



Testimony before the Committee on Ways
and Means, House of Representatives

For Release on Delivery
Expected at 10:00 a.m. EDT
Tuesday, October 30, 2007

PRIVATE PENSIONS

Information That Sponsors and Participants Need to Understand 401(k) Plan Fees

Statement of Barbara D. Bovbjerg, Director
Education, Workforce, and Income Security Issues





Highlights of [GAO-08-222T](#), a testimony before the Committee on Ways and Means, House of Representatives

Why GAO Did This Study

Employers are increasingly moving away from traditional pension plans to what has become the most dominant and fastest growing type of plan, the 401(k). For 401(k) plan sponsors, understanding the fees being charged helps fulfill their fiduciary responsibility to act in the best interest of plan participants. Participants should consider fees as well as the historical performance and investment risk for each plan option when investing in a 401(k) plan because fees can significantly decrease retirement savings over the course of a career.

GAO's prior work found that information on 401(k) fees is limited. GAO previously made recommendations to both Congress and the Department of Labor (Labor) on ways to improve the disclosure of fee information to plan participants and sponsors and reporting of fee information by sponsors to Labor. Both Labor and Congress now have efforts under way to ensure that both participants and sponsors receive the necessary fee information to make informed decisions. These efforts on the subject have generated significant debate. This testimony provides information on 401(k) plan fees that (1) sponsors need to carry out their responsibilities to the plan and (2) plan participants need to make informed investment decisions. To complete this statement, GAO relied on previous work and additional information from Labor and industry professionals regarding information about plan fees.

To view the full product, including the scope and methodology, click on [GAO-08-222T](#). For more information, contact Barbara D. Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

PRIVATE PENSIONS

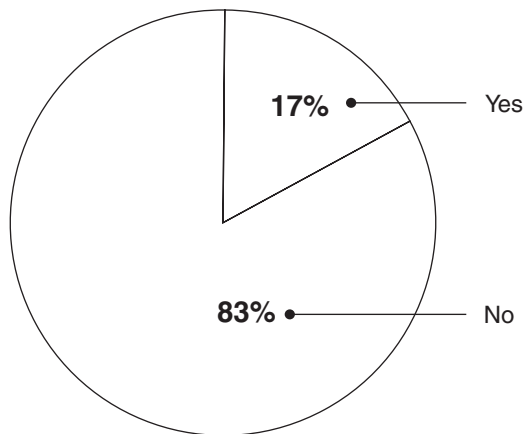
Information That Sponsors and Participants Need to Understand 401(k) Plan Fees

What GAO Found

Information on 401(k) plan fee disclosure serves different functions for plan sponsors and participants. Plan sponsors need to understand a broad range of information on expenses associated with their plans to fulfill their fiduciary responsibilities. Sponsors need information on expenses associated with the investment options that they offer to participants and the providers they hire to perform plan services. Such information would help them meet their fiduciary duty to determine if expenses are reasonable for the services provided. In addition, sponsors also need to understand the implication of certain business arrangements between service providers, such as revenue sharing. Despite some disagreements about how much information is needed, industry professionals have made various suggestions to help plan sponsors collect meaningful information on expenses. Labor has also undertaken a number of activities related to the information on plan fees that sponsors should consider.

Participants need fee information to make informed decisions about their investments—primarily, whether to contribute to the plan and how to allocate their contributions among the investment options the plan sponsor has selected. However, many participants are not aware that they pay any fees, and those who are may not know how much they are paying. Most industry professionals agree that information about an investment option's relative risk, its historic performance, and the associated fees is fundamental for plan participants. Some industry professionals also believe that other fees that are also charged to participants should be understood, so that participants can clearly see the effect these fees can have on their account balances.

Participants' Response to Survey Question on Awareness of Fees
Do you know how much in fees and expenses you are paying for your 401(k) plan?



Source: AARP's Survey of 401(k) Participants' Awareness and Understanding of Fees, developed and deployed by Knowledge Networks, July 2007.

Mr. Chairman and Members of the Committee:

I am pleased to discuss the information that sponsors and participants need to better understand the fees associated with their 401(k) plans. Named after section 401(k) of the Internal Revenue Code, 401(k) plans are private sector pension plans that typically allow workers to save for retirement by diverting a portion of their pretax income into an investment account that can grow tax-free until withdrawn in retirement. Over the past two decades there has been a noticeable shift in the types of plans employers are offering employees. Employers are increasingly moving away from traditional defined benefit plans to what has become the most dominant and fastest growing type of defined contribution plan, the 401(k).¹ As workers accrue earnings on their investments, they also pay a number of fees, including expenses, commissions, or other charges associated with a 401(k) plan.

For plan sponsors, understanding their expenses helps fulfill their fiduciary responsibility to act in the best interest of plan participants. Given this responsibility and the potentially large impact on an individual's account balance over time, it is important that both plan sponsors, typically the employer, and participants, as investors, receive and understand the fee information necessary to make informed decisions. Even a small fee deducted from a worker's assets today could represent a large amount of money years later had it remained in the account to be reinvested. The Department of Labor (Labor) is currently finalizing regulations on the disclosure of fees to participants, and several bills have been introduced to improve such disclosure. These efforts have generated debate about the type of fee information sponsors and participants may need, and the amount and format of fee information that should be disclosed. As Congress considers these issues, you asked us to describe information sponsors and participants need about fees. My remarks today will focus on the information on fees that (1) sponsors need to carry out their responsibilities to the plan and (2) plan participants need to make informed investment decisions.

¹ Defined benefit plans, sometimes referred to as traditional pension plans, generally provide a fixed level of monthly retirement income that is based on salary, years of service, and age at retirement regardless of how the plan's investments perform. In contrast, benefits from defined contribution plans are based on the contributions to and the performance of the investments in individual accounts, which may fluctuate in value.

To describe the fee information needed by 401(k) plan sponsors and participants, we relied on our previous work that examined the types of fees associated with 401(k) plans and who pays these fees, how information is disclosed to sponsors and participants, and Labor’s oversight of fees.² We also used information from Labor and from industry professionals on the subject of fee disclosure to plan sponsors. We conducted our review in October 2007 in accordance with generally accepted government auditing standards.

In summary, plan sponsors need to understand a broad range of information on expenses associated with their 401(k) plans to fulfill their fiduciary responsibilities. For example, sponsors need information on expenses associated with the investment options that they offer to participants and the providers they hire to perform plan services. Such information would help them meet their fiduciary duty to determine if expenses are reasonable for the services provided. In addition, sponsors need to understand the implication of certain business arrangements between service providers, such as revenue sharing. While industry professionals might agree about some of the information that sponsors need, they disagree about how much information is needed about individual expense components when a package of plan services, known as a “bundled” arrangement, is sold to a sponsor for a single price. Despite this disagreement, industry professionals have made various suggestions to help plan sponsors collect meaningful information on expenses. Labor has also undertaken a number of activities related to the information on plan expenses that sponsors should consider.

Participants need fee information to make informed decisions about their investments—primarily, whether to contribute to the plan and how to allocate their contributions among the investment options the plan sponsor has selected. To make informed decisions, participants need to be made aware of an investment option’s relative risk, its historic performance, and the fees they pay. However, many participants are not aware that they pay any fees, and of those who are, most may not know how much they are paying. Most industry professionals agree that information about investment fees, such as the expense ratio—a fund’s operating fees as a percentage of its assets—is fundamental for plan

² GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, [GAO-07-21](#) (Washington, D.C.: Nov. 16, 2006).

participants. Some industry professionals also believe that other fees that are also charged to participants should be understood so that participants can clearly see the effect these fees can have on their account balances.

Background

Roughly half of all workers participate in an employer-sponsored retirement, or pension, plan. Private sector pension plans are classified as either defined benefit or defined contribution plans. Defined benefit plans promise to provide, generally, a fixed level of monthly retirement income that is based on salary, years of service, and age at retirement, regardless of how the plan's investments perform. In contrast, benefits from defined contribution plans are based on the contributions to and the performance of the investments in individual accounts, which may fluctuate in value.

The Employee Retirement Income Security Act of 1974 (ERISA)³ establishes the responsibilities of employee benefit plan decision makers and the requirements for disclosing and reporting plan fees. Typically, the plan sponsor is a fiduciary.⁴ A plan fiduciary includes a person who has discretionary authority or control over plan management or any authority or control over the management or disposition of plan assets.⁵ ERISA requires that plan sponsors responsible for managing employee benefit plans carry out their plan responsibilities prudently and solely in the interest of the plan's participants and beneficiaries. Plan sponsors, as fiduciaries, are required to act on behalf of plan participants and their beneficiaries. These responsibilities include

- selecting and monitoring service providers to the plan,
- reporting plan information to the government and to participants,
- adhering to the plan's investment policy statement and other plan documents (unless inconsistent with ERISA),
- identifying parties-in-interest to the plan and taking steps to monitor transactions with them,
- selecting investment options the plan will offer and diversifying plan investments, and

³ 29 U.S.C. §§ 1001-1461.

⁴ Any person who makes investment decisions with respect to a qualified employee benefit plan's assets is generally a fiduciary. The duties the person performs for the plan rather than their title or office determines whether that person is a plan fiduciary. 29 U.S.C. § 1002(21)(A).

⁵ 29 U.S.C. § 1002(21).

-
- ensuring that the services provided to their plan are necessary and that the cost of those services is reasonable.

Plan sponsors may receive some information on an investment option's expenses that includes management fees, distribution and/or service fees, and certain other fees, such as accounting and legal fees. These fees are usually disclosed in the fund's prospectus or fund profile. To better enable the agency to effectively oversee 401(k) plan fees, we recommended in November 2006 that the Secretary of Labor should require plan sponsors to report to Labor a summary of all fees that are paid out of plan assets or by participants. This summary should list fees by type, particularly investment fees that are being indirectly incurred by participants.

In addition to receiving information about investment fees, sponsors may receive information about expenses for administration and other aspects of plan operations. Sponsors can also have providers fill out the Form 5500, which ultimately gets filed with Labor,⁶ and includes information about the financial condition and operation of their plans. Generally, information on 401(k) expenses is reported on two sections of the Form 5500, Schedule A and Schedule C.⁷ However, our November 2006 study reported that the form is of little use to plan sponsors and others in terms of understanding the cost of a plan.⁸

While plan sponsors may receive information on investment and other fees, they may not be receiving information on certain relevant business arrangements. In November 2006, we reported that several opportunities

⁶ The Form 5500 includes information on the plan's sponsor, the features of the plan, and the number of participants. The form also provides more specific information, such as information about plan assets, liabilities, insurance, and financial transactions. Filing this form satisfies the requirement for the plan administrator to file annual reports concerning, among other things, the financial condition and operation of plans. Labor uses this form as a tool to monitor and enforce plan sponsors' responsibilities under ERISA.

⁷ Schedule A is used to report fees and commissions paid to brokers and sales agents for selling insurance products. Schedule C includes information on the fees paid directly to service providers for all other investment products, but excludes investment fees deducted from returns. Schedule C also identifies service providers with fees in excess of \$5,000 by name.

⁸ Labor's ERISA Advisory Council Working Group on Plan Fees and Reporting on Form 5500 came to this conclusion, finding that only the fees that are billed explicitly and are paid from plan assets are deemed reportable. Many of the fees are associated with the individual investment options in the 401(k) plan, such as a mutual fund, and are deducted from investment returns and not reported to plan sponsors or on the Form 5500.

exist for such business arrangements to go undisclosed, given the various parties involved in creating and administering 401(k) plans. Problems may occur when pension consultants or other companies providing services to a plan also receive compensation from other service providers. Service providers may be steering plan sponsors toward investment products or services in which they have a direct business interest themselves without disclosing such arrangements. In addition, plan sponsors, being unaware, are often unable to report information about these arrangements to Labor on Form 5500 Schedule C. Our November 2006 report also recommended that Congress consider amending ERISA to require that service providers disclose to plan sponsors the compensation that providers receive from other service providers.

In our prior report on 401(k) fees, we found that the fee information that ERISA requires 401(k) plan sponsors to disclose is limited and does not provide participants with an easy way to compare investment options. All 401(k) plans are required to provide disclosures on plan operations, participant accounts, and the plan's financial status. Although they often contain some information on fees, these documents are not required to disclose the fees borne by individual participants. Overall, we found that the information currently provided to participants does not provide a simple way for them to compare plan investment options and their fees, and are provided to participants in a piecemeal fashion.

Additional fee disclosures are required for certain—but not all—plans in which participants direct their investments. ERISA requires disclosure of fee information to participants where plan sponsors seek liability protection from investment losses resulting from participants' investment decisions. Such plans—known as 404(c) plans—are required to provide participants with a broad range of investment alternatives, descriptions of the risks and historical performance of such investment alternatives, and information about any transaction fees and expenses in connection with buying or selling interests in such alternatives.⁹ Upon request, 404(c) plans must also provide participants with, among other information, the expense ratio for each investment option. Plan sponsors may voluntarily provide participants with more information on fees than ERISA requires,

⁹ Section 404(c) of ERISA generally provides relief for plan fiduciaries of certain individual account plans, such as 401(k) plans, from liability for losses resulting from investment decisions made by plan participants and beneficiaries. 29 U.S.C. § 1104(c). Implementing regulations provide specifics for complying with section 404(c). 29 C.F.R. § 2550.404c-1 (2007).

according to industry professionals. For example, plan sponsors that do not elect to be 404(c) often distribute prospectuses or fund profiles when employees become eligible for the plan, just as 404(c) sponsors do. Still, absent requirements to do so, some plan sponsors may not identify all the fees participants pay.

Some participants may be able to make comparisons across investment options by piecing together the fees that they pay, but doing so requires an awareness of fees that most participants do not have. Assessing fees across investment options can be difficult for participants because the data are typically not presented in a single document that facilitates comparison. However, most 401(k) investment options have expense ratios that are provided in prospectuses or fund profiles and can be compared; based on industry data, expenses for the majority of 401(k) assets, which are in investment options such as mutual funds, can be expressed as an expense ratio.

Sponsors Must Consider a Broad Range of Information to Fulfill Their Fiduciary Responsibilities

Plan sponsors, as fiduciaries, must consider plan fee information related to a broad range of functions. According to Labor, ERISA requires that sponsors evaluate fee information associated with the investment options offered to participants and the providers they hire to perform plan services and consider the reasonableness of the expenses charged by the various providers of services to the plan. In addition, the sponsor must understand information concerning certain arrangements, such as when a service provider receives some share of its revenue from a third party. While industry professionals might agree about some of the information that sponsors need, they disagree about how much information is needed about individual expense components when a package of plan services, known as a bundled arrangement, is sold to a sponsor for a single price. Some pension plan associations and practitioners have made various suggestions to help plan sponsors collect meaningful information on expenses. Labor has also undertaken a number of activities related to the information on plan expenses that sponsors should consider.

Sponsors Need Information to Evaluate Fees and Expenses Associated with Investment Options and Plan Services

In order to carry out their duties, plan sponsors have an obligation under ERISA to prudently select and monitor plan investment options made available to the plan's participants and beneficiaries and the persons providing services to the plan. Understanding and evaluating the fees and expenses associated with a plan's investments and services are an important part of a fiduciary's responsibility. Plan sponsors need to monitor the fees and expenses associated with the plan's investment

options and the services provided by outside vendors, including any revenue sharing arrangements, to determine whether the expenses continue to be reasonable for the services provided.

Industry experts have suggested that plan sponsors be required to obtain complete information about investment options before adding them to the plan's menu and obtain information concerning arrangements where a service provider receives some share of its revenue from a third party. A number of associations recently put together a list of service- and fee-related data elements they believe defined contribution plan sponsors and service providers should discuss when entering into agreements. The data elements include such information as payments received by plan service providers from affiliates in connection with services to the plan, float revenue,¹⁰ and investment-related consulting services. The list is meant as a reference tool for plan sponsors and providers to use to determine the extent to which a service provider receives compensation in connection with its services to the plan from other service providers or plan investment products (e.g., revenue sharing or finders' fees). According to the associations that formulated this tool, the information can aid plan sponsors to evaluate any potential conflicts of interest that may arise in how fees are allocated among service providers.

In our prior work, we noted that plan sponsors may not have information on arrangements among service providers that, according to Labor officials, could steer plan sponsors toward offering investment options that benefit service providers but may not be in the best interest of participants. For example, the Securities and Exchange Commission (SEC) released a report in May 2005 that raised questions about whether some pension consultants are fully disclosing potential conflicts of interest that may affect the objectivity of the advice.¹¹ In addition, specific fees that are considered to be "hidden" may mask the existence of a conflict of interest. Hidden fees are usually related to business arrangements where one service provider to a 401(k) plan pays a third-party provider for services, such as record keeping, but does not disclose this compensation to the plan sponsor. The problem with hidden fees is not how much is being paid to the service provider, but with knowing what entity is

¹⁰ Float revenue is revenue earned from the short-term investment of plan assets.

¹¹ U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, *Staff Report Concerning Examinations of Select Pension Consultants*, (Washington, D.C.: May 2005).

receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered.

While there is general agreement that understanding the fees and expenses associated with a plan's services is an important part of a fiduciary's responsibility, pension professionals disagree about how much information is needed about the expense components of bundled fee arrangements. One representative speaking on behalf of five industry associations stated he did not believe that the requirement to "unbundle" bundled services and provide individual costs in many detailed categories was particularly helpful because the information provided would not be very meaningful and the costs of providing this information would ultimately be passed on to plan participants through higher administrative fees. He also raised concerns about how a service provider would disclose component costs for services that are not offered outside a bundled contract. In addition, he said that posting such information could force public disclosure of proprietary information regarding contracts between service providers and plan sponsors. Finally, he stated that as long as they are fully informed of the services being provided, many plan sponsors might prefer reviewing aggregate costs so that they can compare and evaluate whether the overall fees are reasonable without analyzing each itemized fee.

On the other hand, a representative of another pension association contended that it is possible with very little cost to develop an allocation methodology to provide a reasonable breakdown of fees for plan services. He believes that not disclosing component pricing provides a competitive advantage, enabling bundled providers to tell plan sponsors that they can offer certain retirement plan services for free—when fees are deducted from investment returns—while unbundled providers are required to disclose the fees for the same services. He further stated that any disclosure requirements should apply uniformly to all service providers. In his view this would allow plan fiduciaries to assess the reasonableness of fees by comparison and thereby allow fiduciaries to determine whether certain services are needed, which could lead to lower fees.

Plan Sponsors Need to Collect and Evaluate Meaningful Information on Expenses

Industry professionals have suggested that, before hiring a service provider or adding investment options to the plan's menu, plan sponsors should obtain complete fee information, including information concerning arrangements in which a service provider receives some share of its revenue from a third party. Pension plan associations and practitioners

have made various suggestions to help plan sponsors collect meaningful information on expenses.

In 2004 the ERISA Advisory Council on Employee Welfare and Pension Benefit Plans created a Working Group to study retirement plan investment management fees and expenses as they were currently reported to Labor.¹² In addition to issues related to annual reporting, the Working Group was also interested in determining whether plan sponsors currently receive adequate data from the service providers in order to both understand and report fees. In its final report, the Working Group made the following recommendations, among others, in an effort to further educate plan sponsors and fiduciaries about plan fees.¹³

- Plan sponsors should avoid entering transactions with vendors who refuse to disclose the amount and sources of all fees and compensation received in connection with plan.
- Plan sponsors should require plan providers to provide a detailed written analysis of all fees and compensation (whether directly or indirectly) to be received for its services to the plan prior to retention.
- Plan sponsors should obtain all information on fees and expenses as well as revenue sharing arrangements with each investment option. Plan sponsors should also determine the availability of other mutual funds or share classes within a mutual fund with lower revenue sharing arrangements prior to selecting an investment option.
- Plan sponsors should require vendors to provide annual written statements with respect to all compensation, both direct and indirect, received by the provider in connection with its services to the plan.

¹² Section 512 of ERISA provides for the establishment of an Advisory Council on Employee Welfare and Pension Benefit Plans. The duties of the council are to advise the Secretary and submit recommendations regarding the Secretary's functions under ERISA. The council consists of 15 members appointed by the Secretary of Labor: Three members are representatives of employee organizations; three members are representatives of employers; there is one representative each from the fields of insurance, corporate trust, actuarial counseling, investment counseling, investment management, and accounting; and three members are representatives of the general public. 29 U.S.C. § 1142.

¹³ *Final Report of the 2004 ERISA Advisory Council Working Group, Health and Welfare Form 5500 Requirements* (Nov. 10, 2004).

-
- Plan sponsors need to be aware that with asset-based fees, fees can grow just as the size of the asset pool grows, regardless of whether any additional services are provided by the vendor, and as a result, asset-based fees should be monitored periodically.
 - Plan sponsors should calculate the total plan costs annually.

More recently in 2007, one witness before the ERISA Advisory Council recommended further that plan sponsors should evaluate fees associated with three categories of services:¹⁴

- Net investment expenses would not only include investment expenses, such as the expense ratio of a mutual fund, but would also subtract any fees or commissions paid to a broker, consultant, or advisor for services in the categories below.
- Administrative expenses would include specific charges for operational services, such as record keeping, administration, compliance, and communication, as well as revenue sharing or other payments from investments.
- Advisory expenses would include amounts paid directly by the plan to consultants, advisors, or brokers, as well as indirect payments from sources such as investments or related companies.

In addition, some industry professionals believe that plan sponsors, as they monitor investment alternatives, should review investment alternative results against appropriate benchmarks and compare their plans' options to competing funds with similar investment goals.¹⁵ A benchmark is used to compare specific investment results with that of the market or economy. Industry professionals also noted that although there are

¹⁴ Written Comments of C. Frederick Reish, Reish Luftman Reicher & Cohen, for Testimony before the 2007 U.S. Department of Labor Advisory Council on Employee Welfare and Pension Benefits Plans Working Group on Fiduciary Responsibilities Update and Revenue Sharing Practices, (Sept. 20, 2007).

¹⁵ Although some industry professionals believe that participants should be provided comparative benchmarks for their investment options, not all industry professionals agreed. Most industry professionals we consulted believed that benchmarks would be more useful for plan sponsors than for participants. Since plan participants do not have any control over the investment options offered in a plan, industry professionals said that benchmarking is less useful to plan participants than plan sponsors, since plan sponsors use benchmarks in evaluating alternatives to their plans' investment options.

appropriate benchmarks for mutual funds, benchmarks are not as readily available for other types of investment products. According to one industry professional that we spoke with, plan sponsors do not have good benchmarks to assess the reasonableness of investment options' expense ratios. Only limited information is available, and a national database of funds and their expense ratios does not exist. He further stated that without such a source, selecting which funds constitute a meaningful comparison set is not an easy task, and may be open to interpretation. Disclosure encourages price competition, but in his opinion, because of the lack of available information, the 401(k) market is relatively ineffective at fostering price competition.

Labor's Initiatives Related to 401(k) Plan Sponsors

Labor, in its comments on our November 2006 report, stated that the agency has proposed a number of changes to the Form 5500, including changes that would expand the information required to be reported on the Schedule C. The changes are intended to assist plan sponsors in assessing the reasonableness of compensation paid for services and potential conflicts of interest that might affect those services. According to testimony earlier this month from the Assistant Secretary of Labor, the agency will be issuing a final regulation requiring additional public disclosure of fee and expense information on the Form 5500 within the next few weeks.¹⁶ This change will be helpful to plan sponsors as they look retrospectively at the preceding plan year. In addition, Labor was considering an amendment to its regulation under section 408(b)(2) of ERISA, expected to be issued this year. This amendment would help to ensure that plan sponsors have sufficient information on the compensation to be paid to the service provider and the revenue sharing compensation paid by the plan for the specific services and potential conflicts of interest that may exist on the part of the service provider.

Labor's ERISA Advisory Council currently has a working group focusing on fiduciary responsibility and revenue sharing. One area of focus is what service providers should be required to provide when they enter into a revenue sharing or rebate arrangement. Labor also provides a model form on its Web site specifically designed to assist plan fiduciaries and service providers in exchanging complete disclosures concerning the costs

¹⁶ Statement of Bradford P. Campbell, Assistant Secretary of Labor, Before the Special Committee on Aging, U.S. Senate, Oct. 24, 2007.

involved in service arrangements. Other associations and entities continue to develop model fee disclosure forms for plan sponsors.

We are currently conducting work in the area of 401(k) plan sponsor practices, identifying how plan sponsors decide which features to include in the plans they establish and how plan sponsors oversee plan operations. Part of our work will consider how plan sponsors monitor the fees charged to their plans. We expect to issue a report in 2008.

Basic Fee Information Is Important for Participants to Make Informed Decisions

Before making informed decisions about their 401(k) plan investments, participants must first be made aware of the types of plan fees that they pay. For example, according to one nationwide survey, some participants do not even know that they pay plan fees. In 2006, we reported that investment fees constitute the majority of fees in 401(k) plans and are typically borne by participants. Most industry professionals agree that information about investment fees—such as the expense ratio, a fund’s operating fees as a percentage of its assets—is fundamental for plan participants. Participants also need to be aware of other types of fees—such as record-keeping fees and redemption fees or surrender charges imposed for changing or selling investments—to gain a more complete understanding of all the fees that can affect their account balances. Whether participants receive only basic expense ratio information or more detailed information on various fees, presenting the information in a clear, easily comparable format can help participants understand the content of the disclosure.

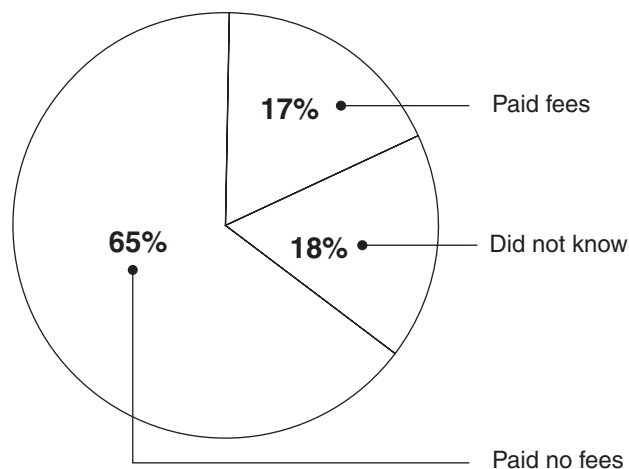
Participants May Not Be Aware of the Fee Information Needed to Make Informed Decisions

Currently, most participants are responsible for directing their investments among the choices offered by their 401(k) plans, but may not be aware of the different fees that they pay. According to industry professionals, participants are often unaware that they pay any fees associated with their 401(k) plan. In fact, studies have shown that 401(k) participants often lack the most basic knowledge—that there are fees associated with their plan. When asked in a recent nationwide survey whether they pay any fees for the 401(k) plan, as figure 1 shows, 65

percent of 401(k) participants responded that they do not pay fees.¹⁷ Seventeen percent said they do pay fees, and 18 percent stated that they do not know. When this same group was asked how much they pay in fees, as shown in figure 2, 83 percent reported not knowing.

Figure 1: Participants' Response to Survey Question on Awareness of Fees

Do you know whether you pay any fees for your 401(k) plan?

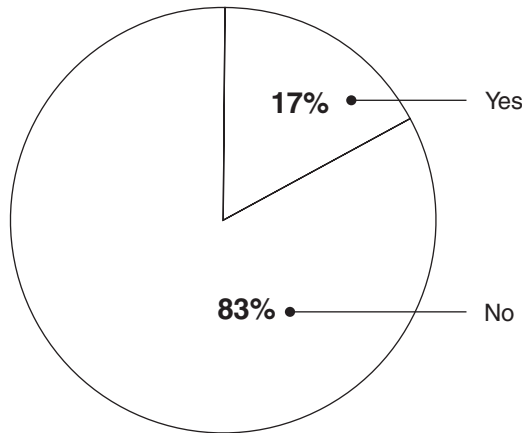


Source: AARP's Survey of 401(k) Participants' Awareness and Understanding of Fees, developed and deployed by Knowledge Networks, July 2007.

¹⁷ AARP Knowledge Management, *401(k) Participants' Understanding and Awareness of Fees*, (Washington, D.C.: July 2007). AARP commissioned a nationally representative survey of 1,584 401(k) plan participants age 25 and older. The survey was fielded from June 8 through June 24, 2007, by Knowledge Networks of Menlo Park, California, to members of its nationally representative online panel. The overall sample was designed to be nationally representative of 401(k) plan participants age 25 and older.

Figure 2: Participants' Response to Survey Question on Awareness of Fees

Do you know how much in fees and expenses you are paying for your 401(k) plan?



Source: AARP's Survey of 401(k) Participants' Awareness and Understanding of Fees, developed and deployed by Knowledge Networks, July 2007.

Participants Need Information on Investment Fees

Although it is clear that participants require fee information to make informed decisions, it is not so clear what fee information is most relevant. In 2006, we reported that investment fees constitute the majority of fees in 401(k) plans and are typically borne by participants. Investment fees are, for example, fees charged by companies that manage a mutual fund for all services related to operating the fund. These fees pay for selecting a mutual fund's portfolio of securities and managing the fund; marketing the fund and compensating brokers who sell the fund; and providing other shareholder services, such as distributing the fund prospectus.¹⁸ These fees are charged regardless of whether the mutual fund or other investment product, such as collective investment funds or group annuity contracts, is part of a 401(k) plan or purchased by individual investors in the retail

¹⁸ Fees related to marketing and compensating brokers to sell the fund are known as 12b-1, or distribution fees, and are limited by the Financial Industry Regulatory Authority, the entity that succeeded the National Association of Securities Dealers Inc., to a maximum of 1 percentage point of the total expense ratio per year.

market.¹⁹ As such, the fees are usually different for each investment option available to participants in a 401(k) plan.

In our previous report, we recommended that Congress consider amending ERISA to require all sponsors of participant-directed plans to disclose fee information on 401(k) investment options to participants in a way that facilitates comparison among the options, such as via expense ratios.²⁰ As mentioned earlier, there have been at least two bills recently introduced in Congress on the subject. Industry professionals have also suggested that comparing the expense ratio across investment options is the most effective way to compare options' fees. They generally agree that an expense ratio provides valuable information that participants need and can be used to compare investment options because it includes investment fees, which constitute most of the total fees borne by participants. According to an industry official, the disclosure of expense ratios might include a general description of how expense ratios vary depending on the type and style of investment. For example, investment options with relatively high fees, such as actively managed funds, tend to have larger expense ratios than funds that are not actively managed. Also, investment options that are only available to institutional investors tend to have lower expense ratios than other types of funds.

Most of the investment options offered in 401(k) plans have expense ratios that can be compared, but this information is not always provided to participants. In addition, investment options other than mutual funds may not be required to produce prospectuses that include expense ratios, but according to industry professionals, most options have expense ratio equivalents that investment industry professionals can identify.

¹⁹ Mutual funds that use brokers to sell shares may also impose a sales fee, or "load," when a fund is bought, transferred, or sold to compensate the broker. SEC does not limit the size of the sales load a fund may charge, but the Financial Industry Regulatory Authority does not permit exceeding 8.5 percent of the purchase price. A "front-end load" is incurred when a mutual fund is purchased and reduces the amount available to purchase fund shares. A "back-end load" is a fee that is charged when a mutual fund is sold or transferred. Back-end loads generally decrease over time in steps until they are eventually eliminated.

²⁰ We found that it is hard for participants to make comparisons across investment options because they have to piece together the fees that they pay, and assessing fees across investment options can be difficult because data are not typically presented in a single document that facilitates comparison.

Participants Also Need Information on Other Fees That Affect Their Account Balances

Industry professionals also believe that participants need information on other fees that are not included in the expense ratio but still affect their account balances. For example, annual fees or fees on a per transaction basis that can be deducted from account balances should be disclosed, such as administrative and record-keeping fees, participant loan origination fees, and annual loan charges.²¹

In addition, industry professionals also recommended that certain investment-specific fees be disclosed, including

- redemption fees or sales charges—fees that may be imposed by the provider as a result of changing investments in a given period,
- surrender charges—fees that may be imposed as a result of selling or withdrawing money from the investment within a given number of years after investing, and
- wrap fees—fees that are assessed on the total assets in a participant’s account.²²

Some industry professionals recommended that plan participants be provided information on their returns net of all fees so that they can clearly see what their investments have earned after fees. Others recommended that information be disclosed that explains how the investment and administrative costs of the plan affect their investment returns and their overall retirement savings in the plan. These officials believed that such information would help participants understand that fees are an important factor to consider when directing their investments.

Whether participants are provided with basic expense ratio information or more detailed information on various fees, or both, providing the information in a clear, easily comparable format can assist participants in understanding the information disclosed. In our prior reports on helping

²¹ Plan record-keeping fees cover individual account maintenance for plan participants. They cover a variety of activities, such as enrolling participants, processing fund selections, preparing and mailing account statements, and other related administration activities. A loan origination fee is charged to a participant who elects to take a loan from the plan. The fee covers document preparation and loan processing expenses. Annual loan charges are imposed for account maintenance.

²² Wrap fees are for various expenses, such as sales commissions, administrative expenses, and/or recording keeping fees. However, wrap fees can also be assessed against specific investment options and/or at the plan level based on total plan assets. For example, a wrap fee may be assessed against a “low fee” investment option because the investment provider does not contribute toward the cost of plan record-keeping and administration.

the public understand Social Security information and on more effective disclosures for credit cards, we found that certain practices help people understand complicated information.²³ These practices include

- language—writing information in clear language,
- layout—using straightforward layout and graphics,
- length—providing a short document,
- comparability—making options easy to compare in a single document, and
- distribution—offering a choice of paper or electronic distribution.

Labor’s Initiatives Related to 401(k) Plan Participants

In our prior work, we noted that Labor is considering the development of a new rule regarding the fee information required to be furnished to participants under its section 404(c) regulation. According to Labor officials, they are attempting to identify the critical information on fees that plan sponsors should disclose to participants of 404(c) plans (but not all participant-directed plans) and the best way to do so. The initiative is intended to explore what steps might be taken to ensure that participants have the information they need about their plan and available investment options, without imposing additional costs, given that such costs are likely to be charged against the individual accounts of participants and affect their retirement savings. The officials are currently considering what fee information should be provided to participants and what format would enable participants to easily compare the fees across a plan’s various investment options. Labor is also currently evaluating comments received from consumer groups, plan sponsors, service providers, and others as it develops its regulation.

Labor also has ongoing efforts designed to help participants and plan sponsors understand the importance of plan fees and the effect of those fees on retirement savings. Labor has developed and makes available on its Web site a variety of educational materials specifically designed to help plan participants understand the complexities of the various fee and

²³ GAO, *Social Security Statements: Social Security Administration Should Better Evaluate Whether Workers Understand Their Statements*, [GAO-05-192](#) (Washington, D.C.: Apr. 1, 2005); GAO, *Social Security Administration: Longstanding Problems in SSA’s Letters to the Public Need to Be Fixed*, [GAO/HEHS-00-179](#) (Washington, D.C.: Sept. 26, 2000); GAO, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, [GAO-06-929](#) (Washington, D.C.: Sept. 12, 2006); and GAO, *SSA Benefit Statements: Well Received by the Public but Difficult to Comprehend*, [GAO/HEHS-97-19](#) (Washington, D.C.: Dec. 5, 1996).

compensation arrangements involved in 401(k) plans. Its brochure titled *A Look at 401(k) Plan Fees* is targeted to participants and beneficiaries of 401(k) plans who are responsible for directing their own investments.

Conclusions

Both 401(k) plan sponsors and participants need fee information in order to make the most informed decisions. For plan sponsors, requiring that certain information on fees be disclosed can help them understand what services they are paying for, who is benefiting, and whether their current arrangements are in the best interest of plan participants. Requiring plan sponsors to report more complete information to Labor on fees—including those paid out of plan assets by participants—would put the agency in a better position to effectively oversee 401(k) plans and, in doing so, to protect an increasing number of participants. The mere act of requiring such information may actually promote competition among the entities that provide services to plans and possibly reduce the fees service providers charge.

For plan participants, given the voluminous amount of information that could be disclosed, determining the relevant information that participants most need is key. At a minimum, providing information such as expense ratios or other investment-specific fee information could be the place to start. Also, making sure that the information is accessible in terms of the language, layout, length, comparability, and distribution can ensure that participants actively utilize the information disclosed. As participants become more sophisticated or demand more information, decisions can then be made about the type and format of additional fee information.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other members of the committee may have at this time.

Contacts and Acknowledgements

For further information regarding this testimony, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, at (202) 512-7215 or bovbjergb@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Tamara E. Cross, Assistant Director; Daniel F. Alspaugh; Monika R. Gomez; Matthew J. Saradjian; Susannah L. Compton; Craig H. Winslow; and Walter K. Vance.

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "E-mail Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, DC 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, jarmong@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548