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Attn: Participant Fee Disclosure Project  
Office of Regulations and Interpretations  
Employee Benefits Security Administration  
U.S. Department of Labor, Room N-5655  
200 Constitution Avenue, N.W.,  
Washington, DC 20210

**Subject: Proposed Regulations Under 404(a)(5)**

Dear Sir/Madam:

Watson Wyatt is pleased to submit our comments on the Employee Benefit Security Administration's proposed regulation under ERISA Section 404(a)(5) issued in the Federal Register on July 23, 2008.

Watson Wyatt is a global consulting firm focused on human capital and financial management. We have provided consulting services for hundreds of defined contribution retirement plan sponsors since the inception of 401(k) plans. As part of these services, we have assisted numerous clients in establishing the investment and service objectives for their DC plans, and in implementing new investment and service structures, including through supporting their selection of new investment managers and service providers for their DC plans. We also have helped many clients consider how new investments, services and fees should be communicated to participants. As such, we bring significant practical insights into the markets for investments and services and the needs and concerns of employers and participants. This puts us in an excellent position to provide input to the Department of Labor regarding the fee and service information participants need in order to be engaged by and make better use of their DC plan opportunities, including to make more informed choices for services and investments.

These comments build on our letters of October 11, 2007 concerning proposed amendments to the regulations under ERISA Section 408(b)(2), and of July 24, 2007, written in response to your April 24, 2007 Request for Information regarding disclosure of fees and other information to participants in participant directed DC plans. These comments are intended to be consistent with these prior letters, except for one area where we have revised our recommendation since our letter of July 24, 2007, as discussed below.

Please note that we are not authorized and do not seek to provide legal advice to our clients, but instead encourage them to seek advice from their own legal counsel. When we refer to "our understandings" of current and proposed rules, we do so in the context of our role being to identify issues for our clients to consider with the aid of their legal counsel. Our experience is that different legal counsels often have different interpretations, and different clients have varying comfort levels with legal uncertainties. We hope our comments enable the Department to achieve an even more nuanced balance between flexibility and reduced uncertainty.

**Comments on Overall Purposes of Participant Level Disclosure**

The purposes stated in the Preamble are to ensure the ability of participants to make informed decisions with respect to the management of the investments of the DC plan accounts for which they are given an opportunity to give directions. This is an important policy objective. Our experience is that a comparative format facilitates decision making. We applaud the Department for sharing a specific suggested comparative approach while also making clear that fiduciaries have flexibility to depart from



that format in order to better serve the communication needs of their specific participants given their specific service, investment and fee mix. We agree with many other specific provisions in the Department's proposal, and can see many of our comments and those of others made in response to the April 24, 2007 RFI as incorporated in these proposed regulations. This sequence speaks well of the Department's commitment to making good use of public comments, and we are hopeful that this next round of comments will also be given careful consideration.

The current proposal, while attractive in many respects<sup>1</sup>, falls significantly short of its objectives in giving participants the information they need by not requiring disclosure of the portion of investment related fees that are payable for the provision of administrative and other non-investment management services. As documented in numerous publications issued by the Advisory Council, the General Accounting Office and otherwise, "revenue sharing" is the dominant fee structure for the provision of administrative services today. The Department has required full disclosure only for a minority of administrative fees: (1) transactional fees, such as for loans and other "participant specific" events; and (2) per capita fees, which are charged today by a minority of plans to participants. While we appreciate that many of the service and investment providers that commented in response to the April 24, 2007 RFI urged non-disclosure of revenue sharing and we can appreciate that revenue sharing may not be a relevant decision making criterion for all participants, for the reasons discussed below, we think that omission of a disclosure requirement for revenue sharing leaves a significant unjustified gap in these proposed regulations. We strongly urge that this omission be corrected.

Related to our comments on revenue sharing, we also wish to emphasize the connection of this proposed regulation to the amendment proposed to ERISA Section 408(b)(2). Plan sponsors<sup>2</sup> are dependent on investment and service providers making full, accurate and timely disclosures to them. For this reason, we have tied our suggestions for a revised effective date to the issuance of the proposed amendment to ERISA Section 408(b)(2) and the related class prohibited transaction exemption proposal.

### **Watson Wyatt's Specific Comments**

1. **Effective Date.** The proposed effective date is the first day of the plan year beginning on or January 1, 2009.

**Comment:** We do not believe the proposed effective date is realistic for the majority of plans.

Our experience is that a minority of plan sponsors – generally, a subset of plans with very large assets (\$1 billion and above) – are already giving most or all of the required disclosures; however, the majority of plans are not making all of the proposed disclosures and need significantly more time to do so. The majority of plans are very dependent on their service providers, and have relatively little bargaining power outside the vendor selection process; instead, they are sold "products" that offer relatively little customization within the product portfolio of their vendor. These plan sponsors do not typically have communications that are developed or disseminated independently of their vendors, and will be effectively dependent on their provider(s) for coming into compliance. The providers to such plans will need to modify existing systems and procedures, and our expectation is that they will need additional time to develop and implement new communication material and delivery routines.

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<sup>1</sup> We have not commented on each provision in the proposed regulations, but have selected issues where we can add unique value based on our role as the leading consulting organization to medium to very large DC plan sponsors not a part of a larger organization providing DC recordkeeping services and/or investment products.

<sup>2</sup> We refer to "sponsors" without seeking in this letter to distinguish the fiduciary role of a sponsor from its settlor function. We do this for the sake of convenience, recognizing that the proposed regulations apply only to fiduciaries, that some sponsors do not act as named fiduciaries (but limit their roles to appointment) and that communications can be both a fiduciary and settlor function.



Additionally, even the sponsors of the very large plans that are already in substantial compliance should be given additional time to fully review the final regulations and consider how best to balance any new compliance concerns with their business objectives. Such sponsors should not be penalized for having already achieved the spirit intended!

All plan sponsors should be able to rely on the accuracy of the data provided to them by their providers, as discussed in Comment Three. Such an approach assumes that sponsors are receiving all the data needed. This assumption will be more realistic once the proposed amendments to the ERISA 408(b)(2) regulations have been finalized. Therefore, we propose an effective date that (either formally or effectively) is six months from the effective date of the finalized 408(b)(2) regulations, subject to an exception for plans that will implement a significant restructuring of their investments, services and/or fees within the following six months. Plans that foresee a significant restructuring (which would, itself, have to be communicated to participants) may delay compliance with the regulations for up to twelve months from the effective date of the finalized 408(b)(2) regulations.

This two pronged approach ties together the two major regulatory initiatives of the Department of Labor that concern DC plan fees (with the third initiative of new 5500 disclosure already having a decided schedule). We encourage the Department to seek to finalize these two regulatory initiatives at the same time, and to thereby maximize the likelihood that the two sets of regulations can support one another in furtherance of their overlapping objectives.

One of the desired outcomes of the 408(b)(2) regulations is that sponsors will review their current investments, service offerings and fees, and be motivated to seek improvement of them as part of a competitive process that is informed by additional information and activity in the market place. In the Preamble, the Department has offered its estimates of how the 404(a)(5) regulations will reduce overall fees. We think the Department should give similar focus to the pro-competitive impacts of the 408(b)(2) regulations, and how the two regulations can combine to incent sponsors to improve the participant experience.

While it is desirable that participants make fully informed selections within a menu set by the sponsor, it is of at least equal and probably more fundamental importance that a sponsor offer as fully competitive a menu as its position within the market allows. Emphasis on the duty of fiduciaries to exercise careful judgment in the development of their menus has been a constant feature of Department guidance, from the originally proposed regulations under 404(c), and is reaffirmed in the Preamble to these proposed regulations. Providing for a delayed effective date of the 404(a)(5) regulations for those sponsors that initiate a significant change in their investments, services or fees will encourage more sponsors to act upon the information that results from provider compliance with the 408(b)(2) regulations.

Our experience is that many sponsors want a consolidated communication campaign. For a sponsor that will be giving new information to participants as part of its compliance with ERISA Section 404(a)(5), it will often make business sense for the sponsor to encourage participants to consider the new information provided while they review their investment and service selections. Sponsors that are pursuing a new investment, service or fee offering should be allowed to give their participants a single and comprehensive communication that offers new information about new offerings. Otherwise, sponsors could be required to give two successive "calls to action" – with the first being to give more consideration to investments that might end up being replaced (for example). Participants might be confused by such an approach, and the risks of such confusion could cause sponsors to delay possible improvements based on new market conditions to their plan absent relief from the usual effective date for the new disclosures. Therefore, we recommend that sponsors making a significant investment, services or fee change be given an additional six months.



Given that the additional six months is elective, we do not think that a formal definition of “significant” is needed.

Another reason why a delayed effective date is appropriate stems from the need by many plan sponsors to develop benchmarks for age based asset allocation funds, as discussed in Comment Five.

2. **Disclosure of Revenue Sharing.** Section 1.404a-5(c)(2)(i) contains an exclusion from that portion of the regulations for administrative fees and expenses “included in investment-related fees and expenses.” Section 404a-5(d)(1)(iv), concerning automatically provided investment-related information does not require disclosure of the administrative portion of investment related fees and expenses. Section 404a-5(d)(4), concerning information to be provided upon request, does not specify that participants may request identification of the administrative portion of investment related fees. These requirements can be compared to those in the proposed regulations under 408(b)(2), where, the Preamble to the proposed regulation distinguished the “investment management fee” from other revenue streams that are subject to disclosure to a plan sponsor, and described these as among those that may be included: “float revenue, 12b-1 distribution fees, wrap fees, and shareholder servicing fees.”

**Comment:** We recommend that Section 404a-5(c)(2)(i) be rewritten to omit the exclusion of administrative fees and expenses “included in investment-related fees and expenses” and that instead the fact and total rate of such charges be required to be disclosed on an annual basis, within the comparative format envisioned. We do not believe that the per participant dollar amounts of such “investment-related” administrative fees should be a required quarterly disclosure under 404a-5(c)(2)(ii) and recommend that this subsection be written more clearly to exclude any inference of such a requirement.<sup>1</sup>

We believe that participants will benefit from understanding whether or not their expense ratios cover all or a portion of the non-transactional administrative services that may be provided to their plan. Disclosure will allow comparison between different employer offerings, but more importantly, will serve to give participants a more realistic assessment of their employer benefits. The failure to disclose the fact of revenue sharing may lead some participants to conclude that their employer is paying for all non-transactional administrative costs. Sponsors should not be subject to the risk that their participants will make this mistaken assumption. While the sponsors of very large plans may choose to disclose the fact of and rates for revenue sharing independently of any regulatory requirements, the majority of plans (as noted above) are very dependent on the standard offerings from their service providers for compliance. We expect that many of the service providers to the majority of plans – particularly those with a business model that combines the provision of investments and services -- will not develop systems for the automatic delivery of communication material that make these disclosures absent a specific regulatory or other legal requirement.

We also note our experience that a minority of plans do not have any separate transactional charges for participant level events such as loans, but instead pay their vendor for the processing of such transactions through investment related expenses, including revenue sharing. We believe participants in such plans should be informed that the investment related expenses cover administration, including participant initiated transactions.

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<sup>1</sup> This is a change in our recommendations made in our July 24, 2007 letter, where we responded to the Department’s RFI with recommendations that each of the fact, rate and dollar amounts of revenue sharing be required disclosures.



We also observe that the currently proposed regulations may unintentionally create a new incentive for sponsors to use investment, service and fee structures that rely on revenue sharing. Our experience is that revenue sharing can be used to provide plan sponsors and participants with a cost effective approach to paying for administrative services. We have helped many sponsors negotiate more favorable approaches to revenue sharing (so that there is flexibility for using revenue sharing for plan purposes other than to pay recordkeeping fees). We have also helped many other plan sponsors develop and implement investment, service and fee structures that do not utilize revenue sharing or similar asset based revenues. These sponsors have found these alternatives to be cost effective and better suited for their specific populations. We do not think, as a policy matter, that the Department should issue a disclosure requirement that favors one fee structure over another.<sup>1</sup> Instead, we think that diversity of choice will better promote both competition and selection of fee structures that are tailored to specific plan sponsors and their participants.

The distribution of prospectuses and similar documents – whether required or only upon request – is not sufficient to meet the need for participants to identify “revenue sharing.” Prospectuses will identify certain forms of revenue sharing – such as 12b-1 fees – specifically, but often make only general reference to share holder service fees, sub-transfer agent fees, etc. Plan sponsors have often had difficulties in finding such information, and we do not see why participants should be expected to have superior resources for ferreting out such information.

Finally, we note that our letter of October 11, 2007 recommended disclosure of the fact of and rates for revenue sharing from all investments, both those unrelated to a record keeper and those managed by a related entity (a “proprietary” fund). We noted that a delayed effective date might be appropriate to allow vendors to comply with this requirement. We reaffirm this suggestion here, and note that our effective date proposal for the 404(a)(5) regulations is consistent with this.

- 3. Performance History.** Section 404a-5(d)(1)(ii) requires annual reporting of performance data for the preceding 1, 5 and 10 years periods “if available.” The Preamble states that plans with funds that have not existed for all three periods “are expected to explain that the data is not available for this reason.”

**Comment:** We interpret this portion of the Proposed Regulations as allowing the use of representative performance history where actual performance does not exist. An example would be to give composite performance history for an investment manager of a new separately managed account where previously that investment manager has documented performance using the same intended strategies in a different vehicle subject to different fees. We believe participants can benefit from reviewing such composite performance data, and recommend that the final regulations specifically allow but not require the disclosure of composite performance data in situations where the information is clearly identified as being a composite and actual past performance data is not available.

- 4. Reliance on Providers.** Footnote seven in the Preamble states that “fiduciaries shall not be liable for their reasonable good faith reliance on information furnished by their service providers with respect to disclosures required by paragraph (d)(1).”

**Comment:** We recommend that this statement be incorporated in the final regulations themselves and be generally applicable to all of the disclosure requirements.

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<sup>1</sup> We note that DOL Advisory Bulletin 2003-3 states that the allocation of fees to participants is a fiduciary responsibility, and notes that both per capita and pro rata fee structures (and combinations there of) may be reasonable. The Bulletin is “neutral” in expressing a preference of one structure over others, and absent development of a record suggesting neutrality is no longer appropriate, these regulations should also be neutral.



5. **Benchmarks.** Section 1.404a-5(d)(1)(iii) requires disclosure of benchmark performance using “an appropriate broad-based securities market index.” The Preamble states an expectation that “most plans will simply identify the performance benchmark already being used for the investment option pursuant to the Commission’s prospectus requirements, if applicable.” The Department seeks comments on how this requirement should be modified for un-registered options.

**Comment:** We recommend that the Department allow use of the benchmark identified in a prospectus, for options that are subject to them, but that the Department encourage development and application of a written investment policy statement (an “IPS”) for all plans. Our reading of the Department’s guidance is that an IPS is not required, but if one is developed, the IPS must be written. Our experience is that sponsors with a written IPS often find it a helpful tool for developing and then implementing their investment strategy, including for the selection and monitoring of options. Fundamentally, the IPS offers a device for fiduciaries to hold themselves accountable, which is certainly a salutary policy objective. When we are asked to support sponsors in the development of a policy statement, we recommend inclusion of a market based index for each “core” investment alternative (see Comment Six below). Use of a written IPS provides a mechanism for using non-registered options and helps sponsors avoid reliance on a current specific investment manager for registered options.

We note that the development of benchmarks for age based asset allocation funds is more involved than that for an option with a largely static asset allocation objective. This is part of our rationale for a delayed effective date. We do not think, however, that this additional difficulty is reason to exempt age based asset allocation funds from this requirement. Our experience is that such funds are becoming the predominant “qualified default investment alternative” under ERISA Section 404(c)(5), and have been attracting significant assets through affirmative participant elections. QDIAs should be subject to at least the same level of disclosure as non-QDIA funds. .

6. **Designated Investment Alternatives.** Section 1.404a-5(h)(1) defines “designated investment alternative” as an investment “designated” by the plan and as not including “brokerage windows, self-directed brokerage accounts or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.” The Preamble states the new regulations are intended to apply principles contained in prior regulations under Section 404(c) to all investments for which participants are given an opportunity to give direction.

**Comment:** Our reading of the Preambles to the regulations under 404(c) has been that a sponsor’s duties of prudent selection and monitoring under 404(a) extend only to investments that a sponsor has selected to offer its participants. We have understood there to be an argument that if a sponsor offers “the universe” of available investment options (subject to removing options that create prohibited transaction risks or create other legal problems), it has not exercised any choice, and therefore, has no duty for selection or monitoring. The Department’s introduction of new terminology suggests that it may be taking a different view, so that the duties of selection and monitoring – and the related participant disclosure requirements now being proposed – will apply only to designated options, while something less than the legally available “universe” can also be offered and not be subject to any of the selection, monitoring or disclosure requirements.

We recommend that the Department combine any exclusion of otherwise applicable requirements with alternative required disclosures to participants, so that participants are informed that any offerings of non-designated investment alternatives are made without the benefit of sponsor review.

Our experience is that there are a variety of “brokerage window” offerings, that range from the “full legal universe” of all mutual funds and individual securities (or very close to it), to “windows” that



offer only mutual funds or only individual securities, to “selective” “windows” that are comprised of a limited set of mutual funds. The limited set may be restricted to mutual funds that the record keeper has developed trading and revenue sharing agreements with, and may, on occasion be further restricted to mutual funds managed by entities related to the record keeper (proprietary funds). In this last situation in particular, it is unclear that the apparent rationale for a reduced compliance requirement should apply, as it is not clear who has made the actual menu selection, the sponsor or the provider. The number of offerings within “windows” can range from many thousand to several hundred or even less.

Generally, we think that the offering of additional funds, outside a “core” group that is “designated” by the sponsor is pro-competitive and helpful to participants; however, to the extent some options are subject to lesser (or no) requirement for fiduciary selection and monitoring and/or reduced (or no) participant disclosures, we think it is very important that participants understand the two sets of menus as being distinct, and that participants are given information on how the two menus differ in terms of any fiduciary oversight by the sponsor. Our experience is that many very large plans that offer “windows” already distinguish their “core” or “designated” offerings from those available in a “window,” including to note that only “core” options have been selected and are being monitored by the sponsor. We recommend the Department add an additional disclosure requirement to support better participant choice when considering a “designated” versus a “window” offering, at least for those “window” offerings that are based on restrictions other than merely legal ones.

In closing, we wish to express our appreciation for the attention given to these and related issues by the Advisory Council and the Department. We believe that new guidance can benefit plan sponsors, service providers and participants alike by making plan sponsor and provider obligations clearer. We expect that greater disclosure requirements will increase the availability of fee information in the marketplace, and have pro-competitive effects.

Each of the undersigned is available for any specific follow up questions or comments you have concerning this letter, and we would be happy to help the Department consider new language for “window” offerings, and otherwise, as you review our recommendations.

Sincerely,

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