the plans that the Labor Department is thinking about focusing new fee reporting requirements on.

Now, the way we see some of the fee reporting, it is all over. It is effective in some plans, but not uniformly. Participants have to ask for certain things; they have to know to ask for certain things; they have to pull information from several different sources.

You know, and 404(c) plans, it is easier to get that information, no question about it. But is it complete? It is just not clear to us that it is.

Mr. BOUSTANY. I thank you.

I yield back.

Chairman MILLER. Mr. Yarmouth?

Mr. YARMUTH. Thank you, Mr. Chairman.

I only have one question, and I think I know the question, but it seems like there is nothing to prohibit any of the providers from disclosing their fee structure. And my question is—and anyone can address is—why is unreasonable that this wouldn't become a huge competitive advantage, in what is apparently a pretty competitive field, 700,000 plans out there?

Why couldn't we allow—just allow the markets, the providers to use that as their advantage? The lowest fee structure, if they advertised it, would give them a competitive advantage.

Mr. HUTCHESON. If I might, thank you for that question.

The reason—and I will try not to be too complicated here, or complex, rather—401(k) are today governed partially in a fiduciary environment, as they were originally intended and contemplated, and partially in a non-fiduciary environment. They are exemptions that exist that permit non-fiduciary investment firms and others to participate in 401(k) plans, where otherwise they might have been prohibited from doing so, had the exemption not been given.

And so this intermingling or blending of non-fiduciary and fiduciary philosophies is the root cause of this. And if you bifurcate the two, fiduciary standards of care demand transparency and open competition based on equal information between the buyer and the seller.

It is the non-fiduciary component of 401(k) plans that is obscuring this, partially due to that exemption or to exemptions. And when I say "that exemption," I am referring to the Merrill exemption that permits them to participate in 401(k) plans and receive various forms of compensation without being held to a fiduciary standard.

And if we help everybody to a fiduciary standard, this might self-correct.

Mr. YARMUTH. Can I just ask for clarification? Do I understand you correctly that what you are saying is that different providers

have different obligations under these plans, and therefore the fees wouldn't be apples to apples?

Mr. HUTCHESON. Exactly. You can take two physicians' offices. Both of them have 20 employees. One of them has service providers that acknowledge their fiduciary status and behave as such. The other physician's office has the exact same mutual funds, or funds, but yet their service providers are hiding behind an exemption that protects them from fiduciary responsibility.

And, therefore, they are not held to the same standards of disclosure, and that has to be eradicated from the 401(k) system. I believe that it will self-correct if that happens.

Mr. CHAMBERS. My experience is that, although certainly there are some folks who will perform a service as a fiduciary and others who will perform the same service as a non-fiduciary, is that I don't see any less disclosure of fees in one situation, as opposed to the other.

And, clearly, plan sponsors, if they wish to off-load fiduciary status onto someone rather than retaining it themselves, they certainly have the capacity and the marketplace to do that. As Mr. Hutcheson just pointed out, there are organizations out there who will accept this role.

There are other organizations, though, that say, "I will do it in a different fashion," and that is the marketplace. There is a decision. I don't believe that in under any circumstances do you need to homogenize that, do you need to invariably go out and find someone who is willing to serve as a fiduciary to perform the function to the exclusion of someone who is not, particularly for purposes of this hearing, if both of them are charging relatively the same fee or, even if they are not, if they are disclosing it.

Mr. HUTCHESON. If I may just clarify, because 401(k) plans are a fiduciary animal, they are subject to trust laws. And trust laws have fiduciaries. And fiduciaries must be able to discharge their duties unimpeded. They must not have obscured information or they must not have information withheld.

Let me give you a specific example. I was asked by the chairman of an organization to come in and explain how their investment providers are managing their fee for free. Well, clearly, that can't be the case, but that is what the chairman was told. And we are talking about $100 million plan.

And I categorically and summarily disagree absolutely. The fiduciaries simply didn't know what the pay or cost structure was of the plan. None only does ERISA demand that fiduciaries know, but if fiduciaries don't really understand whose getting paid, then they can't discharge their duties.

And they are withholding information, because they are not held to a fiduciary standard. And I believe strongly that they should be.

Mr. BUTLER. If I may, as a further answer——

Mr. YARMUTH. I think I am glad I asked this question.

Mr. BUTLER. Pardon me?

Mr. YARMUTH. I think I am glad I asked this question.

Mr. BUTLER. Well, what I would like to do is just elaborate and talk about money for a minute, as opposed to fiduciaries. Mr. Chambers, in his written testimony, presented an elegant, perfect example of how fees are charged.

He used as an example $150 for the total cost of operating a plan for, say, a participant; $50 of that cost would be for the actual administration of the plan, $100 would be for the money management portion.

And then he pointed out that, on the $100 of the money management portion, which is going to the mutual fund, they are going to give up or pay $10 of it back to the company doing the administration. So the administration company is actually getting $60, and the mutual fund company is getting a net of $90.

In the real world, you can expand that to a real situation. Let's say that we have a $10 million plan. It has 150 employees, probably an engineering firm, a law firm, company that has been around for at least 15 to 20 years. And so now, instead of $150, we have actually 1.5 percent, which would be pretty typical, $150,000 is what is now being paid, one way or the other, to administer this plan of $10 million.

We have got $100,000 going to the mutual fund. They are giving up $10,000 of it and paying it to the record-keeper. Somebody understanding that there is that breakdown of cost could now start shopping for the record-keeping services. And on this particular plan, they would be able to get those services for something in the neighborhood of roughly $10,000 a year. They don't need to pay $50,000.

The $10,000 for the record-keeping is really for the seamless electronic environment that allows people to dial up their account on the Internet, and that is a basic commodity in the industry today.

So now you have a plan sponsor who has an opportunity possibly to save his participants about $40,000. And at this point, he is now looking at the other component of the plan, which is the mutual fund company that is charging $90,000. And a person confronted with that information is going to say to himself, "Maybe I can get this money managed for something closer to $40,000, instead of $90,000," and he could.

So now he is just saved his participants, including himself, because he has his own account to think about, he saved himself and his participants about 1 full percentage point per year. The magic of compound interest works against us when we start taking fees or paying fees out of money that could otherwise be compounding, tax-deferred.

It is counterintuitive. In this particular example, let's say we have saved about—we have increased our returns by about 10 percent, let's say. So you ask yourself, "Well, why is that leading to 20 percent more money downstream?" And the answer to that is, because that additional 1 percent compounded adds up to 20 percent of the total account balance.

He has essentially saved his participants 20 percent of what they otherwise would have spent, and effectively he has increased everybody's retirement nest egg by 25 percent. And that is what this is really all about; that is why these hearings are so important.

Chairman MILLER. The gentleman's time has expired.

Mr. Kline?

Thank you for the question.

Mr. KLINE. Well, I am going to let us continue down that line. It looked like Mr. Chambers wanted to have something to say. I would like you to do that, and then I would like to address my question.

Mr. CHAMBERS. Thank you, sir.

The point that I was going to make is, that that is exactly the problem that I have highlighted. Mathematically, that makes great sense. But should the employer or whoever it is who is making the decision on who is going to be investing plan assets or whose products will be available, who is going to be administering the plan, that they should do that, either solely on the basis of fees or largely on the basis of fees?

There was no indication here about what the relative performance of the two record-keeper. Does the record-keeper, does the new program permit all the bells and whistles that the employer and the employees want? That costs money. Does the investment adviser, who is being selected, because, in fact, they charge fewer dollars, you know, per thousand, what is their relative rate of return over a long period of time?

All of this needs to be put into the perspective of a lot of different people making decisions on the basis of a lot of different points.

Thank you.

Mr. KLINE. Thank you. I knew you were chomping at the bit there, so to speak.

I don't know, Mr. Chairman, do the witnesses have this——

Chairman MILLER. I don't know, but we will get it to them.

Mr. KLINE. Okay.

Chairman MILLER. Yes, it was shown up. Maybe it can be put back up on the plasma screen.

Mr. KLINE. It seems to me like there is some agreement here in the committee—and maybe throughout the room—that transparency and visibility into these funds is a useful thing.

But I am concerned that we sometimes do confuse the famous apples and oranges, and I am just trying to understand. I think, Ms. Bovbjerg, you were talking about this issue earlier, not confusing or not trying too hard to compare the Thrift Savings Plan with some other 401(k)s.

And this, clearly, is doing exactly that. It is comparing the Thrift Savings Plan with some—I don't know if that is a real fund, but it shows a significant difference, when you compare the TSP with this notional 401(k). It looks like those are dollars per individual.

What I would like you to do is go back where you were a couple of questioners ago and talk about why it is that the Thrift Savings Plan comes in at asset-based fees of 0.6 percent and why it is not. We are a little apples and oranges here when we try to compare other 401(k)s. Could you do that for us, kind of pick up where you were? Thank you.

Ms. BOVBJERG. Absolutely.

I think I would also like to say that this is a graph that is similar in spirit to one that was in our report on fees that looks at what, if your fees were 1 percent higher over a 20-year period, what would that mean? It would be about a 17 percent loss of income, assets.

The Thrift Savings Plan uses administrators across the federal government to help people sign up to make changes. The Department of Education has them; the GAO has them; Congress has them.

Mr. KLINE. And these are public employees rather than——

Ms. BOVBJERG. These are public employees, and they are—Congress pays for its office. GAO pays for its personnel office that has these people in the Department of Education, so——

Mr. KLINE. Thus reducing the costs?

Ms. BOVBJERG. Yes. So the six basis points is not really what the administrative cost is of the Thrift Savings Plan, but that is not to take away from the fact that Thrift Savings Plan is very efficiently run. So the administrative costs are still pretty low.

Mr. KLINE. Okay, thank you.

Yes, Mr. Hutcheson?

Mr. HUTCHESON. The underlying investments in the Thrift Savings Plan are what we call index funds generally. They are passive funds. You are getting the broad market.

In the private sector, funds very similar to what is in the Thrift Savings Plan are available to employers. They might be slightly more expensive, because it is a price based on the assets in the plan. But what we are seeing here is a perfect example of what Professor Sharpe, who won the Nobel Prize in Economics, and also many other people have said.

If you track the broad market as closely as possible, you will get market returns, and you really, over the long haul, can't do better than that.

Mr. KLINE. Sure, I understand. You are proposing that we use the index funds. But what I was trying to get at is that there is—in the fee world, which we are trying to get visibility in the fees—what is now shown here, was what Ms. Bovbjerg pointed out—that because the taxpayers are paying, in some part, for the administration of this, because we have public employees who are doing part of this work, the Thrift Savings Plan is not the best apple-to-apple comparison and what fees are.

Thank you, Mr. Chairman. I yield back.

Chairman MILLER. Thank you.

Mr. Wu?

Mr. WU. Thank you, Mr. Chairman.

First, I want to ask the panel—and, Bob, you in particular—do we have pretty much uniformity of agreement that disclosure of the various fees is non-objectionable, as long, as you said, Bob, that it does not drown out other valuable information, that disclosure of brokerage fees, 12b-1 fees, and so on and so forth, that all of those disclosures are appropriate.

Mr. CHAMBERS. Well, I generally agree, but I think that where the rubber hits the road is going to be in terms of what fees needed to be disclosed and how we slice and dice the fees that are out there.

And to go back to one of the points that the chairman made earlier, and when he was alluding to my Toyota example, when you go to buy a car, there is not fee disclosure on how much Toyota paid for the glass, and there is not fee disclosure on how much Toyota paid for the computer components. There is an overall fee.

And I agree: There are ways to assess whether that particular automobile is better than another automobile, through miles per gallon, you know, performance, which is what we are talking about here.

So I think that the council's concern—well, the overall concept is, yes, we are very favorably behind the idea of full and fair disclosure of fees. But I do think that where we are going to run into issues is, exactly how are we going to be slicing and dicing that? Because I don't know that it is necessarily essential for a plan participant—to mix the two metaphors now—that a plan participant needs to know how much the glass costs in the car.

And I can see, for example, that, if you have a large financial institution which has been empowered through contract, you know, to perform services for a plan, and if, for example, that financial institution decides that it is going to take one of the functions that it is contractually bound to perform, and to hand it off to one of its affiliate companies, you know, say it has a captive trust company, for example, I don't know that that necessarily is something that needs to be disclosed. That is internal proprietary information.

But by and large, overall fees, yes, we are very much in favor of that.

Mr. WU. Yes. And because of the limitations of time, let me just say that, in contrast to, say, a Toyota, because of the difficulty of predicting future market performance, because the market is basically different from being able to calculate the speed or safety of a car, some of the rear-view mirror things, if you will, like fees, take on a disproportionately important role, I would like to be—I would be very interested in hearing from all the panelists what disclosures you all feel are important and the best display format for that, so that it is most useful for investors.

And I would like to ask that question and get that set of answers over time in writing, because I would like to turn to Mr. Hutcheson for a second. And I am not sure that this came out, Matt, in your oral testimony, but in going through your written testimony last night, there was a recurring theme of non-fiduciary functions and fiduciary functions and having those mixed together, and a core problem of mixing those non-fiduciary and fiduciary functions together.

But as I read the materials, one of the non-fiduciary functions was actually the investment decisions of the plan's beneficiary. And I would like to take me through this a little bit. It is one of the—where you are going with this, if we take it all the way out with a fiduciary plan, is that we ultimately get the plan beneficiary off the loop, in terms of decisionmaking about investment vehicles.

Mr. HUTCHESON. That is right. I personally believe—and just to clarify before I answer the question—that no person can time the market. I just don't believe it. I think there is empirical research that shows that there is only a few points in time each year where the market really takes a big leap forward, and you have to be in the market at that point in time.

And so placing decisions in people who have no financial or economic or investing experience, and not only just placing investment decisions, but we are talking about trust assets subject to fiduciary prudence.

So 404(c) says that a participant will not be deemed a fiduciary to the extent that they are directing these trust assets, and that is kind of a conflict in fundamental fiduciary prudence and trust oversight, as we have been accustomed to, many, many years, decades before 404(c) was enacted.

And very short, I believe that participants play with their accounts based on recommendations of friends, what they see in the news. They have the ability to make changes. 404(c) says that you have to be able to change your allocations quarterly or more frequently, as the market dictates. Why would they want to be changing their accounts based on what happens yesterday?

That is not prudent. It makes no economic sense. It is not based on good, sound investment research or theory. It in itself, I believe, is bad public policy. And it, in my opinion, goes contrary to fundamental laws of fiduciary prudence.

Mr. CHAMBERS. May I add one point, please, to that? And that is—well, actually two points.

One is, I don't think that that is a correct statement of trust law, number one. It is difficult for someone to be a trustee for himself or herself. And, therefore, you are not a fiduciary, which involves acting on behalf on someone else. So I don't think that that is a correct statement.

Number two, you need to take a look at the program, I think, that Mr. Hutcheson is proposing. Now, you know, one of the comments or one of the things that we talk about is the series of movies that were out a number of years ago, you know, "Back to the Future."

Well, I think that what he is suggesting is the opposite, which is "Forward to the Past." There is, if you take a look at what he is suggesting—which is a very viable program for employers who are so inclined. I am not trying to say that it is a bad program at all. I don't think that it is particularly viable in the view of most employers with whom I work.

It is essentially the creation of a television set that only gets one channel, and it is a channel that, whoever it is that is putting that set together, is developing. One set of investments, you know, no loans, no this, no that.

Why would an employee want to make a decision to change an investment because of what happened yesterday? There may be something else in his or her life that dictates that. It also may be that they no longer have confidence in the investments that they previously made.

Chairman MILLER. The gentleman's time is expired. Thank you.

Mr. WU. Thank you, Mr. Chairman.

Chairman MILLER. Mr. Andrews?

Mr. ANDREWS. Thank you, Mr. Chairman.

I very much appreciate the witnesses, and I appreciate this hearing. I view this hearing as a continuation of work that this committee has done on a bipartisan basis over the last number of years, reflecting a number of points of consensus.

The first point of consensus is that it is a reality that individuals are managing their own investment decisions, and I think there is a consensus that we should not impede that individual choice or individual freedom.

In the wake of the Enron scandal a few years ago, there were some discussions of putting legal limitations on choices people could make in their own 401(k) plans. I, frankly, opposed those suggestions, and I am glad they are not the law.

The second point of consensus is that people should—we should facilitate people getting sound investment advice. Now, there is still significant disagreement over what that means. There was a compromised reach in the act of 2006. We will evaluate the efficacy of that compromise and continue the discussion, but I think it is obviously true that sound investment advice is better than no investment advice or, frankly, a lot better than investment advice from an incompetent source who doesn't know what he or she is talking about.

The third point of consensus is that we should maximize transparency so that people making these individual choices have the widest array of facts in front of them so they can make the best choices, which leads us to today's discussion, which is, what should the form and nature of that transparency include?

I will confess to you, I come to this discussion as an agnostic. I am very interested in what you think as to how we can answer that question. But in my simple agnosticism, I would make the following proposition.

We talk about people buying cars? I think the best example is someone selling their house. It is the single most important economic decision most Americans make. And when most Americans sell their home, they ask one question. They ask two questions, really: How much am I going to get for the house? What is the sale price going to be? And how much of the sale price am I going to get to keep?

I actually practiced real estate law before I did this and represented hundreds of homebuyers, and they would ask the realtor how much they were going to get for the home, how much the contract was going to be for. And they would ask me, as their attorney, how much they were going to get to keep.

And we have disclosure laws, RESPA, in the real estate context that tells someone how much of the proceeds they have to pay to someone else, the real estate commission and other fees, and how much they get to keep.

I think that is the basis on which we should build this disclosure. I think we should build it on the proposition—if my 401(k) were invested, and I got to keep everything, every dollar earned on that investment decision, how much would that be? And then how much are we going to get in a net return, after whatever fees, or contracts, or considerations are paid?

Does anybody disagree with that as a conceptual framework for approaching this problem?

Okay. Now, I think there is a second category of this disclosure we also have to think about. And I am not sure whether the present law covers this or not, and that is the situation where, to use the analogy, the sale price of my house is too low because the realtor was conflicted in some way, that the realtor sold the house to her sister-in-law rather than to the highest bidder.

Does anyone think that the present ERISA statute does not prohibit that situation? Does anybody think that the present statute

doesn't prohibit the situation where the person making some plan decisions is depriving me of the highest price or the best investment?

Mr. BUTLER. If I may, I think there are all kinds of opportunities for that to happen right now, under the current situation. Forbes magazine talked about the extent to which the brokerage industry's own mutual funds do very poorly as investments, comparatively speaking.

And the reason for that is because the brokerage industry's source of revenue, to a large extent, has to do with trading commissions. So the mutual funds that they operate, in many cases, are feeding troughs for their trading operation. And that is an example that I see in the industry, along the lines of what you were just talking about.

Mr. ANDREWS. Okay. Because my time—do you agree with that conclusion of Mr. Butler or not?

Mr. BUTLER. Yes, I do. I would say that——

Mr. ANDREWS. No, I know you agree. I asked Mr. Chambers if he agrees with you.

Mr. CHAMBERS. I don't always agree with myself, so I need to deal with that.

Mr. ANDREWS. Okay.

Mr. CHAMBERS. Before I respond to that, to respond to your comment or your question, I am concerned with your using the word "best" in conjunction with what ERISA requires, as opposed to what is reasonable, which is, in fact, what the statutory standard is.

Mr. ANDREWS. Of course, it doesn't require what is reasonable. It requires what is in the best interests of the participant party.

Mr. CHAMBERS. Best interest, yes, but not necessarily the best result.

Mr. ANDREWS. Okay. You would agree, that is not synonymous with reasonable, though. If you make a reasonable choice that is not in the fiduciary interest of your——

Mr. CHAMBERS. No, but somebody has to act reasonably. And one of the ways that they have to act reasonably is within the best interests of the participants and the beneficiaries.

I think that, if everyone had to go around chasing the best investment results, or if everyone had to go around chasing the lowest conceivable method of administrative fees, I think that this would be a very different world.

Mr. ANDREWS. Of course, that is not what I asked, though. I asked whether you thought that the statute prohibits someone making a conflicted or self-interested decision in the investment context.

Mr. CHAMBERS. I think that, yes, the statute does currently prohibit that.

Mr. ANDREWS. Effectively?

Mr. CHAMBERS. Pardon me?

Mr. ANDREWS. Effectively? Do you think there is any loopholes in that?

Mr. CHAMBERS. Are there loopholes? I don't know that I would call this a loophole, but remember that, for example, employers have issue—every employer that sponsors a plan invariably has

issues about its role as the settlor of the plan, the sponsor of the plan, versus its role as a fiduciary of the plan. And that is something that is inherent in sponsorships.

So I don't know that you would call that a loophole, but certainly that is something that everyone has to be concerned about.

Mr. ANDREWS. My time is expired. I would just ask if Mr. Hutcheson wanted to respond.

Chairman MILLER. Mr. McKeon wanted to tag on——

Mr. ANDREWS. Sure, Mr. Chairman, I would yield.

Mr. MCKEON. Will the gentleman yield?

In your example, if the realtor brings an offer to me to sell my house, I can accept or reject it. So I don't see where that really plays a role, a comparable role.

The first part, where you talked about just final net return, it sounds great to me. I don't know where——

Mr. ANDREWS. Yes, if the gentleman would yield, here is the analogy of the realtor bringing an offer. Someone has to make a decision which options to give the plan participant. You could limit——

Mr. MCKEON. But it all washes out with the net return.

Mr. ANDREWS. It washes out——

Chairman MILLER. I will take your answer off the air.

Mr. ANDREWS. Thank you.

Chairman MILLER. Mr. Sarbanes?

Mr. SARBANES. Thank you, Mr. Chairman, and thank you for holding the hearing.

I have a brief question. In my view, when it comes to information, there are two ways you can hide the ball. You can not disclose enough information, or you can disclose so much that it becomes impossible for the consumer of the information to sift through it and understand it. You see that happen in many, many different arenas.

So, Mr. Butler, I wanted to ask you to address this, because it is not just about more disclosure. It is about better disclosure. And I feel as though I get plenty of information on a lot of things that represent "full disclosure" that I can't make heads or tails of. And this is another arena were that would be the case.

So it is about how you package it. And your index, obviously, attempts to do that. But if you could just speak to the pitfalls of too much disclosure or how we package or present the information in a way that is really constructive for the consumer.

Mr. BUTLER. I would love to address that.

First of all, the need to know, from a decisionmaking standpoint, really centers on the company management people who are basically charged with deciding what kind of plan and which vendors they are going to use. That is why my first book was called "The Decisionmaker's Guide to 401(k) Plans."

The participants really then wind up being the beneficiaries of hopefully some informed decisionmaking. When you are looking at the component costs of one of these plans—and the example that I was using earlier—what is important is for these decisionmakers to be able to basically understand each component cost so that they can effectively decide whether or not they want to be part of a package deal or not.

And the example that I used, we presupposed that we had mutual funds and then a separate company, let's say, as a record-keeper. But, in fact, in about 70 percent of all 401(k) plans, it is all in the same building. It is the mutual fund that also has three floors of record-keepers keeping track of the money and doing the compliance-related issues.

And so the important thing is for this bundled provider to be able to present to the decisionmakers, their clients, what the component costs are so that the decisionmakers can decide whether or not they want to be part of a package deal. Or can they create a much better opportunity for their participants by breaking things up and shopping for better opportunities?

It is like, when you buy a car, you might decide that you don't want the manufacturer's Bose stereo because you can get a much better deal buying a stereo independently.

Mr. SARBANES. Do you think that the "decisionmakers" can be as susceptible to getting too much information, as beneficiaries can, or because they are better versed and this is their responsibility, to make these decisions, that they are sort of protected against that?

Mr. BUTLER. My experience, in the smaller company environment—and, bear in mind, 70 percent of all Americans work for companies that have less than 100 employees—my experience is that decisionmakers in that environment tend to be the company owners, who are by definition successful businesspeople, many are self-styled investment experts themselves, or mutual fund experts.

Also, the CFO or controller will also be part of that de facto decisionmaking committee. And these people are very, very sophisticated. They make the right decisions if given the right information.

Mr. SARBANES. Thank you.

Mr. CHAMBERS. May I comment?

Mr. SARBANES. Sure.

Mr. CHAMBERS. I guess I agree with most of what Mr. Butler just said. The one issue that I have is, that I am not sure that it is appropriate or essential to get a bundled provider to explain what the cost allocation is or the expense allocation is, if it is not making those services available independent of one another.

In other words, the way—and I just went through this with a client—that is a small employer, about 100, 150 employees, and they wanted to look at new record-keeping investment systems. And they went to some programs that were bundled, and we found out what the total costs were from that. And then they went to other programs which were not bundled, and we found out what the total costs were there.

I don't know that it would be essential to receive information from the bundled program, for example, about how much it was allocating to provide record-keeping, as opposed to some other component, if that is not available from that same organization. I don't know that that is information that is going to help you to make a meaningful decision.

Mr. SARBANES. Well, I hear that, and I worry—it is a fair point, although it could also be the beginning of a slide, kind of slippery slope, in terms of what comparative information is available.

I yield back. Thanks.

Ms. SHEA-PORTER. Thank you, Mr. Chairman.

I can remember when the fees for banking and mortgages were so absolutely confusing, and there has been some streamlining. And probably my son, who is 17, is the only one who still pays 10 percent monthly on his balance at a bank, and we are going to straighten that out.

But the reason I brought that up was because it is difficult for people who are not knowledgeable to understand. And it is pretty clear on the bank statements to me now, you know, what the fees will be. And I will be teaching my 17-year-old shortly the same thing.

But when you try to compare different plans, I think there is an obligation—this actually is to Ms. Bovbjerg—an obligation to be as explicit as possible. And I think it is possible to be simple, as well, when you are explaining the fees.

And I listened to my colleague talk about the costs of the TSP, for example, and I wanted to ask you to address that. He said that federal employees were picking up some of the cost of the administration. Do you have any idea how much the federal employees are actually picking up? And is it possible to compare those two plans?

I am fortunate enough to be in the TSP, and it is clear, and the administrative fees are lower. So could you address that, please?

Ms. BOVBJERG. And you have touched on one of the reasons that makes it so difficult to compare the Thrift Savings Plan to other types of retirement saving vehicles.

When I brought up the thing about the Thrift Savings Plan, I did want to say that, you know, this graph is essentially showing the math between two things. And the math is correct, but it is the implication that six basis points is sort of normal I was a little concerned about.

The Thrift Savings Plan has certain levels of expenses. And, in fact, we will be reporting on these costs for Congressman Davis in a couple of months. But the Thrift Savings Plan does take its—gets revenue from not only, you know, from not having to do things, but also from the money that is what I would call "left on the table," you know, the federal government matches and puts in 1 percent.

And for people who come to the federal government, the people who leave before they invest, can only take their money, and they leave the federal money on the table. That also nets the administrative costs for the TSP. That is one of the reasons why they look so low.

I would like to say that, in terms of reporting to individuals, it is critical that it be simple, that it be clear, it be all in one place, and that people don't have to go ask for it, because they will never find it. Only a certain percentage of people will know to do that.

But it is hard. It is hard for the Social Security Administration to produce a benefits statement that 270 million Americans can understand. And they put a lot of effort into it. So I don't want to discount what I know are the concerns about, how do you really make something that people will find accessible? It is not easy, but it is important.

Ms. SHEA-PORTER. Right, but it is doable, that is what you are saying.

Ms. BOVBJERG. It is doable.

Ms. SHEA-PORTER. Right, and still leave a healthy profit for those who are the administrators.

Ms. BOVBJERG. I can't say what it would cost, different kinds of sponsors. And, certainly, I know that the Department of Labor is weighing, you know, sponsor burden against the outcome and trying to figure out how they can best achieve some sort of optimal result.

Ms. SHEA-PORTER. Okay, thank you.

Chairman MILLER. Thank you very much.

And thank you for all of your testimony.

A couple of things here. One is, I guess the question I would ask—and I appreciate Mr. Andrews raising the point, if you had a net-net-net figure, would that tell you what you really need to know as a consumer, or would these other packages of information be more informative, or what have you? And that is obviously to be discussed further.

But the real question for me is, again, a lot of people—you know, you can have $100 million plan, and a lot of people are struggling to put in $6,000, $7,000 into this plan. And they don't have a lot of room for risk and fees and the rest of this.

And the question that I would raise is, are we sure that we are getting the value added for that? And is there a reasonable reason why somebody made a decision to go in that direction? Or was it a conflicted decision? Or was it a decision that really didn't meet that reasonableness when you consider who is in the plan?

You know, the Miller family doesn't have a lot of margin of error for mistakes. My employer apparently does, because we have got $1 trillion debt he is running around with. But, you know, the sponsor of this plan, the owner of the business, and maybe the officers, depending on the size of it, they may have a lot of income. People working for them may have reasonable income or good income. But good income today doesn't give you a lot of room for risk.

So, you know, the question is, how does that factor in? And I guess the disappointment I see is that you have a lot of people dipping into other people's money. You know, I didn't put the money into the 401(k) plan so a lot of strangers could come in and start dipping into this, under manufactured titles, for fees of questionable services, whether I need them or not need them.

Now, I am an individual, and so then we have to go to the plan, we have to go to the sponsors, and I think that is the central question for me, that this really is about other people's monies. And I think that, also, you are in an atmosphere where people have determined—maybe it is the advent of the Internet—but if you can charge a real small fee a billion times, you can become a really rich company. And people say, "Oh, that fee doesn't matter."

Well, as we have seen, every one of you have given us a comparison chart of what it would mean—let's just use the 1 percent differential. That is a lot of money to a middle-class working American, at the end of the time, when they think they are going to retirement, and what are they going to be able to extract if they don't want to eat up the principal of that nest egg?

Those are big differences. One of you said that the difference was the—between the 1 percent and 1.5 percent, 1.5 percent differential, the person who was on the bad end of that bargain would have

to work an additional 7 years. I mean, these are big consequences to workers and to families.

And I guess my concern—I mean, one of the things discussed with the members of the committee and with others, is the question really, are they getting value added here?

You know, I have listened to I don't know how many financial shows over 20 years, where one side is saying, "This should be the position for most American investors, an index fund. It is safe, it is low cost, and the rest of that."

And the other people say, "Oh, no, you can go out there, and you can beat the market," and there is a lot of reasons why people say that, because they are out there trying to beat the market, and they need clients to do so. And that may be good for some people, but it may not be good for this plan that is becoming a larger and larger percentage of people's retirement.

This isn't their mad money; this is their retirement. By default, this has become one of the two remaining legs on the retirement stool in this.

You know, we have been talking about a comparison of the thrift plan, but I think IBM and Xerox are even more efficient in these 401(k) plans than the thrift. Does anybody have any knowledge of that, that they—one of you had it in your statement, I am sorry.

Mr. BUTLER. My understanding is that Xerox charges .03 percent to their employees. They probably have some other costs, but they are paying those costs as a tax-deductible corporate business expense, instead of having participants pay it with money that would otherwise be compounding tax-free.

Chairman MILLER. That is because of a separate decision they made, how they would allocate the costs. So that is a benefit, I guess, that you would argue they feel strongly enough financially to be able to shift.

Mr. BUTLER. Exactly. And there is no way that Xerox would then be paying 100 basis points as a corporate business expense. They have just figured out what the fixed cost is for each participant in the plan, and it is probably about $50 a year to keep track of the money, per person.

Chairman MILLER [continuing]. Xerox is not a small business, with, you know, 100, 150 employees. So there is some bargaining——

Mr. CHAMBERS. I think you need to look at it as an employer contribution to the plan. And Xerox could ask the employees to pay whatever the amount is and be providing a larger employer contribution in the form of a match or, perhaps, in a profit-sharing contribution. And the employees would be in the same position.

So I think that you are correct, but there is another way to do it, which is the way that a lot of employers are doing it.

Mr. HUTCHESON. Chairman Miller, I don't think that anybody is suggesting radical open-heart surgery. I think what we are suggesting is, is asking that plans be governed by prudent fiduciaries in possession of full and correct information. Once they are in possession of all the information, if they want bells and whistles, and the fiduciaries certainly have the discretion to purchase them on behalf of the participants and beneficiaries to whom they serve.

Without full information, the fiduciaries are impeded. And if we have a seller and a fully informed buyer, the free market system will take care of this. But as it is today, the purchasers of retirement services do not understand, not even the Department of Labor fully understands what the nature of the economics are or is.

And, thus, we have a situation. That is what needs to be remedies. We need to empower the fiduciaries with correct, full information, and let knowledgeable fiduciaries and the knowledgeable deliverers of services negotiate on equal standing.

Mr. CHAMBERS. I don't disagree with that at all. I think we need to maintain confidence in this system. I think we need to improve confidence in this system.

And I think that, again, all of us on the panel agree that there needs to be another methodology of providing this information to all three of the constituencies that we have been discussing, participants, and the fiduciaries, and the government, in order to pursue this. I don't disagree with that at all.

But I think it is important to make sure, as I have mentioned before, that the cost of doing this is not going to overwhelm the benefit that comes from it, that, in fact, we wind up not diminishing end-of-the-road retirement benefits, simply because we have overemphasized fees, compared to all of the other important considerations that go into the administration of these plans and the investment of their assets.

Chairman MILLER. Should the plan sponsor know whether or not there is conflicting financial arrangements for the placement of those funds?

Mr. CHAMBERS. I think that the plan sponsor needs to understand what the relationships are. And I think, then, that the plan sponsor needs to make a decision as to whether there is a conflict there, whether the conflict is——

Chairman MILLER. So they should have the information? You would agree that they should have the information?

Mr. CHAMBERS. I think that they need to have information relating to what the role of each service provider is. And then they can decide whether or not there is a conflict.

One of the issues that are out there is that you may have a service provider that has a relationship at this end of the spectrum with a financial organization, and you have entirely independent people working at that plan level. So the question is, is there a conflict?

There may be a conflict in an entirely unrelated area. Does the administrator or the plan sponsor need to know that? I think it would be very helpful, but I am not sure that in every situation you are going to be able to provide that information.

Ms. BOVBJERG. Which is why recommended the Congress amend ERISA to explicitly require service providers to provide that information to plan sponsors.

Chairman MILLER. If "A" is placing their funds with "B," and "B" is getting money from "C," that in itself is an important piece of information.

Mr. CHAMBERS. Right. How about if a bank is a lender to a particular organization, you know, is a primary lender or is involved—that is why I am saying——

Chairman MILLER. Well, with all due respect, you know, those questions are answered every day in the courtrooms of this country, because among the biggest players in this field, they are suing one another over exactly those relationships.

We just saw a whole series of arrangements in the mutual fund industry, 3, 4, 5 years ago, where all kinds of privileges were extended based upon other arrangements. People were allowed to trade after 4 o'clock. People were allowed to not mark to market. People were allowed to go over until the next day.

You know, and they were based upon loans and placements of funds. I mean, that goes on in the financial services industry every day. Big clients get privileges, and connected people get privileges. So this goes on all the time.

The question is, you know, my little firm, and I am trying to take care of my employees, should I know whether the person I am working with has these financial relationships? I will then make a decision about whether I think that is impacting or not impacting, or it may come back to me a year later when I see what happens. I may say, "Whoa, whoa, let's go back and see what that relationship was."

Mr. CHAMBERS. I believe, sir, that if you are limiting this primarily to the retirement plan context, I think, then, that it would be possible to come up with a reasonable way of creating disclosure that is beneficial.

But as I was mentioning, I think it is very difficult—if I decide that I want to go to a bank to serve as the trustee of my retirement plan, and it turns out that that bank is the primary lender to an organization that is providing retirement services to me, all right, is that a conflict? And how is it that somebody is supposed to be disclosing that too me?

Chairman MILLER. That may or may not be. Again, when people look back over transactions, very often they all of a sudden recognize a conflict that they didn't recognize at the time. So the information is important.

It has been very important to the SEC. It has been very important to states' attorneys generals and to others, because patterns do develop. We just saw a pattern develop of inside trading. There, the enforcement officers recognized it for the investment firm, and then they decided they would cut themselves in on it. You know, we just went through the arrest here this last week.

So the information is important, not only at the time you can make your judgment, whether you think that is right or wrong; it may be important down the road, if a pattern develops or these people have relationships. You know, it may not be about your fund, but it may be about all of the investors that come there and the fund they go to.

You may be part of a larger piece of action. That is all I am saying. So I just am asking whether or not that arrangement, in and of itself, should be a piece of information that is available. I am not determining whether it is a conflict or not a conflict, simply whether that disclosure is important.

And most of these things that concern me about little people, it is because I see the big guys fighting it out. You know, they are battling over their pension plans, very large corporations, because somebody decided they were going to dip their hand into other people's money, with an insignificant fee, and they could drain it off.

I mean, that is sort of the nature of financial abuse in the financial services industry. People come up with these schemes sort of, you know, every full moon.

Any other questions?

[Additional statements for the record follow:]

[The prepared statement of Mr. Altmire follows:]

Prepared Statement of Hon. Jason Altmire, a Representative in Congress From the State of Pennsylvania

Thank you, Mr. Chairman, for holding this important hearing on "Hidden 401(k) Fees," and for your continued leadership on issues of great importance to America's working families.

I would like to extend a warm welcome to today's witnesses. I thank all of you for taking the time to be here and look forward to hearing from you.

In recent years, 401 (k) plans have emerged as the most common way for Americans to save for their retirement. Currently, nearly 50 million employees are enrolled in 401(k) plans as compared to approximately 20 million employees who are enrolled in traditional pension plans. With the rise of the number of employees using 401 (k) plans to prepare for their retirement, we must work to ensure that their plans operate as efficiently as possible.

Many have raised concerns about the operation of 401(k) plans. The most common complaint is that administrative and management fees for 401 (k) plans are not clearly defined and delineated. Many of these fees nickel and dime the retirement savings of employees who may not even be aware of their existence. I share these concerns and believe that these fees should be properly disclosed, rather than simply deducted from the account balances of employees.

I also believe that we should do more to encourage employees to invest in 401 (k) plans and properly prepare for their retirement. While there is no doubt that it is increasingly difficult for workers to plan for a secure retirement, there is much that can be done to make this security more attainable. I look forward to hearing our witness' ideas on this issue.

[The prepared statement of Mr. Hare follows:]

Prepared Statement of Hon. Phil Hare, a Representative in Congress From the State of Illinois

Since the beginning of the 110th Congress, the Education and Labor Committee has been investigating what has been termed the "middle class squeeze," referring to the challenges the majority of Americans face in acquiring financial stability, affording high healthcare costs, saving for college and building retirement security, despite having jobs with strong wages. I am happy to see today we are reviewing the issue of retirement and the roadblocks involved in pension and retirement plans that make it difficult for the middle class to build retirement security.

There is no doubt that we all support employer-sponsored retirement plans and would like to help facilitate the expansion of those plans by providing the support and assistance employers need. However, I will not support efforts that do this on the backs of hard-working employees. The discussion about hidden fees in 401(k) plans, which the majority of American workers have, is extremely upsetting to me. Full disclosure of these fees is critical so that employees have full knowledge about their investments and the ability to compare plans to choose the best one for them.

Questions for the Panel

• Mr. Chambers: Would requiring the disclosure of these fees discourage employers from offering retirement plans because of increased administrative costs? What do your clients need from the federal government in order to provide reasonable retirement options for their employees?

• Ms. Bovbjerg: We as Members of Congress are privileged in that we have the best retirement plan in the world—the Thrift Savings Plan (TSP). The government

will match employee contributions to this plan up to 5%. We also have the choice among many investment options. What can we do as legislators either through better disclosure reporting or financial offsets to expand TSP-type plans to all sectors of the American workforce?

• Mr. Hutcheson: How did this "culture" come to be that has allowed unscrupulous extractions from the bank accounts of hardworking Americans? How do we reestablish the integrity of our retirement structure? Can disclosure or elimination of hidden fees do it alone? And, what options do employees have once they know about the hidden fees they are paying?

Chairman MILLER. Well, thank you very much. I think your testimony and your comments and your responses to the members of the committee have been very helpful for this initial hearing. And we would hope that you would agree with Mr. McKeon, that you would continue to serve as a source of information to us, as we continue this discussion.

Thank you. The committee will stand adjourned. Thank you.

[Whereupon, at 12:55 p.m., the committee was adjourned.]