PRESENT LAW AND BACKGROUND RELATING TO QUALIFIED RETIREMENT PLAN FEES

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on October 30, 2007

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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I. OVERVIEW

The Committee on Ways and Means has scheduled a public hearing for October 30, 2007, on the appropriateness of fees that are charged to certain types of employer-sponsored qualified retirement plans. Specifically, the hearing addresses the fees charged to qualified retirement plans that are defined contribution plans. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides background and economic data relating to fees charged in connection with qualified defined contribution plans,[2] a description of present law rules in the Internal Revenue Code (the "Code")[3] that relate to the amount and disclosure of such fees, and a discussion of issues and analysis relating to such fees.

The Code provides for the favorable tax treatment of a variety of retirement savings plans sponsored by employers, provided that such plans meet certain qualification requirements. Such plans are commonly referred to as "qualified retirement plans." A defined contribution plan is a plan under which each participant's retirement benefit is equal to the participant's allocable share of the trust that funds the plan. Under a defined contribution plan, each participant's retirement benefit in such a plan is increased by contributions to the trust and earnings on those contributions, and is decreased by losses on plan assets and fees paid from plan assets. As of December 31, 2006, $9.6 trillion in assets was held in qualified retirement plans. Of this amount, $3.2 trillion was held in defined contribution plans maintained by private employers.

The fees that may be incurred in connection with qualified retirement plans may be divided into three broad categories: (1) fees related to plan administration; (2) fees related to specific services requested by plan participants; and (3) fees related to the investment of plan assets. When these fees are paid from plan assets, the amount available under the plan to pay retirement benefits is reduced by the amount of such fees paid. By reducing the net return on investments, fees can substantially reduce the accumulated plan assets available at retirement under a defined contribution plan. In a recent survey of section 401(k) plans, the average reduction in the rate of return due to plan fees was calculated to be 0.75 percent.[4]

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Qualified Retirement Plan Fees* (JCX-103-07), October 30, 2007. This publication is also available on the web at www.house.gov/jct.

[2] This pamphlet does not discuss the rules and issues relating to fees charged in connection with individual retirement accounts or annuities ("IRAs"), regardless of whether the IRA is part of an employer-sponsored retirement program. This pamphlet also does not discuss fees charged in connection with qualified retirement plans that are defined benefit plans.

[3] Except as otherwise noted, references to sections and to the Code in this document are references to the Internal Revenue Code of 1986, as amended.

[4] Deloitte Consulting, LLP, International Foundation of Employee Benefit Plans, and International Society of Certified Employee Benefit Specialists, Annual 401(k) Benchmarking Survey: 2005/2006 Edition, Deloitte Development, LLC, 2006. Available at http://www.iscebs.org/PDF/srvy401kresults_06.pdf.

The following example demonstrates the effect of this recent study's findings on retirement plan assets available at the time of retirement. Assuming an average before-fee rate of return of 8 percent and annual contributions to a section 401(k) plan of $5,000, if there were no fees incurred with respect to the annual contributions, the account would grow to $247,115 in 20 years. For the average reduction in rate of return of 0.75 percent per year that was found in the recent study, the account value at the end of 20 years is reduced by $21,181, or 9.37 percent. By contrast, if the reduction is 0.25 percent per year, the final amount is reduced by $7,294 (a reduction of 3.04 percent). In the case of a fee that reduces the rate of return by 2.0 percent per year, the final amount is reduced by $52,151 (a reduction of 26.75 percent).

Plan fees can vary dramatically across different plans. For example, larger companies and larger plans tend to have smaller expense ratios because the fixed costs with respect to plan expenses can be spread over more participant account balances and greater amounts of aggregate plan assets. The mix of assets impacts overall costs to the plan as some asset classes are more costly to manage than others. In addition, some plans may have higher fees because they offer additional services, such as financial planning or, in the case of a plan that permits a participant to direct the investment of the participant's account under the plan, the plan may have higher expenses associated with offering a variety of platforms to allow for the participant direction (e.g., the plan might allow for both telephone call centers and web-based applications). Some plans may have higher fees for investment related expenses because such fees also cover administrative and recordkeeping functions (sometimes referred to as a bundled fee arrangement or bundled services agreement).

The Code generally does not include specific rules that restrict the amount of fees or require specific disclosure of fees incurred by qualified retirement plans. An exception is the prohibited transaction rules set forth in the Code. These rules generally permit a plan to pay a service provider a reasonable fee. Other non-tax rules may apply to limit the amount of fees that may be charged to qualified retirement plans or that may require disclosure of such fees to plan sponsors and participants. For example, Federal and State law banking rules, State law insurance rules, Federal and State securities laws, and licensing laws applicable to professionals (such as attorneys and investment brokers) may apply to a specific service provider or to a particular investment alternative offered under a retirement plan.

The Employee Retirement Income Security Act of 1974 ("ERISA") contains rules that govern fees that can be charged to retirement plans with respect to plan assets. Under ERISA, fiduciaries of a retirement plan are required to discharge their duties solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants. This duty includes defraying plan expenses and ensuring that the expenses are reasonable. Thus, ERISA expressly permits the payment of fees in connection with plan administration, but such fees must be reasonable. ERISA also contains rules that require the disclosure of plan fees to plan participants.

II. BACKGROUND

A. Favorable Tax Treatment of Qualified Retirement Plans

The Code provides for the favorable tax treatment of a variety of retirement savings plans that are sponsored by employers, provided that such plans meet certain qualification requirements. Such plans are commonly referred to as "qualified retirement plans." Qualified retirement plans include the following types of plans: (1) plans qualified under section 401(a), which are commonly referred to as "tax-qualified plans" and which may include qualified cash or deferral arrangements (so-called "section 401(k) plans"); (2) plans described in section 403(a), which are commonly referred to as "section 403(a) annuities" and which are employee retirement annuities that meet certain requirements applicable to tax-qualified plans; (3) section 403(b) tax-deferred annuities, which may only be sponsored by certain types of tax-exempt employers;[5] and (4) section 457(b) plans sponsored by State and local governments, which are sometimes offered by a governmental employer in lieu of a section 401(k) plan.[6]

In general, a qualified retirement plan may be designed as either a defined contribution plan or a defined benefit plan. Under a defined contribution plan, the employer or the employee (or sometimes both) make contributions to the plan. These contributions, plus earnings on the contributions, are credited to an individual account on behalf of each employee who participates in the plan. For each employee, the account balance of the employee under the plan at the time of retirement represents the employee's retirement benefit. Therefore, under this type of plan, the employee is at risk for the investment performance of the plan because the investment performance directly affects the amount of benefits available upon retirement. In addition, any reduction in the employee's account balance, such as fees deducted from the account, directly affects the employee's retirement benefits. A section 401(k) plan is the most common defined contribution plan that is sponsored by employers.[7]

In contrast, under a defined benefit plan, the employee earns a benefit pursuant to a formula in the plan that is typically based on length of service and final pay or average pay. For example, a typical formula under a defined benefit plan might provide a benefit at normal retirement age in the form of an annual annuity payment that is equal to one percent of the

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[5] Section 403(b) tax-deferred annuities may be purchased by: (1) an organization that is exempt under section 501(a) and is described in section 501(c)(3); (2) certain types of educational organizations or an employer which is a State or political subdivision of a State; and (3) by certain ministers and churches.

[6] The term qualified retirement plan is also typically used to describe two types of plans that are funded by individual retirement accounts established by the participating employee: (1) simplified employee pensions described in section 408(k); and (2) simple retirement account plans described in section 408(p).

[7] Investment Company Institute, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2005," Research Perspective, August 2006 (Volume 12, No. 1). Available on the web at www.ici.org/pdf per 12.01.pdf.

employee's final average pay multiplied by years of service with the employer. Under this type of plan, the employer is responsible for ensuring that the plan has sufficient assets to pay an employee's promised benefit. Thus, under a defined benefit plan, the employer is at risk for the investment performance of the plan. Fees charged to the assets of such a plan affect the amount of the employer required contributions.

Under the Code, qualified retirement plans are eligible for significant tax subsidies if they satisfy certain minimum qualification requirements. One such requirement is that the plan generally must be funded. In general, this is satisfied by establishing a trust for the exclusive purpose of providing benefits for the participants under the plan.[8] These plans are also subject to qualification requirements that limit the amount of the tax subsidy associated with such plans. The tax subsidies are designed so that the tax benefits are broadly distributed among a fair cross section of the employer's employees (and not just the most highly compensated employees).

The Code provides three favorable tax rules with respect to qualified retirement plans. First, a participant generally is not currently taxed on compensation that is contributed to the plan. Instead, the participant must include any distributions received from the plan in gross income. Thus, contributions to a plan are generally made on a pre-tax basis.[9] Absent this special treatment, under general tax law principles, contributions to a trust are includible in the beneficiary's income at the time the beneficiary's interest in the trust becomes nonforfeitable, which is typically earlier than the actual distribution of benefits from the trust.[10] Second, a taxable employer is generally permitted to immediately deduct contributions made to the plan on behalf of participant employees.[11] The treatment is different in the case of nonqualified retirement plans. In such cases, a matching rule applies that delays the employer's deduction for contributions until such contributions are includible in the participant's gross income.[12] Third, the trust that funds a qualified retirement plan is treated as a tax-exempt entity, with the result that earnings compound in the trust on a tax-deferred basis.[13] This produces the benefit of tax-

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[8] Sec. 401(a) (relating to tax-qualified retirement plans) and sec. 457(g)(1) (relating to section 457(b) plans maintained by State and local governments). Section 403(a) annuities and section 403(b) tax-deferred annuities are funded through the purchase of an annuity contract. In the case of section 403(b) tax-deferred annuities, sections 403(b)(7) and 401(f) permit the funding of the benefit through a custodial account provided that the person holding the assets agrees to hold the assets in a manner consistent with the requirements of section 401(a) (relating to tax-qualified plans).

[9] Secs. 402(a), 403(a)(1), 403(b)(1), and 457(a)(1)(A).

[10] Under the economic benefit doctrine, the receipt of property such as stock options or an interest in a trust is treated as gross income for the recipient. *Commissioner v. Smith*, 324 U.S. 177 (1945); *E.T. Sproul v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (1952).

[11] Sec. 404(a)(1), (2), and (3).

[12] Sec. 404(a)(5).

[13] Secs. 403(b)(7)(B), 457(g), and 501(a).

deferred build-up for the period of deferral, which in some cases may be 20 or 30 years or longer.

The amount of the tax expenditure associated with these favorable tax rules is substantial. For the 2007 Federal fiscal year, the Joint Committee on Taxation estimates the total tax expenditure for the net exclusion of pension contributions and earnings for employer plans and plans covering partners and sole proprietors to be $117.4 billion. The aggregate tax expenditure for Federal fiscal years 2007 through 2011 is estimated to be $661.8 billion.[14] These figures include the tax expenditure relating to both defined benefit plans and defined contribution plans.

As mentioned above, among the qualification rules that a tax qualified retirement plan must satisfy are rules that limit the amount of the tax benefits with respect to each plan participant and the plan in general. These rules include limits on the contributions an employer can deduct for any one taxable year.[15] Section 401(a) limits the amount of annual additions that can be made to a participant's account balance under a defined contribution plan to the lesser of 100 percent of the participant's compensation or $45,000 (for 2007).[16] Elective salary reduction deferrals by a participant in a section 401(k) plan, section 403(b) tax-deferred annuity, or section 457(b) plan maintained by a State or local government are subject to a separate annual limitation. The limitation on the amount of annual elective deferrals is generally $15,500 (for 2007), although participants who have attained age 50 may be eligible to make an additional $5,000 (for 2007) in elective deferrals.[17]

Most qualified plans are subject to rules that require a minimum number of an employer's active employees to participate in the plan, and that the plan provide for nondiscriminatory benefits (when the benefits of highly compensated employees are compared with the benefits provided to nonhighly compensated employees).[18] These rules are designed to ensure that the tax benefits are broadly distributed among all of an employer's employees, and are not unduly concentrated among the most highly paid employees of an employer. Special additional rules also apply to certain types of plans. For example, in addition to the minimum participation and nondiscrimination rules described above, many tax-qualified retirement plans are subject to the top-heavy rules of section 416, which require that the plan provide certain minimum benefits if

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[14] Joint Committee on Taxation, *Estimate of Federal Tax Expenditures for Fiscal Years 2007-2011*, (JCS-3-07), September 24, 2007. This publication is also available on the web at www.house.gov/jct.

[15] Sec. 404(a).

[16] Sec. 415(c)(1). Annual additions include employer and employee contributions and the employee's allocable share of any amounts forfeited by other participants.

[17] Secs. 402(g)(1), 414(v), and 457(e)(15).

[18] See, for example, secs. 401(a)(4) (nondiscrimination of contribution and benefits in tax-qualified plans), 401(a)(26) (minimum participation rules for tax-qualified defined benefit plans), and 410(b) (minimum coverage rules applicable to tax-qualified plans).

the benefits provided under the plan are too heavily concentrated among key employees of the employer.

As of December 31, 2006, $9.6 trillion was held by trusts and other funding vehicles for qualified retirement plans. This amount has grown at an annualized rate of 6.1 percent since 1996, when $5.3 trillion was held for qualified retirement plans. The chart below shows the growth in total pension assets over this time period. The table below shows the asset balances of various types of pension plans since 1996. While assets in all categories have increased, defined contribution plans have grown faster than defined benefit plans. As of December 31, 2006, $3.2 trillion was held in defined contribution plans maintained by private employers, compared with $2.2 trillion held by defined benefit plans maintained by private employers.

As of March, 2007, it is estimated that 51 percent of private sector employees in the United States participated in an employer sponsored retirement plan. It is estimated that 43 percent participated in defined contribution plans, while only 20 percent participated in defined benefit plans.[19] Approximately 76 percent of public sector workers participated in some type of employment-based retirement plan in 2004.[20]

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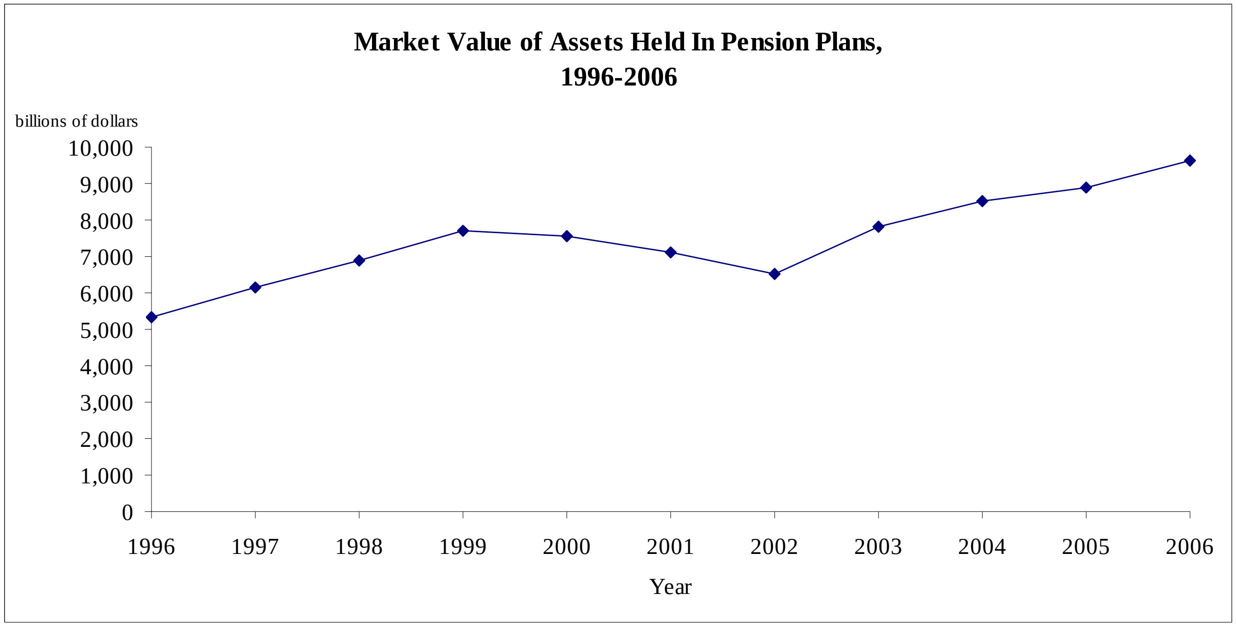
[19] National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007, U.S. Department of Labor, Bureau of Labor Statistics, Summary 07-05, August 2007. Available on the web at www.bls.gov/ncs/ebs/sp/ebsm0006.pdf.

[20] Employee Benefit Research Institute, Facts from EBRI, June 2007 available at http://www.ebri.org/pdf/publications/facts/0607fact.pdf. EBRI estimates are from the 2005 March Current Population Survey for public sector wage and salary workers aged 21-64.

Pension Asset Balances (billions of dollars; amounts outstanding end of period)											
Year	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Private Defined Benefit Plans	1,590.2	1,763.5	1,907.7	2,074.6	1,979.0	1,810.2	1,639.3	1,994.5	2,132.2	2,149.3	2,257.5
Private Defined Contribution Plans (1)	1,634.2	1,949.3	2,236.2	2,519.2	2,488.6	2,238.0	2,037.9	2,525.6	2,783.0	2,971.0	3,266.7
State and Local Government Retirement Funds	1,509.2	1,794.5	2,030.6	2,325.8	2,293.1	2,206.6	1,930.5	2,344.0	2,572.0	2,701.5	2,979.8
Federal Government Retirement Funds (2)	605.8	659.1	716.0	774.0	796.7	859.7	893.8	958.5	1,023.5	1,074.5	1,142.1
assets in TSP (3)	46.4	60.7	77.3	94.6	97.7	100.6	102.3	128.9	146.3	167.8	200.6
Federal net of TSP	559.4	598.4	638.7	679.4	699.0	759.1	791.5	829.6	877.2	906.7	941.5
Total Pension Assets	5,339.4	6,166.4	6,890.5	7,693.6	7,557.4	7,114.5	6,501.5	7,822.6	8,510.7	8,896.3	9,646.1

source: Board of Governors, Federal Reserve System, Flow of Funds, release September 17, 2007.

(1) Includes 401(k) plans; excludes IRAs and Keoghs
(2) Includes Thrift Savings Plan (TSP), National Railroad Retirement Investment Trust, and nonmarketable government securities held by Federal retirement funds
(3) Data from audited financial statements of the TSP



B. Fees Charged in Connection with Qualified Retirement Plans

The fees that may be incurred in connection with qualified retirement plans may be divided into three broad categories for fees related to: (1) plan administration; (2) specific services requested by plan participants; and (3) the investment of plan assets. When these fees are paid from plan assets, the amount available under the plan for retirement benefits is reduced. For example, in the case of a section 401(k) plan where fees are paid by plan assets, each participant's account balance in the plan is reduced by the participant's allocable portion of the fees paid by the plan.

Fees related to plan administration include fees charged by attorneys and consultants for plan design (e.g., the expenses associated with the initial establishment of the plan or plan amendments required to be adopted by a plan on account of changes in qualification requirements of the Code or other laws), compliance with periodic reporting requirements, and participant communications (e.g., periodic benefits statements, summary plan descriptions, websites, and telephone service assistance). In general, these types of fees may be paid by the sponsoring employer or may be paid from plan assets.

Fees related to specific services requested by plan participants include fees charged in connection with loans to participants against the participants' interests in the plan, or the review of a court order to divide a participant's interest in the plan pursuant to a divorce decree. For a defined contribution plan, such fees are often charged against the participant's account balance.

Fees related to plan investments are typically paid from plan assets. Such fees include any of the expenses associated with buying and selling investment assets, such as broker commissions, appraisal fees, attorneys' fees, and investment management fees. The following is a description of the fees typically charged in connection with common investment alternatives offered under participant-directed plans,[21] such as section 401(k) plans:

- Mutual funds: The manager of the mutual fund typically charges a management fee with respect to the assets of the fund and which are paid out of the assets of the fund. In addition, some mutual funds provide for a sales charge which respect to each investment in the fund and is either paid upon initial investment (a "front-end load") or upon sale of the investment (a "back-end load", "deferred sales charge", or "redemption fee"). Some funds charge "rule 12b-1" fees, [22] which are fees paid from

[21] See A Look at 401(k) Plan Fees, U.S. Department of Labor, Employee Benefits Security Administration. Available on the web at www.dol.gov/ebsa/publications/401k_employee.html.

[22] Rule 12b-1 fees take their name from the Securities and Exchange Commission rule that permits a fund (such as a mutual fund) to pay such fees. Generally, the rule permits a fund to pay distribution fees out of a fund's assets only if the fund has adopted a plan permitting the payment of such fees. Distribution fees include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares, and paying for advertising, and the printing and mailing of sales literature. See "Answers with respect to Mutual Fund Fees and Expenses," Securities and Exchange Commission, available on the web at www.sec.gov/answers/mffees.htm.

the assets of a particular fund to cover broker commissions or promotional expenses. If a participant's account balance is invested in a fund that pays rule 12b-1 fees, then such fees effectively reduce the participant's account balance. In some cases, the rule 12b-1 fees are used to pay for administrative costs associated with the plan.

- Variable annuities: An insurance company and an employer sponsoring a qualified retirement plan may enter into a group variable annuity contract, under which the insurance company offers investment options that may be chosen by plan participants, such as mutual funds. The group variable annuity contract is often described as "wrapping" around the investment options available under the contract. Some of the options may contain an insurance component which might include special fees. In addition, the variable annuity contract is subject to surrender and transfer charges if the employer terminates the group contract. Sometimes the amount of the surrender charge decreases over a specified time period, such that there is no charge (or a reduced amount) after the expiration of the time period.
- Collective investment funds and pooled guaranteed investment contract (GIC) funds: Collective investment funds are comprised of the pooled assets of various investors (e.g., two or more qualified plans participate in the fund) and are managed by a bank or trust company. A pooled GIC fund is issued by an insurance company or bank. A GIC is an insurance product that offers a specified rate of return over the life of the contract. A pooled GIC fund is a common method of providing a fixed income investment alternative to plan participants. Collective investment funds and pooled GIC funds involve management and administrative fee charges.

In general, the fees described above are negotiated by the employer that sponsors the plan. However, in some cases, the fees may not be subject to negotiation (e.g., front-end and back-end loads charged in connection with mutual funds). In addition, the total amount of fees paid and the distinction between the type of fees being paid may not be readily apparent to either the plan sponsor or participants. For example, as described above, it is possible that investment fees charged to plan assets and classified as investment fees may be used to pay for plan administration services, such that there is no separately stated fee (or a reduced fee). This particular practice is the subject of recent litigation. The issue in most cases is whether the practice complies with the fiduciary requirements that apply to retirement plans.[23]

[23] See James P. Baker, "How Much Is Too Much? A Primer on the 401(k) 'Feegate' Litigation," *Benefits Law Journal*, Summer 2007.

C. Impact of Fees on Retirement Savings

The amount of fees charged against plan assets has a significant impact on the amount of plan assets that are available for retirement benefits. The following table illustrates the impact of fees on a hypothetical participant in a section 401(k) plan who elects to contribute $5,000 annually to the plan for each of 20 years, beginning on January 1, 2007. The table illustrates the growth of the contributions over 20 years under a variety of earnings and fees assumptions. The fee assumptions generally represent the range of fees currently charged with respect to qualified retirement plans (this economic data is discussed in the following section). The first panel of the table assumes an average before-fee rate of return of 6 percent; the second panel assumes an average before-fee rate of return of 8 percent; and the third panel assumes an average before-fee rate of return of 10 percent.

In panel one, which assumes an average before-fee rate of return of 6 percent, if there were no fees incurred with respect to the annual $5,000 contributions or the earnings thereon, the account would grow to $194,964 in 20 years. In the case of a fee that reduces the rate of return by 0.25 percent per year, the account value after 20 years is reduced by $5,607 (a 2.96 percent reduction). If the reduction in the rate of return is 2.0 percent per year, the account value is reduced by $40,118 (a 25.91 percent reduction). For the average reduction in the rate of return in a recent survey of plans (0.75 percent),[24] the final account value is reduced by $16,285, or slightly over 9 percent.

In panel two, which assumes an average before-fee rate of return of 8 percent, if there were no fees incurred with respect to the annual contributions or the earnings thereon, the account would grow to $247,115 in 20 years. In the case of a fee that reduces the rate of return by 0.25 percent per year, the account value after 20 years is reduced by $7,294 (a 3.04 percent reduction). If the reduction in the rate of return is 2.0 percent per year, the account value is reduced by $52,151 (a 26.75 percent reduction). For the average reduction in rate of return of 0.75 percent per year, the account value is reduced by $21,181, or 9.37 percent.

Panel three assumes an average before-fee return of 10 percent. If there were no fees incurred with respect to the annual contributions or the earnings thereon, the account would grow to $315,012 in 20 years. In the case of a fee that reduces the rate of return by 0.25 percent per year, this amount is reduced by $9,501 (a 3.11 percent reduction). If the reduction in the rate of return is 2.0 percent per year, the amount is reduced by $67,898 (a 27.48 percent reduction). For the average reduction in rate of return of 0.75 percent per year, the account value is reduced by $27,586, or 9.60 percent.

As set forth above, a fee structure is more costly to participant account balances as rates of return increase. The same percentage point reduction in the rate of return leads to a greater loss in account value, both in absolute dollars and in percentages, as the gross rate of return increases. This is attributable to the amount used to pay the fees and the loss of earnings at the higher rate of return on such amounts.

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[24] Deloitte Consulting, LLP, supra.

Impact of Fees on Retirement Savings							
Annual gross rate of return: 6 percent							
Fees as a reduction in the annual rate of return	0.00%	0.25%	0.50%	0.75%	1.00%	1.50%	2.00%
Annual net-of-fee rate of return	6.00%	5.75%	5.50%	5.25%	5.00%	4.50%	4.00%
Annual contribution	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000
Number of years of contributions until retirement	20	20	20	20	20	20	20
Final account value at retirement	$194,964	$189,357	$183,930	$178,679	$173,596	$163,916	$154,846
Reduction in final account value due to fees	$0	$5,607	$11,033	$16,285	$21,367	$31,048	$40,118
Percentage reduction in final account value due to fees	0.00%	2.96%	6.00%	9.11%	12.31%	18.94%	25.91%
Annual gross rate of return: 8 percent							
Fees as a reduction in the annual rate of return	0.00%	0.25%	0.50%	0.75%	1.00%	1.50%	2.00%
Annual net-of-fee rate of return	8.00%	7.75%	7.50%	7.25%	7.00%	6.50%	6.00%
Annual contribution	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000
Number of years of contributions until retirement	20	20	20	20	20	20	20
Final account value at retirement	$247,115	$239,820	$232,763	$225,934	$219,326	$206,745	$194,964
Reduction in final account value due to fees	$0	$7,294	$14,352	$21,181	$27,789	$40,370	$52,151
Percentage reduction in final account value due to fees	0.00%	3.04%	6.17%	9.37%	12.67%	19.53%	26.75%
Annual gross rate of return: 10 percent							
Fees as a reduction in the annual rate of return	0.00%	0.25%	0.50%	0.75%	1.00%	1.50%	2.00%
Annual net-of-fee rate of return	10.00%	9.75%	9.50%	9.25%	9.00%	8.50%	8.00%
Annual contribution	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000
Number of years of contributions until retirement	20	20	20	20	20	20	20
Final account value at retirement	$315,012	$305,511	$296,319	$287,426	$278,823	$262,445	$247,115
Reduction in final account value due to fees	$0	$9,501	$18,693	$27,586	$36,190	$52,567	$67,898
Percentage reduction in final account value due to fees	0.00%	3.11%	6.31%	9.60%	12.98%	20.03%	27.48%

III. MAGNITUDE OF FEES AND SOURCES OF VARIANCE

As previously discussed, various components of fees contribute to the overall costs of retirement plans. Several studies have been conducted on the amount of retirement plan fees paid by retirement plans. A recent benchmarking survey of 830 section 401(k) plan sponsors revealed an average expense ratio of 75 basis points (bps) (or 0.75 percent) for fund assets.[25] The expense ratio represents total expenses as a fraction of total plan assets. Thus, 75 bps is equivalent to 0.75 percent of plan assets (or $7.50 for every $1,000 of assets invested). Plan fees can vary dramatically across certain plans. Larger companies and larger plans tend to have smaller expense ratios in part because certain fixed charges can be spread over more participants and more plan assets. Expense ratios may also vary because some employers may choose to subsidize certain fees that plan participants would otherwise pay.[26] Some plans may have higher fees because they offer additional services, such as financial planning, which may be bundled with the typical investment management and recordkeeping functions. Individual participant accounts with high investment turnover may also have higher expenses (e.g., the participant frequently redirects the investment composition of the participant's account balance), leading some plans to charge additional fees on frequent traders in an effort to reduce costs on other participants.

According to another survey of defined contribution plans in 2005,[27] total expense ratios ranged from 6 bps (or 0.06 percent) to 154 bps (or 1.54 percent). Key factors that contribute to this variation in plan costs include overall plan size, individual account size, and asset composition. Under this survey, large plans benefited from economies of scale, and plans with more than $10 billion in assets had costs less than half that of those plans with less than $500 million in assets (28 bps (or 0.28 percent) versus 71 bps (or 0.71 percent)). For a given overall plan size, a plan with fewer, but larger individual accounts may have lower expenses than a plan with many, but smaller accounts, in part due to lower administrative and recordkeeping costs since there are less participants in the plan and the spread of such costs over larger account balance and aggregate plan asset amounts. For accounts with an average balance below $55,000, costs are 4 bps (or 0.04 percent) higher than for accounts over $55,000 (19 bps (or 0.19 percent) versus 15 bps (or 0.15 percent) that the latter incurs).

The mix of investment assets impacts overall plan costs as some investment options or classes of assets are more costly to manage than others. Guaranteed investment contracts (GICs), insurance products that offer a specified rate of return over the life of the contract, are

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[25] Deloitte Consulting, LLP, supra.

[26] Investment Company Institute, The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2006, Research Fundamentals, 16:4, September 2007. Available at http://www.ici.org/home/fm-v16n4.pdf.

[27] Hubert Lum, *Why Do Plan Costs Vary?* CEM Benchmarking, Inc., Defined Contribution Insights, March/April 2007. Available at http://www.cembenchmarking.com/research/Articles/WhyDoPlanCostsVary.pdf.

among the least expensive of assets to manage at 26 bps (or 0.26 percent) average total cost. Increasing in costs are broad-based bond portfolios (46 bps or 0.46 percent), domestic large capitalization stocks (57 bps or 0.57 percent) and domestic small capitalization stocks (74 bps or 0.74 percent). The most expensive asset class to manage is the class of alternative investments (106 bps or 1.06 percent), which includes real estate, private equity, and hedge funds. Within each class, costs can vary based on the vehicle which provides the participant access to that investment. For example, a retail large capitalization stock mutual fund may have a higher cost than institutional class shares of the same large capitalization stock mutual fund. On average, the cost difference between retail and institutional class shares of mutual funds is 11 bps (or 0.11 percent). Also, within asset classes, the level of active versus passive management can influence costs. A manager who actively trades stock in an effort to beat a market index may incur greater costs than a passive manager trying to replicate the return of that same market index. Based on 2005 data, this cost differential is 34 bps (0.34 percent) for a plan with all of its assets actively managed versus a similar plan with all of its assets passively managed.

IV. PRESENT LAW

A. Rules Relating to Retirement Plan Fees

The Code generally does not include rules that restrict the amount of fees that can be paid by a retirement plan or require the disclosure of fees incurred by these plans. The exception to this rule is the prohibited transaction rules, which restrict transactions involving the assets of certain retirement plans and related parties (referred to as "disqualified persons"), such as service providers to a plan.

Other non-tax rules may apply to limit the amount of fees that may be charged to these plans or require disclosure of such fees to plan sponsors and participants. For example, Federal and State laws that govern banking rules, State law insurance rules, Federal and State securities rules, and licensing rules applicable to professionals (such as attorneys and investment brokers or agents) may apply to certain plan service providers, depending on the services or investment alternatives offered. The Employee Retirement Income Security Act of 1974 ("ERISA") contains rules that govern the fees that can be charged with respect to retirement plans.[28]

For example, under ERISA, fiduciaries of a retirement plan are required to discharge their duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to participants and defraying the "reasonable expenses of administering the plan."[29] Thus, ERISA expressly permits the payment of reasonable fees in connection with plan administration, but requires that the fees be reasonable.

ERISA also contains rules that require the disclosure of plan fees to plan participants. For example, ERISA requires the administrator of a defined contribution plan to provide participants with an annual summary of certain information relating to the plan (referred to as the "summary annual report").[30] Under regulations issued by the Department of Labor, the summary annual report must include the disclosure of the aggregate amount of administrative expenses paid by a plan for the year.[31] The administrators of both defined contribution and defined benefit retirement plans must periodically provide summary plan descriptions to plan participants

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[28] Not all qualified retirement plans are subject to the fiduciary and disclosure rules of ERISA. For example, governmental retirement plans are exempt. ERISA sec. 4(b)(1).

[29] ERISA sec. 404(a)(1)(A). Certain qualification rules under the Code provide for a somewhat similar rule as the ERISA rule in that the trust holding the plan's assets must be established for the exclusive purpose of providing plan benefits. See, for example, sec. 401(a). The Code-based rules do not expressly describe the payment of fees, although the payment of reasonable expenses and fees paid with plan assets for the administration of the plan is not a violation of the Code-based rules. It is possible, in certain circumstances, that the payment of an unreasonable fee might violate the exclusive benefit rule.

[30] ERISA sec. 104(b)(3).

[31] 29 CFR sec. 2520.104b-10(d)(3).

(referred to as "SPDs"). SPDs are required to provide a description of any fees the payment of which is a condition for the receipt of plan benefits.[32]

In addition, participants in certain defined contribution plans may receive information regarding fees charged in connection with the investment of plan assets. This results because ERISA provides relief from certain fiduciary requirements in the case of a plan that provides for participant-directed investment of plan assets, provided certain requirements specified by the Secretary of Labor are satisfied.[33] Among these requirements are the following disclosures with respect to investment fees: (1) disclosure of any transaction fees and expenses which affect the participant's account balance in connection with purchases or sales of interests in the investment alternatives available under the plan, and (2) a description of the annual operating expenses of each designated investment alternative (e.g., investment management fees, administrative fees, transaction costs) which reduce the rate of return to plan participants and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative.[34]

ERISA is generally administered by the Department of Labor ("DOL"). The DOL is currently considering the issuance of additional guidance with respect to retirement plan fees. For example, the DOL has proposed changes to the annual report required to be filed by retirement plans (on Form 5500) with respect to fee reporting.[35] In addition, the DOL has announced that it is reviewing the rules under ERISA applicable to the disclosure of plan administration and investment fees to participants in participant-directed defined contribution retirement plans. The DOL has requested comments from interested parties.[36] The purpose of the review is to determine to what extent rules should be adopted or modified (or what other actions should be taken) to ensure that participants have the information necessary to make informed decisions with respect to investment of their retirement savings. The comment period closed July 24, 2007.

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[32] 29 CFR sec. 2520.102-3(l).

[33] ERISA sec. 404(c).

[34] 29 CFR sec. 2550.404c-1(b)(2)(i)(B)(1)(v) and -1(b)(2)(i)(B)(2)(i).

[35] 71 *Fed. Reg.* 41,392 (July 21, 2006).

[36] 72 *Fed. Reg.* 20,457 (April 25, 2007).

B. Prohibited Transaction Rules

1. In general

The Code's prohibited transaction rules preclude a "disqualified person" from entering into a "prohibited transaction" with respect to a plan that is subject to the Code's prohibited transaction rules.[37] A disqualified person includes a service provider for a plan, a fiduciary of a plan, and certain persons and entities that are related to service providers and fiduciaries.[38] A fiduciary of a plan is a person who (1) exercises any discretionary authority or control with respect to the management of the plan or the management or disposition of plan assets, (2) renders investment advice for a fee, direct or indirect, with respect to property of the plan or has authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.[39] Tax-qualified plans (i.e., plans that meet the requirements of section 401(a)) and section 403(a) employee retirement annuities are subject to the Code's prohibited transaction rules.[40]

The following types of transactions, whether direct or indirect, constitute prohibited transactions for purposes of the Code:

- Any sale, exchange, or leasing of any property between a plan and a disqualified person;

- Lending of money or extending credit by a plan to a disqualified person;

- Furnishing goods, services, or facilities by a plan to a disqualified person or by a disqualified person to a plan; and

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[37] Sec. 4975. Plans sponsored by certain types of employers, such as a governmental plan, are not subject to the Code's prohibited transaction rules. See sec. 4975(g). ERISA contains prohibited transaction rules that are generally parallel to the rules provided in the Code. See ERISA secs. 406 and 408.

[38] Sec. 4975(e)(2).

[39] Sec. 4975(e)(3).

[40] Sec. 4975(e)(1). A tax-qualified retirement plan and a section 403(a) employee retirement annuity may also be subject to ERISA's prohibited transaction rules. In addition, the ERISA rules may apply to plans that are not subject to the Code's prohibited transaction rules. For example, a section 403(b) tax-deferred annuity plan is not subject to the Code's prohibited transaction rules, but may be subject to ERISA's prohibited transaction rules. If a plan is subject to both the Code and ERISA prohibited transaction rules, the civil penalty specified in ERISA in the case of a violation of the rules is reduced by the amount of the excise taxes prescribed by the Code for such violation. ERISA sec. 502(l)(4).

- Any transfer to, or use by or for the benefit of, a disqualified person, of any assets of a plan.[41]

In addition to the foregoing prohibited transactions, the Code's prohibited transaction rules also limit the following transactions involving a plan fiduciary:

- Any act whereby the fiduciary deals with the income or assets of a plan in the fiduciary's own interest or for the fiduciary's own account; and

- Receipt of any consideration by the fiduciary for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.[42]

A two-tier tax is imposed under the Code on the disqualified person if a prohibited transaction occurs.[43] The initial tax applies during the correction period and is equal to 15 percent of the amount involved with respect to the prohibited transaction for each year or partial year in the "taxable period." The taxable period begins on the date that the prohibited transaction occurs and generally ends on the earlier of (1) the date the transaction is corrected or (2) the date notice of a deficiency with respect to the initial tax is mailed (or, if earlier, the date of assessment of such tax). If the prohibited transaction is not corrected within the taxable period, a second tax applies equal to 100 percent of the amount involved. Both taxes are paid by the disqualified person.

2. Exemptions

The Code provides for statutory exceptions from the prohibited transaction rules.[44] In addition, the Secretary of the Treasury and the Secretary of Labor are delegated authority to establish an exemption procedure for disqualified persons, or an exemption for transactions, if the exemption is (1) administratively feasible, (2) in the interests of the plan, its participants and beneficiaries, and (3) protective of the rights of participants and beneficiaries of the plan.[45] These administrative exceptions take two forms: class exemptions, which are applicable to a class of disqualified persons or a class of transactions that meet the requirements specified in the terms of the class exemption; and individual exemptions, which are applicable solely to the transaction or disqualified person for which the exemption is issued. Administrative exemptions are subject to notice and comment (by publication of a proposed exemption in the *Federal Register*) prior to being granted.

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[41] Sec. 4975(c)(1)(A) through (D).

[42] Sec. 4975(c)(1)(E) and (F).

[43] Sec. 4975(a) and (b).

[44] Sec. 4975(d).

[45] Sec. 4975(c)(2).

Several exceptions to the prohibited transaction rules involve the provision of administrative or investment services by a disqualified person and are conditioned on the amount of fee that is charged by the service provider. For example:

- A plan is permitted to contract or make reasonable arrangements with a disqualified person for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid.[46] Treasury regulations also provide that this exception applies to any service that is appropriate and helpful to the plan in carrying out the purposes for which the plan is established or maintained.[47] This exception does not apply to the prohibitions against fiduciary conflicts of interest (i.e., a fiduciary that deals with plan assets in his own interest or who receives consideration for his own personal account in connection with a plan transaction);[48]

- A bank (or other similar institution that is supervised by the United States or a State) may provide ancillary services to a plan subject to certain conditions, which include guidelines that prevent the bank from providing the services in an excessive or unreasonable manner and in a way inconsistent with the best interests of the plan's participants and beneficiaries. In addition, the plan must pay no more than reasonable compensation for the ancillary services;[49] and

- A plan fiduciary who is also an investment adviser to an open-end investment company is permitted to purchase or sell shares in the investment company on behalf of the plan if the plan does not pay a commission or an investment management fee with respect to the plan assets invested.[50]

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[46] Sec. 4975(d)(2).

[47] Treas. Reg. sec. 54.4975-6(a)(2).

[48] Treas. Reg. sec. 54.4975-6(a)(1). The prohibited transaction rules of ERISA specify that a plan fiduciary may receive reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his or her services for the plan. ERISA sec. 408(c)(2).

[49] Sec. 4975(d)(6).

[50] PTE 77-4, 42 Fed. Reg. 18732 (April 8, 1977).

V. ISSUES AND ANALYSIS

The amount of fees that are charged against qualified retirement plan assets has a significant impact on the amount of retirement benefits that can be provided by remaining plan assets. In the case of a defined contribution plan, the amount of fees charged directly reduces the amount that is available to a participant at retirement. The impact of fees on retirement savings and the degree to which plan sponsors and plan participants understand the fees being charged are topics of recent interest.[51]

Some question whether the regulation of fees charged with respect to retirement plans is an appropriate issue for regulation under the Code. Such commentators note that, in general, fiduciary and disclosure issues with respect to retirement plans are addressed by the non-tax provisions of ERISA. Others respond that Code-based regulation is appropriate given the significant tax expenditure associated with qualified retirement plans. Such individuals observe that the amount of the subsidy for qualified retirement plans is limited and thus Code-based regulation is appropriate because maximization of the subsidy is at issue. Some note that the existing prohibited transaction rules are largely duplicated in the tax and non-tax provisions of ERISA, and thus a form of Code-based fee regulation already exists.

A second issue that arises is over the type of fees that should be regulated and the scope of the regulation. Some assert that there is less need for regulation of administrative type fees and more need for regulation of fees relating to investment services. Such proponents argue that administrative fees are often more easily understood by plan sponsors and are more clearly disclosed by plan service providers. Others assert that all types of plan fees should be subject to more stringent regulation because it may be difficult to determine the amount of fees that relate to administrative services and those that relate to investment services. For example, in the case of a bundled services or fee arrangement, certain investment fees may be used to pay for plan administration expenses. Such individuals point to recently filed lawsuits that assert that such bundled arrangements violate ERISA's fiduciary rules.[52]

A third set of issues arises as to whether additional regulation should be limited to special disclosure rules with respect to fees, or whether there should be additional regulation as to the amount of fees that are charged. With respect to disclosure, some advocate for uniform fee disclosure rules that allow plan sponsors and participants to easily compare information regarding various types of fees on the basis of uniform disclosure rules applicable to plan service providers or plan investment alternatives. Others are concerned that such rules will result in significant increases in plan administration costs or may overwhelm participants with too much information focused on one of the many factors relevant in selecting an investment alternative. With respect to limits on the amount of fees, some argue that plans should be required to offer participants one or more low-fee investment alternatives.

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[51] See, for example, Murray Coleman, "Battle Lines Drawn on 401(k) Fee Reports, " *Wall Street Journal*, October 4, 2007.

[52] Baker, supra.

A fourth set of issues arises as to who should be the beneficiary of fee regulation and what types of plans should be subject to regulation. Some believe that only defined contribution plans should be subject to additional rules, while others believe that additional regulation should only apply to defined contribution plans in which the investments are directed by plan participants. Others assert that protections with respect to plan fees are necessary at the plan sponsor level,[53] and that protections should be extended to defined benefit plans. Such persons observe that plan sponsors do not necessarily have the expertise that enables them to understand the fee structure involved. Such persons also note that, in the case of participant-directed defined contribution plans, the plan sponsor typically chooses a limited menu of investment options that are available to participants and thus should benefit from the same protections available to plan participants. Some assert that sponsor-level protection is only appropriate in the case of small employers. Others counter that a sponsor's size is not necessarily indicative of expertise with respect to plan administration and investment matters.

Concern has also been expressed on the amount of emphasis that should be placed on qualified retirement plan fees. Such persons observe that the extent and quality of services provided are often proportional to the amount of fees charged. Such persons caution that the amount of fees charged are just one component in evaluating the quality and level of services that are provided.

[53] See, for example, Gregory W. Kasten, "High Transaction Costs from Portfolio Turnover Negatively Affect 401(k) Participants and Increase Plan Sponsor Fiduciary Liability," *Journal of Pension Benefits*, Spring, 2007.