

**From:** Matthew D. Hutcheson [mailto:matt@erisa-fiduciary.com]  
**Sent:** Sunday, July 08, 2007 1:46 PM  
**To:** EBSA, E-ORI - EBSA  
**Subject:** Response to Fee and Expense Disclosure RFI

Dear Labor Department; c/o Katherine Lewis:

Attached is a paper, dated July 4, 2007, than addresses many of the questions set forth in the recent Department RFI regarding the rules under the Employee Retirement Income Security Act (ERISA) applicable to the disclosure of plan administrative and investment related fee and expense information to participants and beneficiaries in participant-directed individual account plans (e.g., 401(k) plans).

My intent in responding to the RFI is to convey two basic messages, with the hope that the Department will consider them in policy making decisions:

1. American workers deserve a fair shake at a creating secure and meaningful retirement. The prerequisites of building a successful retirement involve the combining of mutually important principles, concepts, facts, relevant information, etc., that work together in a singular whole for a participant or beneficiary's benefit. This is an important under-girding concept to consider.
2. When principles, concepts, facts, or relevant information are missing, the quality of a participant's future retirement is diminished. Thus, any debate over disclosure must take that reality into account, and any DOL policy involving full disclosure must in my view be made with one thing in mind – protecting the financial futures of America's workforce.

I have come to understand from experience as an independent ERISA 3(21) fiduciary that traditional fiduciary practices deliver better long-term results than those that are complex, circular, conflicting, and obscure. Therefore, I encourage the Department to consider encouraging a return to traditional fiduciary ideals and discourage activities or behaviors that put the fiduciary's interests first. If the Department deems it appropriate to develop policy that protects fiduciaries from liability, do so only after there has been a clear demonstration by the fiduciaries that participants and beneficiaries will directly benefit and be protected by such exercises and activities. Such an ideal is founded upon transparency, honorable and clear communications, participant centric prudent processes, economically sound methodologies, and principle based investing that works. Disclosure policy should therefore work toward that end, which is facilitating the security and possible improvement of future benefits of America's workforce.

Workers are entitled to fair and prudent protections from fiduciaries. Thus, all service provider disclosures must be standardized and be equally fair and prudent. Disclosure exceptions and exemptions in context of this discussion are not appropriate when it comes to protecting our Workforce's retirement benefits. All revenue sharing and compensation arrangements between service providers should therefore be known by plan fiduciaries (and participants if requested) so that proper evaluations, measurements, and decisions can be made. In other words, disclosure policy should apply universally to unbundled and bundled service providers, mutual funds, variable annuities, sub-advised funds, collective trusts, pooled separate accounts, ETFs, etc.

The Department has always expected service providers to disclose "all relevant information" to fiduciaries. Sound fiduciary decisions cannot be made otherwise. Disclosure policy, therefore, may be as simple and succinct as restating pre-existing DOL expectations founded upon transparency, honorable and clear communications, participant centric prudent processes, economically sound methodologies, and principle based investing that works. By meaningful clarification and reasserting its long-standing position, the Department can with relative ease continue to help fiduciaries help the participants and beneficiaries they are charged with protecting.

Thank you for considering the very important matter of retirement plan economics, fees, disclosures, etc.

Sincerely,

Matthew D. Hutcheson  
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**Retirement Plan Disclosure**  
**A Declaration of Ethical Principles and Legal Obligations**  
**July 4, 2007**

**Matthew D. Hutcheson**  
**Independent Pension Fiduciary**

## **ABSTRACT**

Failure or refusal to fully disclose fees, expenses, revenue sharing, and other hidden costs is causing hundreds of thousands of 401(k) and similar plans to operate outside the realm of fiduciary prudence, unknowingly engage in prohibited transactions, and unnecessarily erode the future benefits belonging to participants and beneficiaries.

Notwithstanding the general and widespread need for an increased compliance with pre-existing disclosure requirements, knowledge and understanding of this issue is beginning to permeate the consciousness of government, business, and industry. There is reason for hope, as many – including plan sponsors and service providers – are taking positive steps to learn their duties and reform plan oversight. It will take time, but in the author's opinion, there is an excellent prospect of resolving the fundamental issues of inadequate disclosure of all relevant information to plan decision makers and thus avoid potentially unfavorable long-term consequences which participants and beneficiaries would otherwise bear.

# **Retirement Plan Disclosure**

## **A Declaration of Ethical Principles and Legal Obligations**

### **July 4, 2007**

#### **Ethics of Disclosure**

Disclosure involves much more than the communication of a secret. It is “a critical variable to all of us as individuals in relation to the world around us.”<sup>1</sup> It is a key element that enables us to trust others and make sound, informed decisions. Limited disclosure leads to mystification, to puzzlement, to secrecy.<sup>2</sup> Disclosure, or the lack thereof, is particularly important in retirement plans, because it affects the financial future of millions.

*“‘What people don't know, won't hurt them’ is a common maxim. There exists a common belief that the disclosure of information, rather than the fact itself is to blame. Thus in the Watergate trials, much discussion centered on the fact that President Nixon could have saved himself if the tapes would have been destroyed. The impression was often given that the tapes brought him down, rather than the acts and speeches that were recorded on the tapes. The existence or nonexistence of the tapes would not have changed the actual facts.”<sup>3</sup>*

The current state of the retirement plan industry is similarly troubling. The *records* and evidence of misbehavior in the retirement plan industry are not causing its troubles; the misbehavior itself is. Improper withholding of information from plan sponsors or participants causes fiduciaries unknowingly to violate the law and fundamental fiduciary principles, to which they are obligated to adhere.<sup>4</sup>

Failure or refusal to fully disclose fees, expenses, revenue sharing, and other hidden costs is causing hundreds of thousands of 401(k) and similar plans to operate outside the realm of fiduciary prudence, unknowingly engage in prohibited transactions,<sup>5</sup> and unnecessarily erode the future benefits belonging to participants and beneficiaries.<sup>6</sup>

Yet admitting to such conditions or behaviors could be devastating to the public image, credibility, and possibly the long-term viability of plan sponsors and financial service providers alike; and therein lies the conundrum. The longer full and honorable disclosure is delayed the more damage will be done to sponsors, providers and the participants they should be protecting.

It is argued by many that to disclose past errors and the magnitude of hidden fees could undermine trust in the retirement system itself. But the industry's past penchant for sacrificing ethical and legal duties upon the altar of economic gain must at some point stop. The best time for that was the day before it started. The second-best time is now.

## Why Full Disclosure?

Disclosure has more to do with ensuring the success of a retirement system than it does with simply identifying how much is being paid to whom. In the context of retirement plans, disclosure is wholly germane to an individual's ability—whether a participant or a trustee—to construct a meaningful portfolio that has a chance of accomplishing the desired objective. Failure to disclose relevant information to the investment decision maker, whoever that may be, thwarts a participant's ERISA right to a prudent, low cost portfolio.<sup>7</sup> Thus, to the extent the retirement industry refuses to disclose relevant information, it violates both ethical principles and legal obligations.

A classical definition of ethics is “the science of human duty.” Within the context of a retirement plan, high standards of care and loyalty apply. Those with information necessary for plan decision makers to act prudently on behalf of participants have a duty to disclose that information. Withholding such information violates that duty and results in real human costs. Whether one accepts that fiduciary duties apply, human duties certainly do. To withhold or obscure valuable information for one's own gain within the context of a retirement plan violates a human duty, and is therefore unethical.

Further, participants are entitled under ERISA to a prudent, low-cost portfolio.<sup>8</sup> It should be self-evident that withholding information regarding costs undermines the ability of the trustee and the participant to know whether their investment portfolios are either prudent or low-cost. The participants and fiduciaries can, when provided with full information, exercise diligence to construct and maintain a meaningful portfolio with particular objectives. This is not possible if full information on costs is not available or is hidden. Failure to disclose all relevant information violates ERISA law.

## What Does the Law *Really* Require?

Fiduciaries have a duty to know and control fees and costs. Know means **know**.<sup>9</sup> This includes finders' fees, 12(b)-1 fees, or *other forms of compensation*<sup>10</sup> being paid to any party, by any other party. It is relevant to proper portfolio construction and measurement of the value of specific services rendered. The retirement industry is fully aware of this fiduciary obligation. It also understands that “lay” fiduciaries or participants cannot know and control fees and costs within their portfolios and plans unless the industry discloses that information to them.

## Interaction between Fiduciaries A and B

1. If the law requires fiduciary A (plan sponsor) to know and understand fees and costs in order to construct a prudent, low-cost portfolio; but,
2. Only fiduciary B (service provider, fund manager, advisor, etc.) possesses information regarding fees and costs; and,
3. Fiduciary B understands that:

- (a) fiduciary A has a legal obligation to know what fiduciary B knows; and,
  - (b) unless fiduciary B reveals the information, fiduciary A will remain ignorant; then,
4. There is a fiduciary standard of care that requires fiduciary B to disclose the information to fiduciary A so that fiduciary A can comply with the law.

How does B manage to withhold relevant information? It's simple. Fiduciary B fights tooth and nail to avoid fiduciary status, and B presumes that if he is not held to a fiduciary standard of care, he might be able to continue to withhold relevant information. Acknowledging fiduciary status brings implications he misguidedly wants to avoid.

### **Interaction Between Fiduciary A and Non-Fiduciary B**

If fiduciary A enters into a service agreement with non-fiduciary B, and fiduciary A knows that B is not a fiduciary from the beginning, then fiduciary A might reasonably understand not to expect full and absolute disclosures from non-fiduciary B. Yet, such an understanding does not absolve fiduciary A from pre-existing duties to know, monitor, etc. Further, if fiduciary A is not informed, the participants in the plan for which he serves as fiduciary are also incapable of being informed, and thus cannot under any reasonable standard make "informed investment decisions."<sup>11</sup>

### **The Disclosure Game**

"The Department (Department of Labor) emphasizes that it **expects** a fiduciary, **prior** to entering into a performance based compensation arrangement, to **fully understand** the compensation formula and the **risks associated with** this manner of compensation, **following disclosure** by the investment manager of **all relevant information** pertaining to the proposed arrangement." [Advisory Opinion Letter 1989 WL 435076 (ERISA)] Thus, for a fiduciary to know all relevant information ahead of time, service providers must disclose all relevant information prior to entering into an engagement.

The failure to disclose **all relevant information** effectively forces fiduciaries to violate the law unknowingly. The SEC has taken action against various service providers of 401(k) plans because of hidden compensation arrangements which obscured relevant information to fiduciaries.<sup>12</sup>

The retirement plan industry as a whole has lost a large measure of public trust due by refusing to fully disclose **all relevant fund and plan economic information** to sponsors, participants and their beneficiaries. Then, as if to excuse their obfuscation, they claim to have "disclosed what the law required them to do."<sup>13</sup> That claim does not hold water for reasons that will be discussed in detail below.

Those few service providers that honorably disclose **all relevant information** are frequently (and unfairly) classified as obscurers and withholders of relevant information, and thus also have an interest to correct the wide-spread disclosure problem so the future of their business is not impaired or permanently compromised.

Although the General Accountability Office (“GAO”) has stated that regulators currently lack the information needed to provide effective oversight (*it therefore goes without saying that plan sponsors also lack sufficient information*)<sup>14</sup> the Department of Labor has always and repeatedly stated that it **expects** a fiduciary, to fully understand, following disclosure, **all relevant information** pertaining to arrangements entered into with service providers, fund managers, etc.<sup>15</sup>

Considering that position, it is unexpected that recent court rulings<sup>16</sup> appear to have stated (incorrectly) that disclosure of **all relevant information** is neither required by the law nor important to fiduciary decisions, ongoing monitoring, or the future benefits a plan is able to pay to participants and beneficiaries.

Regulators present a more certain posture on disclosure requirements. For example, consistent with pre-existing obligations to disclose **all relevant information**, the Securities and Exchange Commission (“SEC”) held John Hancock accountable for engaging in inappropriate revenue sharing schemes.

On June 26, 2007, Investment News reported that:

*“John Hancock Life Insurance Co. agreed yesterday to pay \$21.2 million to settle a Securities and Exchange Commission investigation of the Boston-based fund company's failure to **disclose certain revenue sharing schemes**, according to an SEC statement. The payment includes disgorgement, prejudgement interest, and civil monetary penalty. Washington-based SEC ruled that Hancock, a subsidiary of Manulife Financial Corp. in Toronto, from 2001 to 2004 used brokerage commissions to pay for affiliated distributors' marketing expenses without making the practice public.”*

## **Reconciling Conflicting Legal Arguments**

Recent legal arguments have suggested that there is no legal requirement to disclose certain forms of compensation, revenue sharing, or other relevant information. The Department of Labor, the SEC, and pre-existing law and regulatory pronouncements disagree.

Legal defense teams point to, in part, the vague reporting and disclosure requirements of form 5500 and also Labor Regulation 404(c). The weakness of those arguments is that they base their argument on the assertion that the 5500 and 404(c) are in fact the source of the legal disclosure requirements. For example, one should not conclude that because form 5500 filing instructions are not explicit in requiring the reporting or disclosure of certain types of fees or arrangements, that it is unnecessary to disclose them to anyone.

The legal requirements are clearly set forth elsewhere. It therefore goes without saying that the Federal Government contemplated that the pre-existing disclosure laws would be understood and carried forward in all plan management activities, including those of reporting (form 5500) and the management of participant-directed account schemes claiming to satisfy 404(c).

In other words, it is clear that the Federal Government never contemplated that service providers would use the requirements of form 5500 or 404(c) as a defense argument, because there is pre-existing law that already requires disclosure of relevant information. That simple fact explains the absence of repetitive disclosure instructions contained within form 5500 and 404(c). It would be redundant to re-state the pre-existing requirements in outlining form 5500 and in 404(c) regulations. The obligation to fully disclose all relevant information is clear in all the places it should be. It should not be necessary to carry forward and re-state the pre-existing expectations and requirements in form 5500 or its instructions; that ground has already been covered.

In the case of participant-controlled plans, subject to 404(c), disclosure of “***all relevant information***” becomes even more important. A participant will never be able to make “informed” decisions without full disclosure. Participants simply do not have the resources or training to investigate and evaluate costs or other relevant information, especially those that are **not** being disclosed.

In short, the argument of a plan sponsor and their service providers that they “disclosed what the law required them to do”<sup>17</sup> is not sound. The law requires plan sponsors to know—and therefore service providers to disclose—information necessary to enable those making decisions about the plan to fulfill their fiduciary obligations.

### **What Does “*All Relevant Information*” Mean?**

The concept of ***all relevant information*** is based upon five observations:

#### **Observation 1: Fiduciaries must adhere to fundamental standards**

“In managing investments . . . the trustee must adhere to fundamental fiduciary standards.”<sup>18</sup> In order to do so, fiduciaries must start with all relevant information **necessary** to fulfill their obligations to participants and beneficiaries.

#### **Observation 2: Standard of prudent investing is mandatory**

“ERISA’s standard of prudent investing is mandatory, and extends to all assets, even those under the control of participants.”<sup>19</sup> The new prudent investor rule directs the trustee to invest based on risk and return objectives reasonably suited to the trust, and instructs courts to review the prudence of individual investments in the context of the trust portfolio as a whole.”<sup>20</sup> (Consider the serious contradictory implications of how conventional 401(k) plans are managed compared to ERISA’s mandatory prudent investing standards).



In practical terms, this means properly combining poorly correlated assets (stocks and bonds for example).

*“As a practical matter, the employer or other fiduciary that selects the investment menu is likely to find itself duty bound to act prudently in identifying and constructing an asset class option set that offers individual plan participants most of the same investment choices and core diversification opportunities generally available to professional managers of traditional defined benefit plans. It should afford each participant the opportunity to construct a well diversified portfolio that, on a portfolio-wide basis, contains acceptable, low-correlated risk and the prospect of stable returns over the long term. In reality, the 401(k) fiduciary’s task fairly mirrors that of the defined benefit plan trustee. The 401(k) fiduciary should develop the same “efficient frontier” of optimal asset class allocations as the defined benefit plan trustee, focusing particularly on low asset class correlation and covariance, and should identify fund options within each class. It is then up to the individual participant to act reasonably upon this effort. Ironically, however, the risk of regulatory scrutiny or litigation for the 401(k) fiduciary’s failure to do so is probably greater than that of the defined benefit plan investor. The simple fact is that defined benefit plan returns tend to be reported, at least to participants, on a portfolio basis, and because all assets are available to support each individual participant’s pension, there is an appropriate mindset to focus on overall portfolio performance when considering the fortunes of the plan. In the 401(k) environment, however, where there is no assurance that participants will properly diversify and each participant typically receives quarterly statements as to the performance of all options, each investment fund’s performance is highlighted for all participating employees to see and to voice disquietude to their employers, government regulators, or plaintiffs’ class action counsel.”<sup>21</sup>*

Any other method unnecessarily delivers **sub-possible returns**, as explained by Roger Ibbotson:

*“We can extrapolate from the study that for the long term individual investor who maintains a consistent asset allocation [i.e. proper ratio of stocks and bonds] and leans toward index funds, asset allocation determines about 100% of performance.”<sup>22</sup>*

Presuming a fiduciary is in possession of all relevant information, yet fails to make it available to participants who are expected to exercise control over their accounts, sub-possible returns are therefore an unacceptable fiduciary breach when possible returns are easily attainable. However, what if there are economic elements associated with one or more of the underlying funds that are undisclosed to the fiduciary (or the participant for that matter) – such as revenue sharing, higher fees or costs? How does that change the equation? For example, if there are undisclosed fees or costs, does that alter the modeled return output, distort the risk profile of the portfolio, or effectively extend the time horizon? Is that **relevant information**? Undoubtedly, without question.

### Observation 3: Undisclosed fees and costs thwart pre-existing ERISA requirements

An investor must be in possession of all relevant data about fees and costs.<sup>23</sup> There are two primary reasons for this requirement:

First, the law requires disclosure of all relevant cost information so that any person, participant or trustee, can make informed, intelligent, and practical investment decisions.<sup>24</sup>

Second, costs diminish returns. “[*There is an*] obvious and documented inverse relationship that clearly links mutual fund costs and mutual fund returns.”<sup>25</sup> Since creating a prudent portfolio with a modeled return is also required by law, full disclosure is both a matter of law and practical application. This economic principle applies to all other similar investment vehicles such as variable annuities, Exchange Traded Funds, Collective Trusts, Pooled Separate Accounts, etc.

In other words, every dollar spent on the costs of supporting an investment strategy—knowingly or in ignorance—depresses investment returns:

*“If ‘active’ and ‘passive’ management styles are defined in sensible ways, it **must be** the case that*

- 1. before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and*
- 2. after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar*

*These assertions will hold for **any** time period.”<sup>26</sup>*

That is an important and relevant statement from a Nobel Laureate because “*the vast majority of the new funds added to 401(k) plans are **high-cost actively managed equity funds**, as opposed to lower-cost equity index funds.*”<sup>27</sup>

This is not simply another re-hash of the “passive vs. active” debate. It has to do with costs that are not disclosed in actively managed funds. For example, trading (brokerage) and market impact costs (bid/ask spreads) that are not part of the expense ratio and thus not disclosed in the prospectus of an actively managed mutual fund. Yet those undisclosed costs may have a larger impact on depressing the returns realized by participants than the expense ratio itself. This is **highly relevant**, yet never adequately disclosed. In fact, recently a Federal Judge failed to notice this profoundly important economic reality in issuing a ruling adversely affecting tens of thousands of future retirees.<sup>28</sup>

The judge stated; “*Participants incur no transaction fees or sales loads on funds purchased and sold through the Plan’s standard options ...All fund level investors indirectly pay any fund-level expenses, such as management fees, asset based sales charges (12b-1 fees), and other fund expenses, as detailed in the fund’s prospectus...*”

In this instance, the judge limited his ruling to a subset of **relevant information**, excluding information that could be equally relevant. For example, actively managed funds have trading and market impact expenses<sup>29</sup> that can exceed the expense ratio<sup>30</sup>, (which includes 12b-1 fees). **Those trading and market impact costs are not disclosed anywhere in the prospectus.** Furthermore, the prospectus is a forward looking estimation, and does not reveal the actual fund expenses and fees/charges incurred by the fund manager for a particular year. A modeled portfolio with proper risk characteristics cannot be constructed without knowing the actual costs. Actual costs are revealed in the year-end financial statement of the fund, not in the prospectus. The trading costs themselves, which again, can be equal to or greater than the fund management fee (depending on turnover rates), is also not disclosed in the prospectus. It’s disclosed somewhere else altogether,<sup>31</sup> an important and influencing fact omitted in the court’s ruling. Finally, there are elements such as bid/ask spreads that are not disclosed, but can become quite large in funds with low overall liquidity characteristics, such as some small cap and foreign funds. Thus, a trustee or a participant cannot look at the fund’s management fee or expense ratio alone and comply with fundamental fiduciary rules and laws.<sup>32</sup>

Simply stated, an investor (a participant, a trustee, etc.) must be sufficiently informed through disclosure of relevant data to construct a meaningful portfolio.<sup>33</sup>

The argument that fees and costs can be controlled by a participant by “simply choosing funds with the lower expense ratios”<sup>34</sup> mocks existing fiduciary rules as set forth by ERISA and other regulatory pronouncements. This doesn’t mean simply choosing the fund with the lowest expense ratio. The costs must be viewed in context of the portfolio as a whole.

Illustration: How disclosing only the fund expense ratio can deceive.

<u>Fund type</u>	<u>Expense ratio</u>
Large Cap Equity A	1.00%
Large Cap Equity B	1.25%

If the argument that a participant need only to choose a fund with the lowest expense ratio to control costs (an argument that mocks pre-existing legal requirements to construct a meaningful portfolio overall), then a participant would choose Large Cap Equity A. However, does the fund expense ratio contain “**all relevant information?**” No.

There are economic costs about which participants and fiduciaries are almost universally unaware that have the potential of thwarting any reasonable potential for long-term investment success.

Taking the above illustration one step further...

Fund type	Fund Expense ratio	Brokerage Commissions	Total Fund Cost
Large Cap Equity A	1.00%	8.00% <sup>35</sup>	9.00%
Large Cap Equity B	1.25%	0.45%	1.70%

Considering the disclosure of the additional relevant information regarding brokerage commissions incurred, we can see from an actual fund<sup>36</sup> profiled by TheStreet.com that had a 5 star rating, a 1% expense ratio, and an additional **8%** in brokerage expenses that were not reported anywhere in a prospectus. A participant could easily be deceived into thinking they were choosing a lower-cost fund, when in reality they were choosing a fund with a total economic cost **7.3% higher** than they believed it to be. In such scenarios, are participants truly informed as 404(c) requires? How would they know if they were truly informed? Was all relevant information disclosed? No reasonable person would make such a claim. Again, because there is an *“obvious and documented inverse relationship that clearly links mutual fund costs and mutual fund returns,”* the debate over full disclosure becomes crucial for millions.

Therefore, undisclosed fees, without question, impede a fiduciary’s ability to adhere to the ERISA-mandated fundamental fiduciary duty to create a portfolio with a modeled rate of return and identified level of risk. This is especially true when a participant is trying to construct a portfolio to capture 100% of the potential risk-adjusted return that would be available if all relevant data were known and understood.

Costs reduce returns. Simply choosing a fund with the lowest expense ratio is contrary to constructing a proper portfolio with a modeled return<sup>37</sup>, an identified level of risk<sup>38</sup>, over a specified time horizon. Any other method delivers less than 100% of the potential return otherwise available to a participant. And such an outcome is unacceptable to a fully informed participant.

In summary, the absence of ***all relevant information*** impedes the construction of a prudent, disciplined, principle-based portfolio focused on obtaining particular results.

**Observation 4: The relevance of the prudent man (professional) standard**

It has been suggested that it is legal to withhold information from fiduciaries or participants. The argument goes that 404(c) permits a lack of full disclosure. But that position ignores an incredibly important law: Section §404(a) of ERISA states:

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and--

- A. for the exclusive purpose of:
  - i. providing benefits to participants and their beneficiaries; and
  - ii. defraying reasonable expenses of administering the plan;
- B. with the care, skill, prudence, and diligence under the circumstances **then prevailing** that a prudent man acting in a like capacity and **familiar with such matters** would use in the conduct of an enterprise of a like character and with like aims;

The law, pursuant to ERISA §404(a) itself states that **before** 404(c) or any other practice involving assets under fiduciary control is considered valid, a fiduciary must demonstrate that they have discharged their duties with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and **familiar with such matters** would use in the conduct of an enterprise of like character and with like aims.

Under the circumstances prevailing today, what are the views of leading practitioners familiar with matters of disclosure, 404(c), etc?

*“I am here to present my views on section 404(c) of the Employee Retirement Income Security Act (“ERISA”) and the regulation thereunder. (In this testimony, I refer to the statute and the regulation, collectively, as 404(c) unless otherwise specified.) **My views reflect my extensive experience in this area.** That experience includes: assisting employers in complying with 404(c); advising providers on their programs to assist fiduciaries in complying with 404(c); auditing plans for 404(c) compliance; writing and speaking about fiduciary and 404(c) issues; and acting as an expert witness on 404(c) compliance. **In my experience, the vast majority of plans do not satisfy the conditions for obtaining 404(c) protection.** As a result, for the vast majority of plans, the fiduciaries retain responsibility for the prudence of all investment decisions made, including participant-directed investment decisions.”<sup>39</sup>*

*“Most plan sponsors understand the benefit of complying with section 404(c) of ERISA—relief from liability for participant investment decisions. However, **few plan sponsors comply** with the requirements to obtain that relief.”<sup>40</sup>*

*“In general, compliance with the ERISA Section 404(c) regulations is not reviewed by the Department, as this is viewed as **mainly a defense for the fiduciary** (note – a violation of the exclusive benefit concept. Fiduciaries should*

*not act to first protect themselves). There may be an issue if a fiduciary is representing to plan participants that the plan is a 404(c) plan, but the fiduciary is clearly not complying with the 404(c) regulations. In general, enforcement by the Department is focused on the mandatory requirements imposed by ERISA but not on the voluntary aspects, unless it rises to the level of misrepresentation to plan participants. "The Department does have a concern with the broader issue of whether a 404(c) plan is appropriate given the nature of a particular employer's workforce."'<sup>41</sup> (note added)*

Regulators and industry experts familiar with this matter acknowledge that:

1. 404(c) is the defense many are using as a justification for hiding or obfuscating fees;
2. It is the prevailing view that employers do not comply with 404(c);
3. Participants are not "informed" nor can they, by any reasonable standard, be considered able to make "informed investment decisions." Employers are not informed. The Department of Labor itself is not fully informed.<sup>42</sup> It is unreasonable to suggest that participants can make informed investment decisions, because: First, they, like their employer and the DOL, have had information withheld from them by those who are in the know about fees and costs – **relevant information** that is an inseparable element of portfolio construction; but, Second, and more importantly, even if a typical participant receives all relevant information through open and honorable disclosure, they still are incapable of making **informed decisions** because they do not have the knowledge or experience necessary to construct a meaningful<sup>43</sup> portfolio as they are entitled under the law. Thus, there is an unacceptable tension between a statute that allows individually directed plan investments and the right of those individuals to a well diversified, low cost, meaningful portfolio. The current industry model, culture, and conventional plan methodology are to blame.
4. The Department of Labor has made it clear that any service paid for with plan assets must be helpful to the plan.<sup>44</sup> It is readily accepted that 404(c) does not exist for the exclusive purpose of providing benefits, nor is it a "necessary service to the plan"<sup>45</sup> Lay fiduciaries, however, may believe it is a service necessary for **them**, which creates yet another irreconcilable "rub" between ERISA 404(c) and 406(b). Plan assets must not be used for his or her (the fiduciary's) "own interest."<sup>46</sup> As 404(c) exists only to protect the fiduciary,<sup>47</sup> and the additional associated services increase the cost of a plan, and are generally paid for with plan assets, the logical conclusion is that such payments are, by definition, prohibited transactions.
5. The legitimacy of 404(c) is subject to adherence to pre-existing law, namely ERISA 404(a). Validation is dependent upon full compliance 404(c) coupled

with the pre-existing requirement that it be accepted as a legitimate practice for protecting the **participant**, by those familiar with its purpose.

6. The predominant view of prudent individuals<sup>48</sup> familiar with 404(c) is that plans generally do not comply with its requirements. Therefore, how can 404(c) be helpful to the plan?

ERISA 404(a) states that prudent people familiar with such matters must first agree that that 404(c) is a valid fiduciary concept in order for it to be of force. However, knowledgeable people do **not** agree that it is valid fiduciary concept. In fact, prudent, informed people reject it as a fiduciary concept. Therefore, 404(c) is moot as a defense for non-disclosure and obfuscation. In short, 404(c) fails the prudent man standard.

### **Observation 5: Informed fiduciary and participant decision making will end the entrenched culture of obfuscation**

There is a reason the retirement industry embraces a culture of obfuscation: Profits. And sadly, those profits come at the expense of millions of hard-working, middle-class Americans who are simply trying to save for a decent retirement.

To the knowledge of the author, no one in Government, on Wall Street, or in the 401(k) industry has stated that the retirement plan industry discloses “**all relevant information.**” On the contrary, there is widespread agreement that relevant information is indeed being inappropriately withheld from investors. In other words, there is widespread consensus that investors are neither informed, nor can they make “informed investment decisions.”

Consider two recent quotes from the **Chairman of the SEC** that explain how failure to disclose all relevant information obscures the real numbers, permits excess skimming from investor accounts, and conflicts with investors’ best interests:

*“To far too great a degree, and in substantial part because of a regulatory cumbersomeness that **obscures the real numbers**, our financial services industries are able to **skim off** much more of the assets they handle than would be the case in a well-functioning market.”<sup>49</sup>*

*“This witch's brew of **hidden fees**, conflicts of interest and complexity in application is at odds with investors' best interests,”<sup>50</sup>*

In other words, no one in the retirement industry or government is claiming full disclosure exists. Rather, defendants in litigation claim the law **permits** them to obscure the truth. Their rationale can be termed “**deception by legal compliance.**” It will not stand. It will not survive careful scrutiny. It is a violation of pre-existing law and fiduciary principles, and an offense to reasonable and prudent people everywhere.

A service provider cannot withhold relevant information necessary for others to make informed and prudent investment decisions under the cover that they are only doing what

the law requires. ERISA law does not permit obfuscation; it mandates full disclosure of all relevant information. All four elements of an investment strategy (modeled return, identified level of risk, identified time horizon, and identified fees/costs/and economic impact) must simultaneously exist in order to exercise prudence. An investment strategy that ignores one or more elements is imprudent and therefore a violation of the requirements of ERISA. Full disclosure is a necessary (though not a sufficient) condition for designing and implementing a prudent, low-cost investment portfolio.

### **The symbiotic nature of revenue sharing and conflicts of interests**

A recent legal analysis states:

*“...the court found that ERISA and its regulations could not be reasonably read to require the type of detailed disclosure of plan expenses necessary to provide revenue sharing information. The court noted that recent proposals to amend ERISA’s regulations to require revenue sharing disclosures on Form 5500 made it apparent that existing regulations do not require these disclosures.”<sup>51</sup>*

However, ERISA and its regulations can and should be “reasonably read” to require disclosure of revenue sharing.

In June 2007, the General Accountability Office released a report to Congressional Requesters<sup>52</sup> about the conflicts of interest in traditional pensions. The report states:

*“A conflict of interest typically exists when someone in a position of trust, such as a pension consultant, has competing professional or personal interests. Though data are limited on the prevalence of conflicts involving plan fiduciaries and consultants, a 2005 SEC staff report examining 24 registered pension consultants identified 13 that failed to disclose significant conflicts. GAO’s analysis found that, in 2006, these 13 consultants had over \$4.5 trillion in U.S. assets under advisement. GAO also analyzed a sample of ongoing DB plans associated with the 13 consultants that, as of year-end 2004, had total assets of \$183.5 billion and average assets of \$155.3 million. Additional sample analysis showed that the DB plans using these 13 consultants had annual returns generally 1.3 percent lower than those that did not.”*

In those plans identified with conflicts of interest, to what can the 1.3% under-performance be attributed? Again, consistent with Nobel Laureate Sharpe, it is “costs.”<sup>53</sup> Again, as is clearly stated in ERISA and in regulations, fiduciaries have a pre-existing duty to know and control costs.<sup>54</sup>

Revenue sharing gives rise to many of the conflicts of interest and therefore the increased costs identified in the GAO report and elsewhere.

Conflicts of interest cannot exist without the exchange of some form of value. In the case of retirement plans, value is exchanged between parties in interest. A party in interest is



any fiduciary, including but not limited to the plan administrator, officer, trustee, custodian, or employee of such plan; *or a person providing services to such plan.*<sup>55</sup> Conflicts of interest have frequently been discovered between two or more different firms or persons providing services to a plan. In such circumstances, preventing conflicts of interest is very difficult. Conflicts of interest are proscribed by ERISA<sup>56</sup>, and one cannot prevent them without preventing the exchange of value.

The medium of exchange most common to conflicts of interest is commonly referred to as “revenue sharing,” however whatever the popular term may be at any given point in time, the substance of the matter remains unchanged. The most common conflicts of interest live or die by the exchange of dollars between service providers.

It is true that revenue sharing arrangements exist where conflicts of interest do not. However, conflicts of interest do not exist without some form of revenue sharing or exchange of value. Thus, in order for a fiduciary to be certain no conflicts of interests exist, all revenue sharing must be disclosed, known, controlled, etc. Otherwise, conflicts of interest may go unnoticed. It is clearly the law.<sup>57</sup>

The legal hair-splitting as to whether such revenue sharing must be disclosed to participants is not consistent with the exclusive benefit rule.<sup>58</sup> When participants want assurances that fiduciaries are doing their jobs in accordance with all fiduciary standards of care, they should promptly receive such assurances. It’s a fiduciary’s ethical duty. If fiduciaries have properly discharged their duties, they will be in possession of *all relevant information*, and will thus be able to share all relevant information in a matter-of-fact way upon request. They will already have at their disposal all relevant information about fees, costs, revenue sharing, etc.

Impeding prudent fiduciary decisions, by obscuring revenue sharing arrangements between service providers or making them onerous to discover are direct affronts to the fundamental ERISA requirement proscribing agreements or arrangements that conflict with fiduciary standards of care.<sup>59</sup> Thus, again clearly showing that disclosure of relevant information such as revenue sharing is a legal requirement. If revenue sharing is not disclosed, unnecessary services, conflicts of interest, and other wasteful inefficiencies may exist, all of which are prohibited by fundamental ERISA law and regulations.

## Conclusion

The matter of disclosure of retirement plan economics is not only about dollars and cents; it’s also about developing a growing population of responsible professional parties who embrace correct principles and seek the common good of society. The goal of full and honorable disclosure must be to serve the best interests of over fifty million individual plan participants.

Some want society, the judiciary, and regulators to *believe* that withholding *some relevant information* is legal, when it is not. Nor is it ethical. Suffice it to say that law, regulation, and ethics do not permit, nor have they ever permitted, the hiding of any

relevant information from plan decision makers, whether they be plan sponsors, trustees, or participants.

Society cannot expect those who are responsible for the retirement income security of millions of individuals to make good decisions in ignorance.

The industry and regulators must either: (a) Return to the model originally contemplated under ERISA, in which recognized fiduciaries would make all decisions regarding trust assets; or (b) Empower participants to make their own individual decisions with respect to the assets in their personal tax-deferred 401(k) accounts. If the chosen course is to return to the original intent of ERISA, then fiduciaries of 401(k) plans must be armed with all relevant information necessary to construct a low-cost prudent portfolio for the benefit of the participants. Alternatively, if the chosen course is to enable those holding tax-deferred investments to, in essence, serve as their own mini-fiduciaries, then they must be afforded the information necessary to construct the same sort of prudent, low-cost personal portfolio. Either way, the decision makers must be provided access to all relevant information. The first approach—empowering recognized fiduciaries to make investment decisions—is clear, simple and straightforward, and has been the norm in traditional pension plans for decades. The second approach requires the following leaps of faith: (i) Participants are capable of making such decisions regarding prudence; (ii) Participants will understand the costs of their investment alternatives, any revenue sharing arrangements, market timing and impact costs, trading and brokerage costs, short term redemption fees, investment advisory fees, custodial fees, annual account maintenance fees, administration costs, etc.; (iii) There is such a thing as a properly allocated, low-cost individual investment portfolio; (iv) Participants will feel a duty to construct their own investment portfolios and act upon that duty; and, (v) Participants will know how to implement such an individualized investment strategy within their own accounts. ***Regardless of their relative merits, both approaches demand full disclosure of all relevant information.***

As it stands, participants and lay fiduciaries are forced to operate in the dark, without ***all relevant information***. They are obligated to make complex investment decisions and fulfill tasks without a fundamental understanding of the fees, costs, and the future economic impact of their decisions. In such an environment, it can be argued that no one is actually required to serve as a fiduciary for the benefit of plan participants, since information sufficient to serve in such a capacity is being withheld. Recent legal decisions and arguments lead inexorably to the unacceptable conclusion that “nobody is permitted to know, so nobody can be held responsible.”

Notwithstanding the general and widespread need for an increased compliance with pre-existing disclosure requirements, knowledge and understanding of this issue is beginning to permeate the consciousness of government, business, and industry. There is reason for hope, as many – including plan sponsors and service providers – are taking positive steps to learn their duties and reform plan oversight. It will take time, but in the author’s opinion, there is an excellent prospect of resolving the fundamental issues of inadequate disclosure of ***all relevant information*** to plan decision makers and thus avoid potentially

unfavorable long-term consequences which participants and beneficiaries would otherwise bear.

End

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<sup>1</sup> Steele, Fritz. *The Open Organization*. Reading, Mass.: Addison-Wesley Publishing Company, 1975

<sup>2</sup> Ethics of Disclosure: <http://www.learnwell.org/disclosure.htm>

<sup>3</sup> <http://www.learnwell.org/disclosure.htm>

<sup>4</sup> RESTATEMENT (THIRD), *supra* note 3, 227 cmt. b. “In managing investments . . . the trustee **must adhere** to fundamental fiduciary standards.”

<sup>5</sup> Unnecessary and excessive services being rendered that are not “*helpful to the plan.*” 29 CFR §2550.408(b)(2)

<sup>6</sup> United States Government Accountability Office, Report to the Ranking Minority Member, Committee on Education and the Workforce, House of Representatives. November 2006. Page 2

<sup>7</sup> **ERISA entitles participants to a low cost, prudent, fiduciary-managed portfolio through the four components or elements of low cost, prudent, fiduciary-managed portfolio design, implementation and monitoring.**

**A. FIRST ELEMENT - FIDUCIARY MANAGED PORTFOLIO WITH APPROPRIATE LEVEL OF RISK AS DETERMINED BY FIDUCIARIES** ERISA §404(a)(1)(B). Regulations – 29 CFR §2550.404a-1(b)(1)(A); 29 CFR §2550.404a-1(b)(2)(B)(iii); *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 23 EBC. 1001 (5th Cir. 1999)

**B. SECOND ELEMENT - FIDUCIARY MANAGED PORTFOLIO WITH DEFINED MODELED/EXPECTED RETURN AS DETERMINED BY FIDUCIARIES** ERISA §404(a)(1)(A) and (B). Regulations – 29 CFR §2550.404a-1(b)(1)(A); 29 CFR §2550.404a-1(b)(2)(A); *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Communications Satellite Corporation v Federal Communications Commission*, 611 F.2d 883 (D.C. Cir. 1977).

**C. THIRD ELEMENT - FIDUCIARY MANAGED PORTFOLIO WHERE FEES AND COSTS ARE KNOWN, ACCOUNTED FOR, AND MONITORED BY FIDUCIARIES** ERISA §404(a)(1)(A)(i and ii); §406(a)(1)(C); §408(b)(2); *Liss v. Smith*, 991 F. Supp. 278 (SDNY 1998); Interpretive Bulletin 94-2, 29 CFR §2509.94-2. §2(a); §7; OCC Interpretive Letter No 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m at 58 (1992). ERISA §3(14)(B); §404(a)(1)(A), (B) and (D); §406(a); 29 CFR §2550.408(b)(2); Booklet, A look at 401(k) Plan Fees, US Dept. of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter 89-28A (9/25/89); Interpretive Bulletin 75-8, 29 CFR §2509.75-8. ERISA §404(a)(1)(A) and (B); §406(a)(1); §406(b)(1); §406(b)(3); *Brock v. Robbins*, 830 F.2d 640, 8 EBC 2489 (7th Cir. 1987); DOL Advisory Opinion Letter 97-15A; DOL Advisory Opinion Letter 97-16A (5/22/97).

**D. FOURTH ELEMENT - FIDUCIARY MANAGED PORTFOLIO BASED UPON PRUDENTLY DEFINED TIME HORIZONS AS DETERMINED BY FIDUCIARIES**

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ERISA §404(a)(1)(B); 29 CFR §2550.404a-1(b)(1)(A); 29 CFR §2550.404a 1(b)(2)(A); *Metzler v. Graham*, 112 F.3d 207, 20 EBC 2857 (5th Cir. 1997); Interpretive Bulletin 96-1, 29 CFR §2509.96-1; HR Report No 1280, 93d Congress, 2d Session (1974)

<sup>8</sup> *Ibid*, A, B, C, and D

<sup>9</sup> ERISA §404(a)(1)(A)(i and ii); §406(a)(1)(C); §408(b)(2); *Liss v. Smith*, 991 F. Supp. 278 (SDNY 1998); Interpretive Bulletin 94-2, 29 CFR §2509.94-2. UPIA §2 Comments; §2(a); §7; OCC Interpretive Letter No 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m at 58 (1992)

<sup>10</sup> ERISA §404(a)(1)(A) and (B); §406(a)(1); §406(b)(1); §406(b)(3); *Brock v. Robbins*, 830 F.2d 640, 8 EBC 2489 (7th Cir. 1987); DOL Advisory Opinion Letter 97-15A; DOL Advisory Opinion Letter 97-16A (5/22/97); UPIA - §2; §7; §7 Comments

<sup>11</sup> One example; being in possession of sufficient information to make “Informed investment decisions,” such as what ERISA §404(c) requires before one can reasonably claim its presumed protections

<sup>12</sup> June 25, 2007. Washington-based SEC ruled that Hancock, a subsidiary of Manulife Financial Corp. in Toronto, from 2001 to 2004 used brokerage commissions to pay for affiliated distributors' marketing expenses without making the practice public.”

<sup>13</sup> CIGNA case - CIGNA’s 401(k) Fee Suit Defense: We Obey All Current Laws.  
[http://www.plansponsor.com/pi\\_type11/?RECORD\\_ID=37333](http://www.plansponsor.com/pi_type11/?RECORD_ID=37333)

<sup>14</sup> United States Government Accountability Office, Report to the Ranking Minority Member, Committee on Education and the Workforce, House of Representatives. November 2006. Page 2

<sup>15</sup> Advisory Opinion Letter 1989 WL 435076 (ERISA) and other examples

<sup>16</sup> United States District Court for the Western District of Wisconsin; *Hecker et. al. v. Deere & Company, Fidelity Management Trust Company, et. al.*

<sup>17</sup> CIGNA case - CIGNA’s 401(k) Fee Suit Defense: We Obey All Current Laws.  
[http://www.plansponsor.com/pi\\_type11/?RECORD\\_ID=37333](http://www.plansponsor.com/pi_type11/?RECORD_ID=37333)

<sup>18</sup> RESTATEMENT (THIRD), *supra* note 3, 227 cmt. b.

<sup>19</sup> ERISA §404(a)(1)(D), 29 U.S.C. §1104(a)(1)(D).

<sup>20</sup> Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation? Max Schanzenbach Assistant Professor of Law, Northwestern University School of Law  
[http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1146&context=berkeley\\_law\\_econ](http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1146&context=berkeley_law_econ)

<sup>21</sup> *Fall 2002 Journal of Pension Planning and Compliance Editor in Chief, Bruce J. McNeil*  
<http://www.nareit.com/newsroom/millerstudy.pdf>

<sup>22</sup> Roger Ibbotson, Ibbotson Associates. The True Impact of Asset Allocation on Returns

<sup>23</sup> ERISA §404(a)(1)(A)(i and ii); §406(a)(1)(C); §408(b)(2); *Liss v. Smith*, 991 F. Supp. 278 (SDNY 1998); Interpretive Bulletin 94-2, 29 CFR §2509.94-2. §2(a); §7; OCC Interpretive Letter No 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m at 58 (1992). ERISA §3(14)(B); §404(a)(1)(A), (B) and (D); §406(a); 29 CFR §2550.408(b)(2); Booklet, A look at 401(k) Plan Fees, US Dept. of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter 89-28A (9/25/89); Interpretive Bulletin 75-8, 29 CFR §2509.75-8. ERISA

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§404(a)(1)(A) and (B); §406(a)(1); §406(b)(1); §406(b)(3); *Brock v. Robbins*, 830 F.2d 640, 8 EBC 2489 (7th Cir. 1987); DOL Advisory Opinion Letter 97-15A; DOL Advisory Opinion Letter 97-16A (5/22/97).

<sup>24</sup> ERISA §404(a)(1)(A)(i and ii); §406(a)(1)(C); §408(b)(2); *Liss v. Smith*, 991 F. Supp. 278 (SDNY 1998); Interpretive Bulletin 94-2, 29 CFR §2509.94-2. §2(a); §7; OCC Interpretive Letter No 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m at 58 (1992). ERISA §3(14)(B); §404(a)(1)(A), (B) and (D); §406(a); 29 CFR §2550.408(b)(2); Booklet, A look at 401(k) Plan Fees, US Dept. of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter 89-28A (9/25/89); Interpretive Bulletin 75-8, 29 CFR §2509.75-8. ERISA §404(a)(1)(A) and (B); §406(a)(1); §406(b)(1); §406(b)(3); *Brock v. Robbins*, 830 F.2d 640, 8 EBC 2489 (7th Cir. 1987); DOL Advisory Opinion Letter 97-15A; DOL Advisory Opinion Letter 97-16A (5/22/97).

<sup>25</sup> The Battle for the Soul of Capitalism. John C. Bogle. Pages 153 and 154.

<sup>26</sup> <http://www.stanford.edu/~wfsjarpe/art/active/active.htm>

<sup>27</sup> Working Paper 13169, Abstract, <http://www.nber.org/papers/w13169> NATIONAL BUREAU OF ECONOMIC RESEARCH 1050 Massachusetts Avenue Cambridge, MA 02138 June 2007

<sup>28</sup> United States District Court for the Western District of Wisconsin; Hecker et. al. v. Deere & Company, Fidelity Management Trust Company, et. al., page 3

<sup>29</sup> Gregory W. Kasten, MD, MBA, CFP®, CPC, AIFA®, shared his findings in the Spring 2007 Journal of Pension Benefits. He says; “The effective average annual cost (published expense ratio plus turnover costs) was 1.28 percent for fixed income funds and a whopping **3.09 percent** for equity funds.” (emphasis added)

<sup>30</sup> Scale effects in mutual fund performance: The role of trading costs. Roger M. Edelen; Echo Investment Advisors, LLC; ReFlow Management, LLC edelen@echoadvisors.com Richard Evans Carroll School of Management Boston College Chestnut Hill, MA 02467 evansrb@bc.edu Gregory B. Kadlec Pamplin College of Business Virginia Tech Blacksburg, VA 24060 kadlec@vt.edu. Page 28.

<sup>31</sup> “It is a little known fact that specific trading (brokerage) costs can be found in the supplement to the financial statements of a fund entitled “Statement of Additional Information (SAI)” Page 12 [http://www.401khelpcenter.com/pdf/mdh\\_understanding\\_fees\\_v2.pdf](http://www.401khelpcenter.com/pdf/mdh_understanding_fees_v2.pdf)

<sup>32</sup> “Most investors think that the fund’s expense ratio (ER), listed in the prospectus and annual reports, is their true cost of fund ownership. **Wrong.** There are actually three **more** layers of expenses beyond the ER, which merely comprises the fund’s advisory fees (what the managers get paid) and administrative expenses. **The next** layer of fees are the commissions paid on transactions. These are not included in the ER, but since 1996 the SEC has required that they be reported to shareholders. However, they are presented in such an obscure manner that, unless one has an accounting degree, it is almost impossible to calculate how much return is lost as a proportion of fund assets. **The second** extra layer is the bid-ask spread of stocks bought and sold. A stock is always bought at a slightly higher price than it is sold, to provide the market maker with a profit. This “spread” is about .4% for the largest, most liquid, companies and increases with decreasing company size. For the smallest stocks, it may be as large as 10%. It is in the range of 1% to 4% for foreign stocks. For example, at the market close of business on April 12, 2000, Microsoft was quoted at a bid (the price at which an investor could sell the stock) of \$80.125 and an ask (the price at which an investor could buy the stock) of \$80.25. The difference – one eighth of a dollar – is the spread. Because Microsoft is one of the most actively traded stocks in the world, this represents just .15% of the price. At the other end of the spectrum, on the same day, Officeland, a tiny company dealing in used copying machines, traded at .65%/.70% of bid to ask, a spread of 7.7%. **The last layer** of extra expense – so called market impact costs – is the most difficult to estimate. Impact costs arise when large blocks of stock are bought and sold. Imagine that you own half of the shares of a small publicly traded company

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worth \$20 million. Let's further imagine that you have gotten yourself into a jam, need cash, and must quickly sell all of those shares. The selling pressure caused by your actions will drastically reduce stock price, and the last shares sold will fetch considerably less than the first shares sold.<sup>5</sup> (Emphasis added) William J. Bernstein, "The Intelligent Asset Allocator," pages 90 & 91

<sup>33</sup> An investor (a participant, a trustee, etc.) must be sufficiently informed through disclosure of sufficient and relevant data to construct a meaningful portfolio Interpretive Bulletin 94-2, 29 CFR §2509.94-2. UPIA §2(b); §4; Restatement of Trusts ed: Prudent Investor Rule §227(a).

<sup>34</sup> CIGNA Counsel motion to dismiss. Page 3, paragraph 2, second to last sentence. See also [http://www.plansponsor.com/pi\\_type11/?RECORD\\_ID=37333](http://www.plansponsor.com/pi_type11/?RECORD_ID=37333)

<sup>35</sup> Congressional testimony, United States House of Representatives, March 6, 2007. "Are Hidden Fees Undermining Retirement Security?"

[http://www.401khelpcenter.com/pdf/401k\\_fees\\_hutcheson\\_testimony.pdf](http://www.401khelpcenter.com/pdf/401k_fees_hutcheson_testimony.pdf) page 6. "TheStreet.com profiled a fund last year that had a 5 star rating, a 1% expense ratio, and **800 bps** in brokerage expense." "Fee Forensics: The impact of brokerage expense and trade execution in mutual fund portfolios." 2005 Annual Conference of the Center for Fiduciary Studies. Santa Fe, New Mexico.

<sup>36</sup> Ibid

<sup>37</sup> ERISA §404(a)(1)(A) and (B). Regulations – 29 CFR §2550.404a-1(b)(1)(A); 29 CFR §2550.404a-1(b)(2)(A); *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Communications Satellite Corporation v Federal Communications Commission*, 611 F.2d 883 (D.C. Cir. 1977).

<sup>38</sup> ERISA §404(a)(1)(B). Regulations – 29 CFR §2550.404a-1(b)(1)(A); 29 CFR §2550.404a-1(b)(2)(B)(iii); *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 23 EBC. 1001 (5th Cir. 1999)

<sup>39</sup> Testimony of C. Fredrick Reish to ERISA Advisory Council on matters pertaining to 404(c). <http://www.reish.com/publications/pdf/testimony.pdf>

<sup>40</sup> Paragraph 1. [http://www.reish.com/publications/article\\_detail.cfm?ARTICLEID=668](http://www.reish.com/publications/article_detail.cfm?ARTICLEID=668)

<sup>41</sup> IBID 5/15/2001 David Levin Quoting Department of Labor Annual Conference of the American Society of Pension Actuaries <http://www.drinkerbiddle.com/files/Publication/fb9caca8-b365-4ff0-9e5a-9eca71074fac/Presentation/PublicationAttachment/be44f1ea-2cf3-4463-a93c-a19699f9dd77/JPBArticleSpring2001-TheFableofFiduciary.PDF>

<sup>42</sup> United States Government Accountability Office, Report to the Ranking Minority Member, Committee on Education and the Workforce, House of Representatives. November 2006. Page 2

<sup>43</sup> Interpretive Bulletin 94-2, 29 CFR §2509.94-2. UPIA §2(b); §4; Restatement of Trusts ed: Prudent Investor Rule §227(a).

<sup>44</sup> Unnecessary and excessive services being rendered that are not "helpful to the plan." 29 CFR §2550.408(b)(2)

<sup>45</sup> ERISA §406(a)(1)(C)

<sup>46</sup> ERISA §406(b)(1)

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<sup>47</sup> “In general, compliance with the ERISA Section 404(c) regulations is not reviewed by the Department, as this is viewed as **mainly a defense for the fiduciary**” See footnote 41

<sup>48</sup> See footnotes 39, 40, 41, 42, and 43

<sup>49</sup> SEC Speech. Address to Mutual Fund Directors  
<http://www.sec.gov/news/speech/2007/spch041207cc.htm>

<sup>50</sup> SEC Speech. Address to National Italian-American Foundation  
<http://www.sec.gov/news/speech/2007/spch053107cc.htm>

<sup>51</sup> <http://www.ebia.com/WeeklyArchives/401k/CourtCases/19072>

<sup>52</sup> The Honorable George Miller Chairman Committee on Education and Labor House of Representatives  
The Honorable Edward J. Markey House of Representatives.  
<http://edlabor.house.gov/publications/GAOpensions062807.pdf>

<sup>53</sup> <http://www.stanford.edu/~wfsnarpe/art/active/active.htm>

<sup>54</sup> ERISA §404(a)(1)(A)(i and ii); §406(a)(1)(C); §408(b)(2); *Liss v. Smith*, 991 F. Supp. 278 (SDNY 1998); Interpretive Bulletin 94-2, 29 CFR §2509.94-2. §2(a); §7; OCC Interpretive Letter No 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m at 58 (1992). ERISA §3(14)(B); §404(a)(1)(A), (B) and (D); §406(a); 29 CFR §2550.408(b)(2); Booklet, A look at 401(k) Plan Fees, US Dept. of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter 89-28A (9/25/89); Interpretive Bulletin 75-8, 29 CFR §2509.75-8. ERISA §404(a)(1)(A) and (B); §406(a)(1); §406(b)(1); §406(b)(3); *Brock v. Robbins*, 830 F.2d 640, 8 EBC 2489 (7th Cir. 1987); DOL Advisory Opinion Letter 97-15A; DOL Advisory Opinion Letter 97-16A (5/22/97).

<sup>55</sup> ERISA §3(14)(A) and (B)

<sup>56</sup> ERISA §406(b)

<sup>57</sup> *Whitfield v. Tomasso*, 682 F. Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y. 1988); *Whitfield* at 1301

<sup>58</sup> The Supreme Court stated unequivocally in the case of *Varity v. Howe* [116 S Ct 1065 (1996)] that “to participate knowingly and significantly in deceiving a plan’s beneficiaries in order to save the employer money at the beneficiaries expense, is not to ‘act solely in the interests of the participants and beneficiaries.’”

<sup>59</sup> DOL Reg. §2509.94-2, Interpretive Bulletin 94.2; “...at the very least, trustees have an obligation to (i) determine the needs of a fund’s participants, (ii) review the services provided and the fees charged by a number of different providers, and (iii) select the provider whose service level, quality and fees best match the fund’s needs and financial situation. [In addition,] [t]rustees also have an ongoing obligation to monitor the fees charged and services provided by service providers with whom a fund has an agreement, to ensure that renewal of such agreements is in the best interest of the fund. [*Liss v. Smith*, 991 F. Supp. 278, 300 (S.D.N.Y. 1998), citing *Whitfield v. Tomasso*, 682 F. Supp. 1287, 1304, 9 E.B.C. 2438 (E.D.N.Y. 1988)]