



February 8, 2008

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue, NW.
Washington, DC 20210

Re: 408(b)(2) Amendment

Dear EBSA:

I am writing to comment on the Proposed Rule regarding Reasonable Contract or Arrangement under Section 408(b)(2) – Fee Disclosure. I applaud the Department for recognizing that additional regulation in this area is appropriate given the fiduciary obligations of Plan Sponsors and the opaque nature of fees in ERISA plans.

Clarity Sought

That said, with respect to bundled arrangements, I find the proposed regulations unclear, particularly on the most important reason for the regulation. The central truth that must be embodied in any disclosure regulation is that disclosure is inadequate unless it tells the Sponsor and the Participant how much investment managers make (and keep) for the investment management and how much administrative service providers make as a result of their position. Without this knowledge and understanding, Sponsors and Participants are unable to assess quality of services, monitor and evaluate efficiency and proficiency of service providers, and ultimately determine whether what is being paid is in fact worth the results obtained.

In bundled relationships, this distinction is no less important. The harm occurs when Sponsors and Participants believe they are paying top dollar for quality investment management services, but in reality they are paying a bundled provider who siphons a material percentage of the investment management fee to affiliate or other subcontractors for administrative services. It gives the false impression that the more paid to investment managers, the better those funds will perform. It also gives the false impression that administrative services cost less than they do, making it impossible to measure the true value of those services in light of actual costs. Participants in 401(k) Plans have as much right to know what they are paying for investment management services as other investors do. If they are exercising control over the management of their account, such as the case of plans subject to 404(c), they also have the right to know what other services are paid from their accounts.

If the regulation does not require disclosure sufficient to allow Sponsors to determine, at a minimum, the amount of fees going to the services of investment management and recordkeeping, the regulations will actually serve to facilitate inadequate disclosure because neither Sponsors nor Participants will be able to determine the reasonableness of fees for the specific function or service rendered. This is particularly relevant for participants because internal revenue sharing often varies between plan options. For example, if a bundled Plan has two equity funds, Fund A and Fund B, with two different expense ratios, 1% and .5%, a Plan participant does not know, and has no way of knowing, whether Fund A costs more because it has a better manager, because it spends more researching the companies it invests in, because it is less efficient or knowledgeable thus creating additional cost, or because it is subsidizing the administration of the Plan while Fund B is not. Clearly, the difference is material to the investor and to the fiduciary responsible for making sure each investment option is prudent and fees to each service provider are reasonable.

Accordingly, I was surprised to read that the proposed regulations would “generally” not require bundled service providers to “disclose the allocation of revenue sharing or other payments among affiliates or subcontractors within the bundle.” Fed. Reg. 70991. To those who understand what it requires to properly discharge their fiduciary duties, it is a very odd allowance.

While bundled service providers may now, and certainly will under the proposed regulation, consider these arrangements “proprietary or confidential” they ought not to be treated as such because of the associated fiduciary implications. Understanding the very nature of those arrangements is critical to understanding the reasonableness of fees. While I applaud the Department’s proposed regulation for requiring the disclosure of indirect compensation to/from the bundled provider to/from “third parties,” these compensation streams within the bundled provider and between its affiliates or subsidiaries are equally relevant. If the regulation is passed as-is, these arrangements may become an even more convenient means of avoiding the very disclosures the regulations are designed to require.

Finally, the Department’s failure to require these disclosures to plan participants is troubling. These disclosures would already be prepared for the Sponsor under the proposed regulations, and the incremental cost of providing them to the participants would be small, yet the potential for savings to the participants will likely be substantial. Participants are currently provided with account statements, Summary Annual Reports, SAI’s, prospectuses, and other information containing required disclosures far less material than the amount of money the participant is actually paying for both administrative services and investment management. Many participants may not read or consider these costs, but all should have the opportunity to do so and, currently, none can.

Any regulation that affects ERISA plans where participants exercise control over their accounts must not serve to impede that control. The regulation must also not create an imbalance in a Sponsor or Participant’s ability to compare the value and reasonableness of different business models.

What Should Be Disclosed, and to Whom

There should not be a debate over what should be disclosed. There are two core economic elements that dictate long-term outcomes within a defined contribution plan account.

1. Proper portfolio construction
2. Efficient, non-excessive administration

Obviously, there are costs associated with each. Those costs must be disclosed because they have a profound and real impact on outcomes. Thus, basic disclosure must include total economic impact caused by portfolio maintenance and administration.

However, given that there may be both fundamental and optional components integrated into either element, disclosure must be complete so that the person exercising control over the account (whether trustee or participant) can assess and evaluate the appropriateness, relevancy, and value of each service when viewed in light of desired outcomes.

Specific disclosure should include cost of investment management (including trading costs), record keeping and reporting, investment advice and agent commissions, and all remaining fees or charges if any.

To the extent record keeping and other optional services are underwritten through fund expense ratio subsidies, those subsidies must be extracted from the expense ratio and disclosed separately, on their own merits, so those exercising control can measure their value.

With respect to who should receive those disclosures, it is very simple. The appropriate fiduciary must always receive full and complete disclosure. That goes without saying. To the extent a participant is exercising control over their own account, it also goes without saying that they too must receive full disclosure. Without it, they cannot exercise control over their account, but rather are literally handicapped and will in all likelihood make poor investment decisions if the economics of a given portfolio are withheld from them as the decision maker. “Token control” is unacceptable if a participant is bearing the investment cost and risk. Nothing less than “real control” is acceptable. It appears that the Department’s proposed regulations prevent real control by limiting disclosure to those bearing the risks – i.e. the participants. That is not acceptable by any reasonable person or prudent fiduciary standard.

Practical Definition of “Reasonable”

It seems that there is some confusion as to when a fee or cost is reasonable, and when it is not. The reality is, any given thing or cost could be reasonable to someone.

To resolve this apparent conundrum, there must be a practical, mutually acceptable test for reasonableness. If all information is available to all parties to a transaction, and they willingly agree to proceed with that transaction, understanding the nature and desired outcomes of that decision, then the decision is reasonable. It's that simple.

The proposed amendment to 408(b)(2) suggests that participants need not receive full disclosure; only the fiduciary. That position undermines a participant's ability to truly exercise control over their account, and thus ensures that the participant cannot know what is reasonable, and what is not. That reveals a real conundrum under 404(c). Thus, for the proposed regulations to be taken seriously by prudent fiduciaries, the regulation must not thwart a decision maker's ability to determine what is reasonable.

Form of Disclosure

There are two types of disclosure that Sponsors and Participants need in order to make prudent decisions. The first type of disclosure is required before a decision is made. It includes the cost of investment management (including trading costs), recordkeeping and reporting, investment advice and agent commissions, and all remaining fees or charges, if any, relevant to the decision. Disclosure must be made on a fund by fund basis for it to be credible from a fiduciary and decision maker standpoint, and accordingly requires bundled service providers to disclose fees, expenses, revenue sharing etc. between affiliates or subsidiaries. In other words, this first level disclosure helps decision makers (Sponsors and Participants) know what fees and costs to expect from all sources before entering into a transaction.

The second type of disclosure helps decision makers know what they paid during a reporting period, at a glance. In other words, the second type of disclosure should be a summary of total fees paid, possibly on an annual participant statement. The details should also be immediately available to interested participants upon request. Summary disclosure can be quite simple and very inexpensive to deliver.

Consider the following ideal model:

A	B	C	D	E	F	G	H	I	J
Fund	Beginning Balance	Total Contributions	Withdrawals & Disbursements	Transfers	Gross Earnings	Investment Expenses	Admin. Expenses	Ending Balance	Net Return
ABC Stock	\$ 9,562.12	\$ 3,000.00	-	-	\$ 989.20	(\$192.16)	(\$106.47)	\$ 13,252.69	6.24%
XYZ Bond	1,588.00	500.00	-	-	61.92	(\$20.23)	(\$11.21)	2,118.48	1.66%
Stable Value	3,447.22	1,000.00	-	-	157.43	(\$64.30)	(\$35.63)	4,504.72	1.46%
Annuity	4,001.99	1,500.00	-	-	138.31	(\$96.95)	(\$53.72)	5,489.63	-0.26%
Total	\$ 18,599.33	\$ 6,000.00	-	-	\$1,346.86	(\$373.64)	(\$207.03)	\$ 25,365.52	3.55%
Fee & Expense Summary (Columns G & H)									
1. Investment costs:					\$ (373.64)	1.73%			
2. Administrative costs:					\$ (207.03)	0.96%			
Total costs:					\$ (580.67)	2.69%			
Excess (Costs) or Returns									
Your net return				3.55%					
Your personal index				5.35%					
Your excess (costs) or returns				(1.80%)					

Explanation of column headings, A through J:

Column:

- A. Fund – The name of the investment, whether mutual funds, ETF's, Annuities, Employer Stock, Collective Trusts, Pooled Separate Accounts, etc.
- B. Beginning Balance – Reconciled from prior period's ending balance. Beginning and ending balances "are what they are." In other words, they must tie to the actual values of the investments themselves, as reported by the fund/financial institutions. Beginning and ending balances are known and currently tracked by record keepers as a matter of practice.
- C. Total Contributions – Known and tracked by record keeper.
- D. Withdrawals & Disbursements – Known and tracked by record keeper.
- E. Transfers – Movements between funds; known and tracked by record keeper.
- F. Gross Earnings – Calculated. The ending balance is always known by the record keeper at the end of each valuation period. Since all of the other elements that account for the difference between beginning and ending balances are known, the only remaining item is gross earnings, which can be calculated with simple addition and subtraction. The alternative—calculating the gross returns for each fund and participant—would, as the financial industry has stated, be prohibitively complicated and expensive, and would require the financial industry to disclose "gross returns" to a record keeper. We get to the same number this way, and since it is simple arithmetic, it will not cost more than a few hours of programming for record keeping systems.
- G. Investment Fees & Expenses – The sum of investment expenses. Investment expenses include the actual expense ratio reported by investment firms on the investment product's financial statement, other fees (i.e. redemption fees, contract charges, etc.), plus brokerage commissions and costs to clear the trades, investment advice and agent commissions, custodial, and miscellaneous investment product fees/charges.
- H. Administrative Fees & Expenses – The sum of administration and other operational expenses. Administration expenses paid by plan assets are already accounted for by the record keepers. It can include, but is not limited to, record keeping, compliance testing, reporting, consulting, legal, accounting, auditing, or other non-investment specific fees paid directly from plan assets.

- I. Ending Balance – Calculated by adding columns A through H.
- J. Net Return – Derived using standard guidelines for the calculation of investment returns and in common use currently. (For purposes of illustration, net returns in this sample statement are calculated simply by dividing Gross Earnings less Fees & Expenses [numerator] by the beginning balance plus one-half the net contributions [denominator]. In an actual statement, the calculation of net investment returns would be determined using more precise methods that take into account the dates and amounts of actual cash flows.)

The lower section of the disclosure statement identifies the breakdown of investment and administrative costs in both dollar and percentage terms. In addition, it compares the net returns for the individual with a personalized calculation of what they could have received if their plan balances had been invested in a low cost prudent portfolio. The calculation of a benchmark 401(k) performance index for each participant is based on nationally recognized market indexes for widely diversified equity and bond investments, and is similar to a credit score (FICO). It establishes an objective standard of comparison for costs and investment performance in each participant's 401(k) account.

Although this may seem like a lot to absorb, it really comes down to a few very simple principles. First, combine data that is already available from multiple sources, apply a very simple mathematical formula, and full disclosure is the result. Because most of the analysis is happening at the record keeper level, it will not be costly nor will it be difficult to provide this level of full disclosure. The process will enable fiduciaries and participants to construct meaningful portfolios and to negotiate with service providers on an even playing field, with full information necessary to make prudent decisions.

The benchmark index gives fair consideration to service provider assertions that service and performance are all that matter. Underperforming the index therefore reveals that there is an easily avoidable fundamental problem with poor portfolio construction, or excessive fees, or both. Out performing the index over an extended period of time validates the industry's arguments that fees actually take a back seat to service and performance. Thus, it is also fair. Sponsors and Participants have a right to know the bottom-line results regarding the relationship between fees and performance, which is highlighted with the disclosure format outlined above.

Conclusion

Regulation should seek to protect participants within all types of business models, bundled, unbundled, etc. Regulation should not impede a participant's ability to exercise control over their account if subject to 404(c). Regulation should not serve the industry, but rather should treat all parties equally. Full access to all relevant information in a meaningful format should be provided to all decision-makers, in order that that free trade and fair competition can work toward the best interests of the participants. Protecting their interests should be, after all, the central purpose of any proposed regulation.

Sincerely,



Matthew D. Hutcheson
Independent Pension Fiduciary