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United States House of Representatives*

*Hearing on "H.R. 3185, the 401(k) Fair Disclosure for Retirement
Security Act of 2007"*

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Chairman Miller, Ranking Member McKeon and distinguished members of the Committee, my name is Jon C. Chambers and I am a principal in the San Francisco, California investment consulting firm of Schultz Collins Lawson Chambers, Inc. Since 1995, our firm has provided a broad range of investment consulting services to defined contribution plan sponsors. My client base is primarily comprised of 401(k) plans. I consult to plans sponsored by approximately 30 employers on a recurring basis, and also serve other clients on a one-time project basis. My clients include a mixture of publicly traded and privately held companies, as well as not-for-profit organizations and governmental entities. Prior to joining Schultz Collins Lawson Chambers, Inc., I spent ten years as a retirement plan consultant with the accounting firm Coopers & Lybrand.

As an investment consultant to defined contribution plans, I focus a significant portion of my practice on helping plan sponsors and other fiduciaries to quantify and understand the fees incurred in relation to their plans. For our recurring clients, we typically review fee structures at least once a year. Additionally, we are regularly engaged to manage a more formal Request for Proposal (RFP) process intended to help plan fiduciaries select a new plan provider, or to validate the retention of an existing provider. We generally manage between two and six RFP projects each year, although with the recent heightened attention on 401(k) fees, we have been seeing an increased demand for our RFP services. Since we examine 401(k) fees for a broad cross-section of plans, we are well positioned to see a variety of fee arrangements.

I am actively involved in the retirement plan consulting community. I am a member of the Profit Sharing/401(k) Council of America (PSCA), the American Society of Pension Professionals & Actuaries (ASPPA) and a member and past president of the San Francisco Chapter of the Western Pension & Benefits Conference (WP&BC). However, it's important to note that my testimony today is my own, and is not intended to reflect the views of any of these organizations. Over the past year, I've spoken on 401(k) fees at conferences sponsored by WP&BC and ASPPA. During this period, I have met with officials from the Securities and Exchange Commission (SEC), the Government

Accountability Office (GAO) and the Department of Labor's Employee Benefit Security Administration (EBSA) to discuss the issue of improving disclosure of 401(k) fees.

I very much appreciate the opportunity to present my views on 401(k) fee disclosure to this Committee. The issues being discussed are challenging and technical, yet a reasonably successful resolution of the problem would go a long way towards improving the retirement security of millions of Americans. I commend Chairman Miller and this Committee for tackling such an important topic.

Background on the 401(k) Fee Issue

401(k) fees have been a predominant discussion topic in the retirement plan consulting community over the past five years. There are several reasons why 401(k) fees have recently become a critical issue:

- The 2000-2002 stock market plunge reminded 401(k) plan participants that investment returns could be negative, and that fund expenses compound losses. While participants arguably should have been equally sensitive to fund expenses during the bull market of the late 1990s, participants seeing losses in their 401(k) accounts focus greater attention on fees.
- With many companies freezing or terminating their defined benefit plans, 401(k) plans are transitioning from being a supplemental savings vehicle to the primary retirement plan for many Americans.
- Outreach by the Department of Labor has encouraged both plan sponsors and participants to pay greater attention to 401(k) fees.
- Numerous stories in the popular media, including such diverse venues as PBS' Frontline, the *Los Angeles Times*, and *Money* magazine have highlighted 401(k) fee issues, with particular attention focused on egregious examples of excessive fees.
- Litigation (seeking class action status) has been filed against many of the largest companies in America, claiming that 401(k) fees were excessive and not properly disclosed.
- Congressional activities, including hearings held by this Committee, have focused national attention on the 401(k) fee issue.
- Following up on results from hearings and an independent study also published in 1997, as well as on recommendations published in 2004 by the ERISA Advisory Council's Working Group on Plan Fees and Reporting on Form 5500, the Department of Labor has announced a series of regulatory initiatives to improve disclosure of 401(k) fees.

Despite all this attention, the way that most 401(k) service providers charge for fees hasn't changed much over the past decade. As this Committee heard in March, more than 90% of 401(k) fees are investment based. Generally, investment based fees are paid by plan participants, and are not typically disclosed to participants, at least not, in my view, in a clear and obvious manner. While speakers at the March 6 hearings disagreed about

whether the aggregate level of 401(k) fees was excessive, there was general consensus that at least some fee arrangements are excessive, and that more rigorous and comprehensive disclosure standards are necessary. The debate is not about whether more disclosure is desirable, but rather, it is about what type of disclosure should be made, to whom, in what form, and who should bear the cost of that disclosure. Much of the debate centers around whether new disclosure requirements should be imposed by statute or by regulation.

Statutory Changes are Necessary to Resolve the 401(k) Fee Disclosure Problem

I personally believe that we need a material change in the statutory framework governing how 401(k) plans must disclose fees. To understand why this is so requires a brief review of the legislative history of ERISA, and the development of the modern 401(k) plan. ERISA—the Employee Retirement Income Security Act of 1974—was enacted when defined benefit plans were the nation’s predominant retirement plan. The tax code changes permitting 401(k) plans were not enacted until 1978, and 401(k)s weren’t broadly adopted and did not enter the mainstream vernacular until the 1980s. ERISA could not have contemplated disclosure rules for 401(k)s because 401(k)s did not exist when ERISA was enacted.

One question that can be asked is if ERISA sets general standards for retirement plans, why should the rules that apply to 401(k)s be any different? There were certainly defined contribution plans operating in the 1970s. Why can’t the general ERISA disclosure rules be sufficient for 401(k)s? The answer to this question turns on the unique environment in which the modern 401(k) operates. Today, most 401(k) plans are:

- Participant directed (which means that participants choose their own investment approach from a menu of funds selected, directly or indirectly, by their employer);
- Invested (either directly or indirectly) in mutual funds;
- Valued daily, with daily trading; and
- Administered by financial services firms.

While the typical 401(k) plan’s daily valued, participant directed structure provides significant investment flexibility for participants, it also introduces numerous administrative costs. Participants must be educated about the funds on the menu, and how to make rational asset allocation decisions. Call centers and Web sites must be established and maintained to provide participants with information about their accounts, and to permit participants to initiate daily trades. Accounts must be balanced and reconciled daily. And of course, since 401(k) plans operate through payroll deduction, the process of converting salary deferrals into fund purchases on each and every pay date makes 401(k) administration transactionally intensive.

Cost Sharing Arrangements and Employer Conflicts of Interest

Fees for 401(k) plans are generally shared between participants and the employer, with the participants paying investment costs, and the employer paying for the costs of plan administration, to the extent that revenue sharing payments from the plan's investments are not available to offset administrative costs. Various surveys indicate that, on average, more than 90% of 401(k) fees are investment related.

As I mentioned earlier, we manage the RFP process for many 401(k) plans. In our experience, when a mid-sized or larger plan (typically, at least \$10 million in total plan assets), with average participant account balances of at least \$50,000, sends out an RFP, the most typically quoted price for administrative and compliance services necessary to run the plan is "zero." Of course, the true cost of providing these services is not zero. Investment expenses may have been increased to generate additional revenues, which are then used to cover the costs of the administrative services. But an unsophisticated employer conducting an RFP for 401(k) services that sees a zero fee quote for the administrative component from the majority of the respondents very quickly concludes that zero is the right price for these services. Most employers don't worry too much about *why* the explicit fee is zero. They don't realize that their employees must be implicitly paying for plan administration through higher than necessary investment fees. They don't know to ask whether the increased investment fees are more costly to participants than would be the case if the investment and administrative services were engaged separately. They usually choose one of the zero cost fee providers, and move forward.

Unlike the modern employer offering a 401(k) as its primary retirement plan, defined benefit plan sponsors have always had a vested interest in minimizing investment expenses incurred by their plans. Since a defined benefit plan's funding requirements are at least partially determined by the plan's net investment returns, cutting investment expenses has the direct effect of reducing required contributions from the plan sponsor. When ERISA was drafted, employers were presumed to have the same objective as employees—to minimize investment fees, to the extent practical. But under a modern 401(k) plan, an employer has an understandable incentive to select funds with investment fees that are high enough that the employer incurs no administrative costs. Worse yet for the plan participants, under existing ERISA rules, there is no requirement that they receive any disclosure about fees that may be applied to their account. And finally, unless the employer is savvy enough to press the proposing vendor about fee transfers and revenue sharing arrangements, there is no current requirement for fee disclosure from the plan provider to the employer. A federal district court ruling dismissing all claims in one of the recently filed 401(k) excessive fee lawsuits highlighted this point. In support of his decision to dismiss the case, Judge John C. Shabaz notes:

A review of the report [the ERISA Advisory Counsel Report of the Working Group on Plan Fees and Reporting on Form 5500] confirms that the revenue sharing issue raised by plaintiffs' complaint is a matter of policy concern within the Department of Labor. It also unequivocally confirms that present regulations

do not require disclosure of the information. See particularly the report's Recommendations for Regulatory Change at p. 8. Whether, as a policy matter, additional reporting of revenue sharing arrangements should be required, it is not presently required and failure to include such information does not violate existing ERISA standards for disclosure. Accordingly, defendants' failure to so disclose is not a violation of the present statute of [sic] regulations and does not state a claim for breach of the duty of disclosure. (emphasis added)
Hecker v. Deere & Co., No. 06-C-719-S (W.D.Wis. June 21, 2007)

In my experience, employers aren't actively pushing for a transfer of plan costs from employer to employee, they are simply reacting rationally to how the financial services industry presents plan fees today. Most employers with whom we work seek to pay a fair fee for plan services, without causing their employees to pay excessive fees. But when employers are presented with a range of proposals for 401(k) services, all of which provide for zero explicit fees, they presume that zero fees are standard practice for the industry, without understanding the impact of implicit, fund based fees on their employees. One of the key benefits of H.R. 3185 is that employers would be able to make informed decisions about how plan administrative costs would be shared between plan participants and the employer. Employers that choose to pass through all plan costs to participants would still be permitted to do so, either through implicit revenue sharing payments, or through explicit allocation of hard dollar costs (provided, of course, that such plan costs could properly be charged to the plan under ERISA).

Under current law, employers face potential liability if they do not satisfy their fiduciary duty to ensure that 401(k) plan fees are reasonable. This potential liability has recently been made manifest in very real litigation. However, in many cases, employers lack the information necessary to prudently evaluate fee structures. Furthermore, financial firms regularly price their 401(k) services in a manner that causes employers to focus less on fees paid by participants and more on fees paid (or avoided) by the employer. Larger employers have the financial resources and perspective necessary to engage consulting firms such as ours to help them make reasonable and prudent fiduciary decisions. While I believe that employers should continue to play a fiduciary oversight role with respect to their retirement programs, I also believe that we need a statutory solution that requires that financial firms provide employers with sufficient disclosures and other information so that the employers are able to make an informed decision before selecting a 401(k) provider. I also believe that participant disclosures should be enhanced, such that participants better understand the true cost of investing through a 401(k) plan. With better informed employers, and better informed 401(k) participants, over time, competitive market pressures will reduce the cost of 401(k) investing, thereby improving retirement security for all Americans.

Stories From the Trenches: Real World Examples of How Fiduciaries Currently Evaluate 401(k) Fees and Revenue Sharing Arrangements

I'd like to share a few examples about revenue sharing, and how it can be used positively or negatively, and how even the largest employers frequently misunderstand it.

Large Plan Uses Information About Revenue Sharing to Reduce Participant Costs

Recently we were engaged by a large 401(k) plan sponsor to help with investment issues relating to a fund mapping. This particular plan sponsor did not work with an investment consultant on a regular basis. Fiduciary investment reviews for this plan were conducted by the financial firm serving as the plan recordkeeper, in conjunction with the sponsor's own treasury staff. Since treasury staff also managed investment manager reviews for the company's defined benefit pension plan, they felt that they did not need an independent review of their 401(k) plan. In fact, this company would not have engaged an independent investment consultant had it not been for the need to do a mapping study. The company's contract with the financial firm serving as the plan recordkeeper provided for no explicit fee payments—recordkeeping and compliance services were covered by profit margins on the financial firm's proprietary funds, as well as revenue sharing payments from non-proprietary funds that were offered through the plan. The plan sponsor presumed that the plan fees must be reasonable, because the expense ratio on each fund offered through the plan, when considered in isolation, seemed reasonable.

As a tangential element of the mapping project for which we were engaged, we were able to demonstrate to this company that the total explicit and implicit revenue sharing used to support plan administration generated more revenue than the approximate “market rate” for the recordkeeping and compliance functions provided by the financial firm. Based on the information we presented, the company negotiated share class transitions that saved participants more than \$1 million per year. We considered this a huge success. But the main point that I want to emphasize to this Committee is that, in this particular fact pattern, we were able to improve the 401(k) fee structure for a large group of plan participants that already benefited from low cost investment options, and from relatively sophisticated fiduciary oversight. This large employer simply did not understand revenue sharing arrangements well enough to negotiate further improvements without getting information from an independent investment consultant. Better disclosure of 401(k) fees could help many plans whose assets measure in the millions (or even in the hundreds of thousands), and not in the billions, to negotiate more favorable arrangements for their participants. Most of these smaller plans simply cannot afford to engage independent consultants to review their fee arrangements.

Smaller Plan Refuses Zero Fee Arrangement

I understand that certain commentators argue that the “unbundling” of fee arrangements proposed under H.R. 3185 is unnecessary, and could potentially lead to *increased* costs if plan service providers are forced to calculate what portion of an aggregate fee applies to specific service elements. These commentators argue that any new requirement should only require the disclosure of aggregate plan level fees. Additionally, some commentators argue that bundled providers are not able to determine how costs break down between investment and administrative services, so they cannot provide this information.

When we manage an RFP for a company, we typically include proposals from both bundled and unbundled service providers. Furthermore, we ask both the bundled and unbundled providers to separately propose fees for administrative and investment management services. This permits the fiduciaries selecting the vendors to make an informed decision regarding the cost and quality of each service element. In our experience, virtually all bundled providers are willing and able to propose services in this manner, although some bundled providers will only present “unbundled” pricing to larger plans.

Our experience managing an RFP process for a regional bank with about \$15 million in plan assets earlier this year may help illustrate why we believe that any new disclosure requirements should require unbundling of fees. On behalf of the bank, we requested proposals from five different types of providers representing three different business models: large financial firms including two mutual fund companies and two insurance companies, as well as an unbundled arrangement led by an independent third party administrator (TPA).

One of the insurance companies refused to provide unbundled pricing, simply claiming that its fees would be zero. This proposal was rejected without further review. The second insurance company proposed a relatively high hard dollar fee under an unbundled pricing structure, with the hard dollar fee offset by any revenue sharing payments received by the insurer. Alternately, this insurance company suggested that if the plan’s current money market position were invested in a fixed rate account managed by the insurer, all explicit fees would be waived. This insurance company was invited to make a finals presentation to the plan fiduciaries.

The two mutual fund company proposals presented primarily unbundled pricing, with explicit fees that were somewhat lower than the second insurance company’s unbundled pricing, but with a requirement that at least some of the fund company’s own proprietary funds be offered through the plan. One fund company proposed lower hard dollar fees, but offered more expensive funds. The other fund company proposed higher hard dollar fees, but offered less expensive funds. The fund company with the lower cost funds was invited to the finals presentations.

The TPA was named as the third finalist. This proposal featured the lowest hard dollar fees of any of the three finalists, and complete flexibility for investment choice. Without knowing the identity of the other finalists, the TPA suggested that funds from the low cost fund company would be good investment choices.

In this case, the bank selected the low cost fund company as its new 401(k) provider. While the TPA presented the least expensive and most flexible proposal, the bank was concerned that the TPA’s administrative capabilities did not appear to be as deep as the fund company’s.

Conclusions

401(k) fees have been identified as a potential problem for at least a decade. The Department of Labor and the ERISA Advisory Council have focused on this topic since at least 1997. However, other than educational initiatives, very little real progress has been made towards rationalizing, or even better understanding, 401(k) fee structures. In the past five years, 401(k) fee issues have become even more prominent, and it appears that the Department of Labor is now poised to release a series of regulations that will improve 401(k) fee disclosure. However, various commentators have noted that the Department's proposed regulations may be insufficient to address many of the issues faced by employers today, such as properly comparing bundled and unbundled service arrangements. In fact, it appears that the Department's proposed regulations will require less disclosure from bundled arrangements than will be required from unbundled arrangements. Such an uneven disclosure regimen could have the unintended and unwarranted consequence of favoring one type of service provider over another, which could lead to reduced competition and higher fees.

In its current form, H.R. 3185 may not be a perfect bill. The litany of required fee disclosures may be excessive, and it's possible that certain types of fee disclosures could be collapsed and streamlined to reduce costs of complying with the bill and to improve the comprehensibility of the fee disclosure. The basic concepts behind H.R. 3185, however, the concepts of increased disclosure of fees and costs to 401(k) plan fiduciaries and 401(k) plan participants, are, in my opinion, quite sound and are badly needed to protect and improve the retirement security of American workers,

I would like to add that the current bill's proposed requirement that 401(k) plans include some form of balanced index fund might establish a dangerous precedent for statutory endorsement of specific investment approaches. In my view, it is better to let the competitive and ever changing forces of the marketplace, with enhanced and effective disclosure of 401(k) fees and investment costs, drive the choice of investment vehicles for 401(k) plans. As a practical matter, if H.R. 3185 or a similar bill is enacted, we are likely to see index funds featured more prominently in 401(k) plans simply because the enhanced disclosure regimen makes low cost index funds look relatively attractive, and not because the statute requires that they be offered.