

## UNCOVERING AND UNDERSTANDING HIDDEN FEES IN QUALIFIED RETIREMENT PLANS<sup>†</sup>

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*In the United States, the level of concern over 401(k) fees is steadily increasing. However, very few employers understand the nature and scope of the retirement plan industry's business model. Not even the federal government fully grasps the issue. Understanding how hidden fees came about, and recognizing the specific types and amounts of such fees, will help employers make better decisions regarding 401(k) services. This understanding will in-turn help create a more secure retirement for American workers.*

*In this article, Matthew Hutcheson outlines four key concepts necessary for understanding hidden 401(k) fees. First, notwithstanding the obscure nature of retirement plan economics, there is a rigorous way to determine the costs of any such plan. Second, directors, officers, and executives of plan sponsors have a fiduciary duty to know, manage, and control all of the fees charged to plan assets. Third, modern fee structures are the result of mingling fiduciary and nonfiduciary philosophies. Hidden and excessive fees can be corrected by embracing an "independent fiduciary only" approach toward plan management. Finally, there is more at stake than is generally contemplated. Correcting errant business practices in the 401(k) industry is important for participants, plan sponsors, and society as a whole.*

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The original paper, *Uncovering and Understanding Hidden Fees in Qualified Retirement Plans*, was commissioned by the Bureau of National Affairs' (BNA) Legal Library in 2004. After mutual deliberation and consideration between the BNA and I, it became apparent that this particular paper would be better published through a venue such as the 401khelpcenter.com (<http://www.401khelpcenter.com>), whose mission is to publish varying views of 401(k) matters with the intent to deliver objective insight to its visitors.

Since 2004, this paper has been viewed, printed, downloaded, or e-mailed hundreds of thousands of times. It has been studied by the White House, members of Congress, the Department of Labor (DOL), the United States Government Accountability Office (GAO), professors, attorneys, plan sponsors, and others.

Considering the interest in 401(k) and other defined contribution plan fees, it seems timely to publish an updated version clarifying and expanding upon certain points. Also, it seems reasonable to add a discussion of recent legislation and litigation, as well as to include a statement of the principles that shape the conclusions and recommendations in the paper.

## I. Introduction

The level of concern over 401(k) fees is steadily increasing. The fact that the industry is not effectively working toward resolving these concerns could be indicative of an entrenched system that is unwilling or unable to change. Consider the following statement from John Bogle, founder of the Vanguard Investment Group, on PBS' Frontline:

The financial system put[s] up zero percent of the capital and [takes] zero percent of the risk and [gets] almost 80 percent of the return, and you, the investor in this long time period, an investment lifetime, put up 100 percent of the capital, [take] 100 percent of the risk, and [get] only a little bit over 20 percent of the return. That is a financial system that is failing investors because of those costs of financial advice and brokerage, some hidden, some out in plain sight that investors face today. So the system has to be fixed.<sup>1</sup>

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1. Interview by Public Broadcasting Service: Frontline with John C. Bogle, Founder, The Vanguard Group, Inc. (Feb. 7, 2006) (emphasis added), available at <http://www.pbs.org/wgbh/pages/frontline/retirement/interviews/bogle.html> (emphasis added).

While the debate rages over hidden or excessive fees, we know for sure the conventional 401(k) plan is burdened with unnecessary services and those services drive unnecessary fees—many of which are hidden.<sup>2</sup>

The United States has not yet adopted the common sense view, prevalent in other countries,<sup>3</sup> that the duties of a retirement plan fiduciary should be separate from the duties of the business executives who administer the plan on behalf of the firm. In many other countries, a bright line separates the role of the independent fiduciary (who is beholden solely to the plan participants) from that of the directors, officers, and executives of the business that sponsors the plan (whose primary duty is to the company's shareholders).<sup>4</sup> However, in the United States these roles are merged,<sup>5</sup> resulting in the sorts of egregious pension fund scandals that make headlines,<sup>6</sup> as well as the more subtle, day-to-day conflicts of interest that inevitably cloud the thinking of decision makers regarding plan assets. Even if there were no inherent conflict of interest between the needs of the business and the best interests of plan participants, the practical fact is executives are

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2. *Id.* (noting many 401(k) fees are hidden).

3. *See, e.g.*, The Bachmann Group <http://www.bachmanngroup.com> (last visited Nov. 12, 2007); Jupiter, <http://www.jupadmin.co.uk> (last visited Nov. 12, 2007); Trident Trust, <http://www.tridenttrust.com> (last visited Nov. 12, 2007). A truly independent fiduciary is able to run a plan separate from its sponsor, but in accordance with the terms of the plan and trust. There are many so-called "Fiduciary Firms" in the United States, but only a few truly independent firms that play the role a plan sponsor would otherwise play. In contrast, Independent Pension Fiduciaries such as the Bachmann Group, Trident Trust, or Jupiter have been the norm in the United Kingdom for decades.

4. *Cf.* Mark R. Paul & Charles A.A. Whitefoord, *All Buyouts Are Not the Same: It Can Be Different in England*, BUS. L. TODAY, Mar.–Apr. 2000, <http://www.abanet.org/buslaw/blt/blt00mar-buyout.html>.

The American understanding of fiduciary duty holds that management is duty bound to represent the interests of the target corporation's stockholders in the transaction. This duty is usually interpreted as maximizing the share value of the company's stock in the sale. . . . In the United Kingdom, by comparison, the directors owe their fiduciary duty not to the shareholders, but to the company as a whole. That means that their primary focus is on the interests of the company and the effect of any transaction on the company.

*Id.* The view therefore that directors in the United Kingdom view their fiduciary duties differently can then be expanded to explain why the settler (corporation) in the United Kingdom will generally have an independent fiduciary to manage their "pension schemes." *Id.*

5. *See infra* Part III.C.

6. *See, e.g.*, Mary Williams Walsh, *New Jersey Says Its Pension Fund Is Being Examined by the S.E.C.*, N.Y. TIMES, June 1, 2007, at B1; Mary Williams Walsh, *San Diego Sues Company That Invested Pension Fund*, N.Y. TIMES, Aug. 19, 2005, at C3.

occupied with running their businesses and simply do not have the time or expertise required to serve as true fiduciaries to the plan participants.

Enter the 401(k) industry. Financial services firms offer to handle the investment decisions, trading, and administrative tasks associated with the portfolio of assets within the plan—often at zero disclosed cost.<sup>7</sup> Although almost everyone understands at a visceral level that the industry is receiving undisclosed compensation, the methods used to extract those fees are complex<sup>8</sup> and difficult for the busy executives of plan sponsors to follow. The profitability of the 401(k) industry depends upon the magnitude of the fees it can extract from plan assets and plan sponsors—not on how well it protects and enhances the retirement income security of plan participants.<sup>9</sup>

Because a significant difference exists between the duties of a truly independent fiduciary and the profit motives of financial services firms, the 401(k) industry simply is not “getting it done” for America’s workforce; the results just are not there. At the heart of the issue is a profit-oriented, nonfiduciary business model that creates unnecessary and costly services, sells them to plan sponsors as “valuable,” charges additional and often hidden fees, and then fails to assume any responsibility for the poor investment performance that follows.

A clear example of the attitude prevalent in the 401(k) industry is illustrated by the statement of Fidelity’s spokesperson in a *Wall Street Journal* article covering a lawsuit filed in late 2006 against Fidelity Investments and Deere & Company:

The Fidelity spokesman said the company believes it provides “valuable services to 401(k) clients for whom Fidelity serves as a record keeper and a trustee. We believe that the fees . . . collected by Fidelity for those services are reasonable.” He added that “Fi-

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7. See, e.g., FreeErisa.com, John Deere Pension Plan for Salaried Employee—Form 5500 Schedule H, <http://freeerisa.com> (last visited Nov. 12, 2007) (register for access code; enter [http://www.freeerisa.com/5500/InstantView.asp?mainID=10721358&Show=DOL\\_H](http://www.freeerisa.com/5500/InstantView.asp?mainID=10721358&Show=DOL_H)). Deere and Company was sued in 2006 for excessive, unreasonable, and hidden fees. To illustrate the issue of undisclosed costs, consider Deere’s 2003 5500 filing, Schedule H, containing the Plan’s financial statements. Under Section II, Income and Expense Statement, Deere has reported zero (\$0) administrative or management fees. *Id.*

8. See U.S. GOV’T. ACCOUNTABILITY OFFICE, PRIVATE PENSIONS: CHANGES NEEDED TO PROVIDE 401(k) PLAN PARTICIPANTS AND THE DEPARTMENT OF LABOR BETTER INFORMATION ON FEES 15–18 (2006) [hereinafter GAO REPORT].

9. See *infra* Part II.A.

delity retail mutual funds consistently rank against their . . . peers as among the lowest priced mutual funds.”<sup>10</sup>

The subtle error in this statement is that it is not the seller, but the buyer, who should determine whether fees are reasonable. In a free market, where buyers and sellers have equal access to all relevant information, vendors do not dictate to consumers the costs they should, or will, bear.<sup>11</sup> Defying fundamental economic principles, the 401(k) industry has temporarily gotten away with dictating prices because information is not equally disclosed or equally available to buyers and sellers. Because the directors, officers, and executives of plan sponsors have limited insight into the fees and costs the plan is incurring, it is virtually impossible to control those expenses.

To underscore this point, the GAO reported the following:

[The Department of] Labor has authority under ERISA to oversee 401(k) plan fees and certain types of business arrangements involving service providers, *but lacks the information* it needs to provide effective oversight.<sup>12</sup>

If the DOL lacks sufficient information about fees, how can an employer of any size be expected to truly understand, monitor, and control the fees in its plan? Certainly they lack sufficient information as well. Many employers, especially the larger ones, think they are in possession of all information about the fees paid by their plans. Unfortunately, just like the DOL, most employers—both large and small—simply do not possess the insight to ask the right investigative questions and lack the resources to follow the money trail all the way to its conclusion.

Furthermore, those who do understand what questions to ask are seemingly all too eager to accept the canned answers they are given. Employers must have the courage to untangle the Gordian knot that has bound the retirement income security of millions of American workers over recent decades. Much is at stake for plan sponsors, their directors and officers, plan participants, and for society as a whole.<sup>13</sup> There may be no larger sociopolitical problem than the

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10. Tom Lauricella, *Fidelity Is Sued Over 401(k) Fees—Proposed Class Action Aims at Disclosure Practices Regarding Revenue Sharing*, WALL ST. J., Dec. 14, 2006, at C13.

11. Press Release, U.S. Sec. & Exch. Comm’n, Alliance Capital Management Will Pay Record \$250 Million and Make Significant Governance and Compliance Reforms to Settle SEC Charges (Dec. 18, 2003), <http://sec.gov/news/press/2003-176.htm>.

12. GAO REPORT, *supra* note 8, at 2 (emphasis added).

13. See *infra* Parts II, III.

retirement income security of America's workforce. Diligence and honesty are required to unravel the mystery; courage and perseverance are necessary to solve the problem.

Plan sponsors and regulators must uncover a closely guarded secret which lies at the core of the issue of excessive and hidden fees. Consider the following:

Revenue sharing is the "big secret" of the retirement industry. This practice has created an environment that makes it hard for employers and employees to understand the true cost of their retirement services. Gross inequities can exist for both plan sponsors and participants.<sup>14</sup>

"Revenue sharing" is a euphemism for kickbacks from one financial service firm to another and is a common economic driver of conflicts of interest.<sup>15</sup> However, it is not the only hidden fee charged by those in the 401(k) industry. Other sources of fees and costs charged by financial services firms have two dramatic and negative effects on employers and employees alike. First, hidden fees impair the retirement income security of plan participants. Second, unknown costs expose the directors, officers, and executives of plan sponsors to legal liabilities about which they are almost universally unaware. Until employers acknowledge there are elements of their plans they do not understand and their lack of understanding puts both the plan sponsor and the participants at risk, Wall Street firms will continue to advance conventional philosophies and products, fees will be too high, and retirement incomes—the livelihoods of millions of Americans—will be impaired.

The following excerpts illustrate the extent of the problem. I have previously stated, "[r]evenue sharing that is initiated by providers attempting to cut employer out-of-pocket costs adversely affects millions of 401(k) plan participants and sponsors."<sup>16</sup> Former Illinois Senator Peter Fitzgerald declared on November 3, 2003, "[t]he mutual fund industry is now the world's largest skimming operation—a \$7 trillion (now \$12 trillion) trough from which fund managers, brokers, and other insiders are steadily siphoning off an excessive slice of the

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14. MCHENRY CONSULTING GROUP, REVENUE SHARING IN THE 401(k) MARKETPLACE: WHOSE MONEY IS IT? 1 (2001).

15. Matthew D. Hutcheson, Retirement Plan Disclosure: A Declaration of Ethical Principles and Legal Obligations 15–16 (July 4, 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=998127> (follow "Social Science Research Network" hyperlink under "SSRN Electronic Paper Collection").

16. *Id.* at 3.

nation's household, college, and retirement savings."<sup>17</sup> (\$12 trillion update added) A Securities and Exchange Commission (SEC) speech to mutual fund directors on April 12, 2007 concluded that

[t]o far too great a degree, and in substantial part because of a regulatory cumbersomeness that *obscures the real numbers*, [query: what are 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>18</sup>

And a separate SEC speech to the National Italian-American Foundation given a little more than a month later stated that "[t]his witch's brew of *hidden fees*, conflicts of interest and complexity in application is at odds with investors' best interests."<sup>19</sup>

Markets work most efficiently, and most fairly, when buyers and sellers have equal power. In the complex world of financial services, knowledge is power. And in the 401(k) industry, virtually all of the information is held by the sellers (financial services firms on Wall Street) and withheld from the buyers (plan sponsors and participants). It is not surprising, therefore, that gross inequities exist. The solution is simple; it merely requires identifying and disclosing the true nature and extent of 401(k) fees to plan sponsors. With equal knowledge, the market will function to protect the interests of buyers and sellers fairly.

At a visceral level, many plan sponsors understand the playing field is tilted against them. Yet most are unable or unwilling to acknowledge their ignorance in this highly specialized area. They may fear the fiduciary legal exposure inherent in that ignorance and take comfort in the herd mentality of their peers and the soothsaying of the experts on Wall Street. Although ignorance is no excuse under the law, many plan sponsors seem content to accept the status quo offerings of brand-name financial services firms and turn a blind eye to-

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17. *Mutual Funds: Trading Practices and Abuses That Harm Investors: Hearing Before the Subcomm. on Financial Management, The Budget, and International Security of the S. Comm. on Governmental Affairs*, 108th Cong. 3 (2003) [hereinafter *Fitzgerald Statement*] (Statement of Sen. Peter Fitzgerald, Chairman, Subcomm. on Financial Management, The Budget, and International Security).

18. Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), available at <http://www.sec.gov/news/speech/2007/spch041207cc.htm> (query/comment added).

19. Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Address to the National Italian-American Foundation (May 31, 2007), <http://www.sec.gov/news/speech/2007/spch053107cc.htm> (emphasis added).

ward the uneven playing field, with the resultant damage to retirement incomes.

Sadly, it has taken aggressive legal action to bring this issue to a head. Joe Faucher, of Reish, Luftman, Reicher, & Cohen, almost prophetically predicted in his article, *Excessive 401(k) Plan Fees and Costs: The Coming Storm in ERISA Litigation?*, that it could very well take such litigation to effectuate change.<sup>20</sup>

The remainder of this article is organized into four parts: Part II discusses fiduciary philosophy and why the current fee environment results largely from the lack of independent fiduciary oversight; Part III explores industry fee practices and associated fiduciary responsibilities, and provides a historical context; Part IV discusses the most pervasive hidden fees and discusses the influence DOL Regulation 404(c) has had on fees; and, Part V presents concluding thoughts on a solution.

## II. Philosophy

Although some would argue otherwise, it is my position that trying to “beat the market” is a futile and expensive exercise.

Few people achieve a fair return on their investments given the risks they take . . . [S]tudies conclude that “beat the market” advice almost always fails, hampering retirement savings in the long-term . . . The allure of beating the market has created huge profits for those *selling* investment products and services; however, investors in those products have experienced a large gap between their return and the return of the markets.<sup>21</sup>

The added costs associated with conventional methods of plan management, including active fund management and the associated excessive services spawned therefrom, purportedly exist to capture better-than-market returns.<sup>22</sup> However, this is a subtle falsehood. The added costs only pay for the privilege of chasing better-than-market returns; they do not ensure them. It is commonly asserted that if the added costs result in added returns, then the added costs were worth it. However, “[p]rediction is very difficult, especially if it’s about the

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20. Joe Faucher, *Excessive 401(k) Plan Fees and Costs: The Coming Storm in ERISA Litigation*, ERISA CONTROVERSY REP., Feb. 2005, [http://www.reish.com/publications/article\\_detail.cfm?ARTICLEID=506](http://www.reish.com/publications/article_detail.cfm?ARTICLEID=506).

21. RICHARD A. FERRI, SERIOUS MONEY: STRAIGHT TALK ABOUT INVESTING FOR RETIREMENT 2 (1999), <http://www.portfoliosolutions.com/v2/pdf/Introduction.pdf> (emphasis added).

22. *See id.*



future.”<sup>23</sup> The stock market’s behavior cannot be predicted on a consistent basis,<sup>24</sup> yet our entire defined contribution retirement system, to an overwhelming degree, is based upon just the opposite proposition.

Recent studies reveal (and many more continue to substantiate), that a passive 60% stock, 40% bond portfolio outperformed 90% of the nation’s largest corporate pension plan portfolios, “run by the world’s best and brightest investment minds.”<sup>25</sup> The average return on actively managed equity mutual funds over the past 35 years trails the S&P by 87 basis points per year, and 105 basis points on broader indexes.<sup>26</sup> “Over long periods, this difference in return amounted to substantial differences in wealth.”<sup>27</sup> This is an unnecessary waste of participant’s hard earned money.

This is why most academic and many professional advisors recommend that the best investment strategy is to match the market’s performance. You can do this by putting your money in a fund that holds all stocks in proportion to their market value. Since these index funds do no research and little trading, the costs of holding their portfolios are extremely small, some ranging as low as 0.10 percent a year.<sup>28</sup>

If this assertion is true, then any cost incurred to try to beat the market is wasted money, ultimately reducing retirement incomes.

#### A. Costs Determine 401(k) Profitability

[T]here is no other proposition in economics that has more solid empirical evidence supporting it than the Efficient Market Hypothesis [(EMH)]. . . . In the literature of finance, accounting, and

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23. STEVE MORGAN & JEREMIAH HURLEY, *THE FISCAL SUSTAINABILITY OF HEALTH CARE IN CANADA* 27 (Gregory P. Marchildon et al. eds., 2004).

24. TAYLOR LARIMORE ET AL., *THE BOGLEHEADS’ GUIDE TO INVESTING* 166 (2006) (quoting Warren Buffett’s mentor Benjamin Graham) (“If I could have noticed anything over these 60 years on Wall Street, it is that people do not succeed in forecasting what’s going to happen to the stock market.”).

25. *Are Hidden 401(k) Fees Undermining Retirement Security?: Hearing Before the H. Comm. on Education and Labor, 110th Cong. 13* (2007) [hereinafter *Hutcheson Statement*] (statement of Matthew D. Hutcheson (quoting FUTUREMETRICS, DIMENSIONAL FUND ADVISORS, BASIC 60/40 STRATEGY VS. COMPANY PLANS 1987–2003 (2004))).

26. *Id.*

27. *Id.*

28. Jeremy Siegel, *Indexing Your Portfolio: The Evolution of Indices*, YAHOO! FIN., June 30, 2006, <http://finance.yahoo.com/expert/article/futureinvest/6953>.

the economics of uncertainty, the EMH is accepted as a fact of life.<sup>29</sup>

Nobel Laureate William F. Sharpe asserts that the difference between market returns and actual return is cost.<sup>30</sup> This profound statement leads to two fundamental questions. First, “What represents ‘market returns?’” Based upon academic research and empirical evidence, a low-cost 60/40 balance of diversified large-cap equity and multi-sectored bond funds reflects Sharpe’s definition of the “market.”<sup>31</sup> Therefore, “market returns” reflect the investment returns on such a portfolio. There exists a wide array of low-cost Exchange Traded Funds (ETFs), collective trusts, and index mutual funds enabling investment in the market generally, thereby avoiding the costs of active management and its associated overhead, fees, and costs.<sup>32</sup> In short, by purchasing index-tracking equity and bond ETFs, collective trust funds or low-cost mutual funds, every 401(k) investor should be able to achieve market returns.

In light of a clear and attainable measure of market returns, the amount of fees also becomes rigorously quantifiable. *Any gap between the returns of a particular 401(k) plan and market returns represents the actual costs of the plan.* Because it certainly costs something to prudently administer an effective 401(k) plan, the second logical question is, “What is a reasonable fee for managing a plan that consistently obtains near-market returns?”

Given an objective measure of market returns, the buyer of financial services (for example, the plan sponsor) is armed with sufficient information to make a prudent and informed decision. Understanding the relative costs of alternatives boils down to simple math. The costs and fees of the plan are reflected in the amount by which the investment performance deviates from the objective market standard.

In light of that conclusion, a plan sponsor’s objective should be to ensure that plan investments deliver, as nearly as possible, market returns. No fiduciary—whether independent or internal to the plan sponsor—can be expected to do any better over the long term. Con-

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29. Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95–98 (1978).

30. William F. Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J. 7, 9 (1991).

31. See, e.g., B. O’NEIL WYSS, FUNDAMENTALS OF THE STOCK MARKET 137 (2002).

32. See Sharpe, *supra* note 30, at 7 (observing that active managers must pay for more research and more trading).

versely, failing to earn such returns on a consistent basis is an indicator of excessive fees and costs. The retirement plan industry, unfortunately, does not operate under this paradigm, nor can it if the status quo is to be maintained. The reality is, “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>33</sup>

In order to differentiate their services and provide investment features that may be personally appealing to the directors, officers, and executives of a plan sponsor (the decision makers), Wall Street firms layer in costs that diminish the long-term retirement income security of plan participants.<sup>34</sup> Despite the marketing sizzle of lifestyle funds, self-directed investment tools, and trading features, the fact remains that the vast majority of plan participants are singularly unqualified to make investment decisions—particularly in light of the fact that, historically, the vast majority of professionally managed funds do not out-perform index funds.<sup>35</sup>

Plan sponsors, whose directors, officers, and executives have almost always, knowingly or not, served as “fiduciaries” under DOL regulations,<sup>36</sup> should focus on the objective of delivering retirement income to plan participants as efficiently as possible. Any other fiduciary activity, or lack thereof, that works contrary to securing adequate retirement income is, at a minimum, a fiduciary breach and, at worst, fiduciary malfeasance.<sup>37</sup>

In order to understand the gravity and necessity of minimizing costs in order to maximize the performance of invested assets, it is critical to understand the nature of the fiduciary duties held by plan sponsors. In sum, the plan sponsor takes on the responsibility for the

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33. Jeffrey R. Brown et al., *Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans*, at Abstract (Nat'l Bureau of Econ. Research, Working Paper No. 13169, 2007) (emphasis added).

34. Robert Brokamp, *The Fund Fees You Don't See*, MOTLEY FOOL, Feb. 18, 2004, <http://www.fool.com/investing/ira/2004/02/18/the-fund-fees-you-dont-see.aspx> (noting many equity funds have a management fee or expense ratio of up to 3% per year, after hidden fees like portfolio turnover costs, sales charges, opportunity costs, and out-of-pocket fees are included, which means that the average mutual fund has to earn 3% a year just to break even).

35. Brown et al., *supra* note 33, at 4.

36. See EMPLOYEE BENEFITS SEC. ADMIN., U.S. DEP'T OF LABOR, MEETING YOUR FIDUCIARY RESPONSIBILITIES 1–2 (2006), available at <http://www.dol.gov/ebsa/pdf/fiduciaryresponsibility.pdf> (noting that a person or entity using discretion in administering, managing, or controlling a plan is a fiduciary to the extent of that discretion or control).

37. *Id.* at 2.

retirement income security of plan participants and their beneficiaries.<sup>38</sup> To properly fulfill its duties, the fiduciary cannot take into consideration the interests of the sponsoring company, any service providers to the company, nor any other nonparticipant in the plan—including investment banks which may profit from the public offering of the sponsor's corporate stock, or assist it with securities offerings.<sup>39</sup> Yet those fiduciary duties are difficult to fulfill with the proper level of care, expertise, and prudence, and plan sponsors often fall victim to three forces that hem them in and limit their ability to serve the best interests of their employees.

### B. The “Sponsor’s Trap”

I go to [trade meetings] every year, in part to see how bad it is. I went to one seminar, how to succeed in a multi-product—I hate the word “product”—multichannel marketplace. When he got to the end, he said, “Now, if you’ve gotten my point, you know that to succeed in those markets you need to do only one thing: Pay the distributor the most money. The more you pay, the more distribution you get.”<sup>40</sup>

Many companies start down the 401(k) path with the worthy objective of providing their employees the chance to retire with dignity. Though they need to offer a competitive compensation package to prospective employees, that self-interest is, at least at the outset, consistent with the long-term best interests of their workers. Despite those initial laudable goals, many employers have fallen victim to what might be termed the “Sponsor’s Trap” of excessive, often hidden, fees and costs.<sup>41</sup> That trap is bounded by the following three forces:

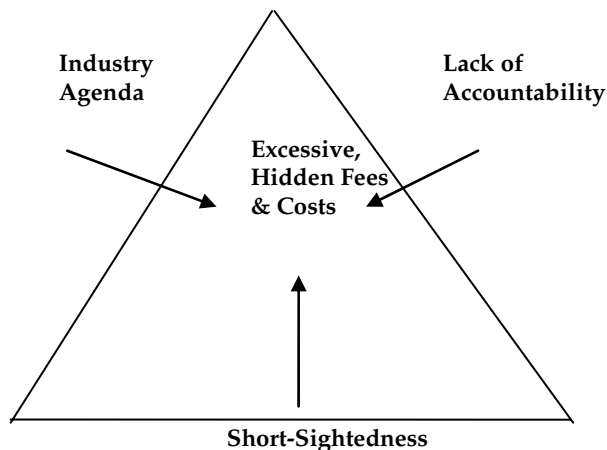
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38. *Id.* at 8–9.

39. *See id.* at 2.

40. Todd Mason, *Acerbic Moral Compass*, PHILA. INQUIRER, Oct. 23, 2005, at C01.

41. *See* Faucher, *supra* note 20.

**Figure 1**

### 1. INDUSTRY AGENDA

It has become common for plan sponsors to delegate the authority to determine the plan's investment options to the financial services industry.<sup>42</sup> In many instances, financial firms are granted absolute discretion regarding investment decisions for plan participants.<sup>43</sup> But those financial services firms answer to their owners, not to plan participants. In fact, their interests can be viewed as diametrically opposed to the interests of the American workers whose retirement funds they are entrusted to invest. Every dollar financial services firms receive in fees—whether hidden or disclosed—is a dollar that is no longer available to support the retirement income of an American worker. Within this context, and with trillions of dollars under their control, it is not surprising that such firms have powerful economic

42. Maureen Nevin Duffy, *Outsourcing a 401(k) Plan*, 191 J. ACCT. 30, 30–35 (2001).

43. ALICIA H. MONNELL & ANNIKA SUNDÉN, CTR. FOR RET. RESEARCH, 401(K) PLANS ARE STILL COMING UP SHORT 6 (2006), [http://www.bc.edu/centers/crr/issues/ib\\_43b.pdf](http://www.bc.edu/centers/crr/issues/ib_43b.pdf).

incentives to offer only those products and services that maximize their own economic performance—often at the expense of plan participants.<sup>44</sup> No individual plan sponsor has the expertise or power to be anything other than a “price-taker.” Just as the farmer is at the mercy of the commodity markets that determine the price of his harvest, so the plan sponsor is at the mercy of the product offerings of Wall Street. The lack of plan sponsor power establishes the first barrier to optimal results in the “Sponsor’s Trap.”

## 2. LACK OF ACCOUNTABILITY

Milton Friedman, the Nobel Prize-winning economist, said in an interview with Fox News:

There are four ways in which you can spend money. You can spend your own money on yourself. When you do that, why then you really watch out what you’re doing, and you try to get the most for your money. Then you can spend your own money on somebody else. For example, I buy a birthday present for someone. Well, then I’m not so careful about the content of the present, but I’m very careful about the cost. Then, I can spend somebody else’s money on myself. And if I spend somebody else’s money on myself, then I’m sure going to have a good lunch! Finally, I can spend somebody else’s money on somebody else. And if I spend somebody else’s money on somebody else, I’m not concerned about how much it is, and I’m not concerned about what I get. And that’s government. And that’s close to 40% of our national income.<sup>45</sup>

While Friedman’s point was to emphasize the inherently inefficient and wasteful nature of government spending, his third scenario is even more pernicious and best describes the current state of the 401(k) industry. Financial services firms are spending someone else’s money—the savings of the American worker—on themselves and are certainly enjoying “a very good lunch” in the process.

Unfortunately for plan participants, plan sponsors, who have the ultimate fiduciary responsibility for preventing this sort of abuse, cannot see through the haze well enough to know how much of the participants’ money is being spent on financial services.<sup>46</sup> In short, the

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44. PSCA.org, Starting a Profit Sharing or 401(k) Plan, <http://www.psc.org/starting.html> (last visited Nov. 12, 2007); see *infra* Part III.D.

45. Interview by David Asman with Milton Friedman, (May 15, 2004), available at <http://www.foxnews.com/story/0,2933,230045,00.html>.

46. See Andrew S. Hartley, *Making the Case for Mandatory Removal of Imprudent Investment Vehicles: Inside Information Can Make Employer Securities a Bad 401(k) Option*, 5 APPALACHIAN J.L. 99, 105 (2006).

lack of accountability paralyzes the sponsor from taking action and erects a critical second barrier in the “Sponsor’s Trap.”

### 3. SHORT-SIGHTEDNESS

Poor management of financial assets, and the failure to manage and reduce fees in 401(k) plans, can have devastating financial effects in the future in two respects. First, the lives of individual American workers are debilitated by the lack of secure and adequate retirement income. Second, society as a whole will undoubtedly suffer as those retirees are unable to participate in the economy in a meaningful way due to inadequate retirement income. One suboptimal plan hurts individuals; yet many such plans hurt the economy generally. These long-term effects are beyond the comprehension of all but the most astute and careful thinkers, but are certainly the inevitable results of ignoring the current state of affairs. Plan sponsors cannot be expected to see the horizon (the long-term implications of their decisions today) when they cannot clearly see the road at their feet. The lack of long-term vision on the part of those serving as plan fiduciaries constitutes the third barrier in the “Sponsor’s Trap.”

So what? To illustrate the depth of the problem of excessive fees, the following comments from industry leaders should be read together:

#### Costs Depress Returns, Not Increase Them—

1. John Bogle observes, “An obvious and documented inverse relationship . . . clearly links mutual fund costs and mutual fund returns.”<sup>47</sup>
2. Nobel Laureate William Sharpe adds,

If “active” and “passive” management styles are defined in sensible ways, it must be the case that before costs, the return on the average actively managed dollar will equal their return on the average passively managed dollar and 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>48</sup>

#### Individual Investors Underperform the Market—

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47. JOHN C. BOGLE, *THE BATTLE FOR THE SOUL OF CAPITALISM* 153–54 (2005).

48. Sharpe, *supra* note 30, at 7 (emphasis added).

3. Jeremy Siegel writes, "The average stock investor lags the market by about 5% per year."<sup>49</sup>
4. John Bogle adds, "During the past 20 years...the average fund investor [i.e., participant] earned just 3%."<sup>50</sup>

The stock market has returned approximately 12% over the past twenty years, so the combination of fees and poor investment decisions have cost individual mutual fund investors somewhere between 5% and 9% annually.<sup>51</sup> John Bogle attributes 3% to the overhead and operating costs of the mutual funds themselves,<sup>52</sup> with the remainder resulting from additional pass-through administration fees, including custodial charges, Certified Public Accounting (CPA) audit fees born by the trust, and poor investment decisions.<sup>53</sup> Because most investment decisions are made by the mutual fund managers themselves,<sup>54</sup> the underperformance of those funds should also be viewed as a cost to investors in those funds. The remainder of the underperformance can be attributed to the self-directed investment decisions of individual participants.<sup>55</sup>

If we return to our prior conclusion that anything less than market returns reflect the fees and costs of the plan, then a competitive market will, over time, determine the proper level of services and as-

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49. JEREMY J. SIEGEL, *STOCKS FOR THE LONG RUN: THE DEFINITIVE GUIDE TO FINANCIAL MARKET RETURNS AND LONG-TERM INVESTMENT STRATEGIES* 292 (2d ed. 1994).

50. *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 403 (2004) [hereinafter *Bogle Statement*] (statement of John C. Bogle, Founder, the Vanguard Group, Inc.).

51. *Mutual Funds: Trading Practices and Abuses That Harm Investors: Hearing Before the Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Homeland Security and Governmental Affairs*, 108th Cong. 147-48 (2003) [hereinafter *Bogle Subcomm. Statement*] (statement of John C. Bogle, Founder, the Vanguard Group).

52. *Id.*

As the trained, experienced investment professional's employed by the industry's managers compete with one another to pick the best stocks, their results average out. Thus, the average mutual funds *should* earn the market's return *before costs*. Since all-in fund costs can be estimated at something like 3% per year, the annual lag of 2.9% in after-cost return seems simply to confirm that eminently reasonable hypothesis.

*Id.* (emphasis added).

53. GAO REPORT, *supra* note 8, at 12-13.

54. *See* Bogle Subcomm. Statement, *supra* note 51, at 133.

55. *See id.* at 149.



sociated fees. It is impossible to determine what exactly the proper level is within today's circumstances.

### III. Summary of Industry Fees and Fiduciary Duties

#### A. The "Big Secret" Revealed

Investment fees, which are charged by companies managing mutual funds and other investment products for all services related to operating the fund, comprise the majority of fees in 401(k) plans and are typically borne by participants.<sup>56</sup>

It is a fundamental truth that plans, and therefore participants, are paying the costs of investing. Most participants, however, are unaware of the costs of doing so.

Recently there has been a lot of press surrounding 401(k) fees and the lawsuits being filed against larger well known vendors. Revenue sharing, "Sub-TA" fees, "shareholder servicing fees," "12b1's," "finders fees," "wrap fees," "mortality fees," "market adjustment fees," etc. . . . the list is growing and no matter what your vendor may call them in the eyes of an attorney and more importantly to your participants they all equal one thing, "kick-backs".<sup>57</sup>

While the industry bristles at the term kickback, the consuming public views these fees as exactly that, and of dubious value to anyone except those receiving the payments.<sup>58</sup> Such fees are significant, too. I have consistently found that "low-cost" plans cost 3% of plan assets annually.<sup>59</sup> More expensive plans can cost 5% or more per year.<sup>60</sup> This

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56. GAO REPORT, *supra* note 8, at 2.

57. E-mail from Jim Johnson, Vice-President, McCready and Keene, to the author (Jan. 17, 2007, 07:46 EST) (on file with *The Elder Law Journal*) (emphasis added).

58. *Id.*

59. Brokamp, *supra* note 34; David Gardner & Tom Gardner, *Bogle Talks Scandal*, MOTLEY FOOL, Nov. 11, 2003, <http://www.fool.com/specials/2003/03111100ceo.htm>; see also Gregory W. Kasten, *High Transaction Costs from Portfolio Turnover Negatively Affect 401(k) Participants and Increase Plan Sponsor Fiduciary Liability*, 14 J. PENSION BENEFITS 50, 51 (2007) ("The effective average annual cost (published expense ratio plus turnover costs) was 1.28% for fixed income funds and a whopping 3.09% for equity funds." (emphasis added)); Walter Updegrave, *Do I Need a Financial Adviser?*, CNN MONEY, July 26, 2002, [http://money.cnn.com/2002/07/24/pf/expert/ask\\_expert/](http://money.cnn.com/2002/07/24/pf/expert/ask_expert/):

Keep in mind that these fees are almost always on top of the underlying fees charged by the mutual funds. Which means the total fee you're paying can really begin to add up. Let's say, for example, you find an adviser willing to handle your \$100,000 portfolio of stock funds for 1.5%. If your stock funds also have annual expenses of 1.4% or so—which is about the average for domestic stock funds, then effectively a total of 2.9% in expenses each year is being deducted from your fund portfolio's return before any of the gain filters down to you.

is substantially greater than what most employers understand their costs to be.<sup>61</sup> High and/or hidden fees in retirement plans are an important component of overall costs. These fees must be understood by both plan fiduciaries at the micro level and the DOL as a matter of public policy if both groups are to fulfill their duties.<sup>62</sup> A simple example will help illustrate this.

When evaluating costs, one must start at the very beginning. All charges, fees, costs, etc. impact the return participants receive, and hence *all* are relevant to the dialogue. There are *investment level costs*, such as fund management fees, and *plan level costs*, such as record-keeping costs. In total, there are many different types or categories of fees, costs, and/or charges that can be paid via the funds themselves, or through the submittal of an invoice to a trustee, who then authorizes payment from plan assets.<sup>63</sup>

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(emphasis added). The transaction and impact costs were not included in the example above. If transaction costs are added to the total, the figure could easily exceed 4%, and 5% if the underlying vehicle is a variable annuity.

60. Updegrave, *supra* note 59. The transaction and impact costs were not included in the 2.9% number cited above. If the average computed in this paper was added, as it should be, the 2.9% figure would jump to 4.25%.  $2.9\% + 1.35\% = 4.25\%$ . Using this same example, if the account were instead a variable annuity, the total cost could exceed 5% if additional contract, insurance, and other associated add-ons are included in the grand total.

61. Kathy Chu, *401(k) Fees Can Chomp a Hole in Your Savings: Charges Can Be Hard to Find*, USA TODAY, Nov. 10, 2006, at 3B.

62. Neil Weinberg, *Retirement Rip-Off*, FORBES.COM, Dec. 11, 2006, [http://www.forbes.com/forbes/2006/1211/135\\_print.html](http://www.forbes.com/forbes/2006/1211/135_print.html).

63. See GAO REPORT, *supra* note 8, at 5–6. See generally ECONOMIC SYSTEMS, INC., STUDY OF 401(k) PLAN FEES AND EXPENSES (1998) (describing the different payment options for fees, costs, and charges). Examples of fees frequently passed through to Trustee for payment from plan assets, over and above the cost of fund management and its related transaction fees/costs are:

- legal expenses (not Settlor related),
- CPA audit fees,
- different kinds of outside consulting fees,
- participant education fees,
- plan amendment and restatement fees (again, other than Settlor),
- company intranet design, programming, and maintenance fees,
- certain travel expenses of plan fiduciaries,
- certain office expenses incurred in the day-to-day administration of the plan,
- certain printing expenses such as payroll stuffers, flyers, announcements, participant awareness campaigns, professional printing of SPDs,
- continuing education of fiduciaries or support staff to fiduciaries,
- publication expenses such as reference books,

Some of those fees, commissions, or charges are not generally disclosed to plan sponsors because they are paid by financial service providers and other financial service firms.<sup>64</sup> For example, a mutual fund manager will pay the broker who clears the trades within the fund itself.<sup>65</sup> The costs associated with this arrangement are between the mutual fund and the broker, and they are therefore not normally disclosed to the plan sponsor.<sup>66</sup> However, these fees/commissions/costs *should be known by the plan sponsor in order for the fiduciaries of the sponsor to fulfill their duties to the participants*. Even undisclosed charges are subject to fiduciary jurisdiction.<sup>67</sup> The fiduciaries are required to know the full amounts of all costs and expenses borne by the plan, even though such charges are paid from one third party to another.<sup>68</sup> The failure to understand the nature and scope of such arrangements is a fiduciary breach<sup>69</sup> and correctly called fiduciary misfeasance.<sup>70</sup>

In their own defense, employers may claim they had honorable intentions and took no deliberate action that harmed the interests of plan participants. Many who serve in fiduciary roles are unaware of the duties they bear, although ignorance is no protection under the law. Under ERISA, “a pure heart and an empty head are not enough” to avoid responsibility for fiduciary breaches.<sup>71</sup> Therefore, plan spon-

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- staff time reimbursements for time spent on plan matters (could be prohibited transaction, but very common),
  - fiduciary insurance premiums, and
  - potentially others.

See GAO REPORT at 36–37.

64. Janet Rubenstein & Jeff Marzinsky, *Hidden Costs: Are 401(k) Fees Taking a Bite Out of Retirement Saving?*, INSIGHT, Spring 2007, at 15, 18, available at <http://www.milliman.com/perspective/insight-magazine/pdfs/InsightMagazine-Spring-07.pdf>.

65. *Id.*

66. *Id.*

67. *Id.*

68. Legality of Aetna ERISA Plan Fees, PWBA Office of Regs. & Interpretations, Advisory Opinion No. 97-16A (May 22, 1997).

69. *See id.*

70. *See* BLACK’S LAW DICTIONARY 658, 1021 (8th ed. 2000).

71. *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983). ERISA stands for “Employee Retirement Income Security Act.” *Id.* at 1458. Therefore, securing participants’ retirement income should be the objective of all retirement plans subject to ERISA. Attorney Fred Reish clarifies this very point through the following comments he made in 2006:

ERISA requires that fiduciaries act for the exclusive purpose of providing retirement benefits. A reasonable interpretation of the language would mean that fiduciaries must focus on the actual benefits

sors should demand to know how much funds cost to operate, not only in management fees, but also in trading costs. Table 1 is a simple example of the costs borne by typical 401(k) plans.

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being produced by [retirement] plans, as opposed to the current culture of looking at a plan's features and services. Also, the prudent man rule requires that fiduciaries act as a knowledgeable investor (or "prudent expert") would in accomplishing the "aims" of the plan. If the aim of a [retirement] plan is to provide adequate retirement income, the prudent fiduciaries should focus first and foremost on whether or not the plan actually is accomplishing that goal. If it is not, then the prudent man rule would require that fiduciaries determine why the plan is not working and take prudent steps to improve its performance.

Fred Reish, *The Starting Point: A Shift in Focus for the 401(k)*, PLAN SPONSOR, June 2006, available at [http://www.reish.com/publications/article\\_detail.cfm?ARTICLEID=590](http://www.reish.com/publications/article_detail.cfm?ARTICLEID=590).

**Table 1****A Simple Example of 401(k) Fees and Costs in a “Conventional” Plan**

Fee/Cost item	Amount as % of plan assets
Fund expense ratio	1.27% <sup>72</sup>
Transaction costs <sup>73</sup>	1.35% <sup>74</sup>
Custodial fees	.05% <sup>75</sup>
Investment advisor & participant education fees	.50% <sup>76</sup>
“Pass through” administration fees charged to plan	.15% <sup>77</sup>
CPA audit and legal fees charged to plan	.05% <sup>78</sup>
<b>Total annual charge to plan assets</b>	<b>3.37%</b>

This is a simple example of the costs for a “conventional” plan. Plans that utilize higher-cost funds will obviously cost more. Costs in plans that utilize variable annuity contracts will most likely be even

72.

SEC citing Independent Research:	1.21%
Morningstar:	1.52%
ICI:	<u>1.07%</u>
<b>Average stated expense ratio of three groups:</b>	<b>1.27%</b>

Request for Comment on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Exchange Act Release No. 33,8349, 68 Fed. Reg. 74,820 (proposed Dec. 24, 2003) (researchers who have published updated data as of 2006); Roger M. Edelen et al., Scale Effects in Mutual Fund Performance: The Role of Trading Costs 28 (Mar. 17, 2007) (unpublished manuscript), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=951367](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951367) (follow “Social Science Research Network” hyperlink under “SSRN Electronic Paper Collection”) (1.21%); Kathryn Haines, *Fund Expenses May Fall—But Only If the Market Does*, MORNINGSTAR.NET, [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/invmgmt/ch10/expense.htm](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/invmgmt/ch10/expense.htm) (last visited Nov. 12, 2007) (1.52%); 1.07% (1.21% + 1.52% + 1.07%) ÷ 3 = 1.27%; MARK R. FETTING ET AL., REPORT OF THE WORKING GROUP ON RULE 12b-1, at 6 (2007), [http://www.ici.org/pdf/rpt\\_07\\_12b-1.pdf](http://www.ici.org/pdf/rpt_07_12b-1.pdf) (1.07%)(1.21% + 1.5% + 1.07%) ÷ 3 = 1.27%.

73. See generally Kasten, *supra* note 59 (detailing elements of transaction costs).

74.

SEC:	1.15%
Journal of Pension Benefits:	1.47%
Morningstar & Independent Research:	<u>1.44%</u>
<b>Average brokerage/transactional costs:</b>	<b>1.35%</b>

Request for Comment on Measures to Improve Disclosure of Mutual Fund Transaction Costs, 68 Fed. Reg. at 74,820 (1.15%); Kasten, *supra* note 59, at 50 (1.47%); Edelen et al., *supra* note 72, at 37 tbl.3 (1.44%)(1.15%+1.47%+1.44%)÷4=1.35%.

75. Example consistent with first-hand knowledge of the author.

76. Example consistent with first-hand knowledge of the author.

77. Example consistent with first-hand knowledge of the author.

78. Example consistent with first-hand knowledge of the author.

higher.<sup>79</sup> As “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>80</sup> it is fair and reasonable to conclude that the average plan has total, “all-in” costs that exceed the example above.

Notwithstanding the above examples, I have seen plans costing in excess of 5% annually, where the plan sponsor believed they were paying less than 1%. Such misunderstandings are pervasive. Even plans that have low fund management fees could cost much more if a larger percentage of administration, accounting, and legal fees are passed onto the plan. There are dozens of different ways that fees can be paid from plan assets and, as stated earlier, accurately discerning *all* fees charged to plan assets is no small task. It is a task requiring the involvement of a professional with substantial experience and expertise in these matters.

#### **B. Who Gets Paid and Why**

In a conventional 401(k) plan, fourteen people, firms, or institutions could potentially be on the receiving end of payments from plan assets. These are listed in the order of involvement:

1. The brokerage firm for clearing the trades of the funds. Payments are taken as commissions out of plan assets and are not seen by participants or fiduciaries.<sup>81</sup>
2. The fund company for providing research services to shareholders. These services are paid for by rebates from the brokerage firms' commissions, and are also not seen by participants or fiduciaries.<sup>82</sup>
3. The fund company for managing the fund. These costs are revealed in the fund's prospectus.<sup>83</sup> The average U.S. stock fund costs between 1% and 1.3% of assets within the fund an-

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79. Smartmoney.com, What's Wrong with Variable Annuities, <http://www.smartmoney.com/retirement/investing/index.cfm?story=wrongannuities> (last visited Nov. 12, 2007).

80. Brown et al., *supra* note 33, at Abstract.

81. Brokamp, *supra* note 34.

82. Brooke A. Masters, *Fees Take a Bite from 401(k)s*, WASH. POST, Jan. 2, 2005, at F01.

83. See EMPLOYEE BENEFITS SEC. ADMIN., U.S. DEP'T OF LABOR, A LOOK AT 401(k) PLAN FEES 6-7, 11-12 (2007).

nually.<sup>84</sup> These expenses can be unnecessary because funds that cost more are generally trying to beat the market, which, although heavily promoted in the industry, is widely believed by experts to be a futile practice.<sup>85</sup> Funds can cost much less (50% to 75%) by utilizing an indexing approach, which has lower risk and reasonably predictable results over the long term.<sup>86</sup>

4. Plans managed by insurance companies may have extra embedded costs associated with mortality underwriting elements. This is a common expense within variable annuity contracts.<sup>87</sup>
5. The clearing agent clears and consolidates trades from multiple-fund institutions and aggregates the associated data for efficient import into a custodian's record-keeping system.<sup>88</sup>
6. The custodian holds funds in an account for the benefit of the trust, and provides electronic data feeds to record keepers and third-party administrators so they can process and post to individual participant accounts held in sub-accounts at the record keeper level.<sup>89</sup>
7. The record keeper or third-party administrator is paid to take aggregate or omnibus accounts at the custodial level and

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84. John Waggoner, *Index Funds' Low Cost Makes Them a Solid Place to Start*, USA TODAY, Feb. 27, 2004, [http://www.usatoday.com/money/perfi/columnist/waggon/2004-02-27-index\\_x.htm](http://www.usatoday.com/money/perfi/columnist/waggon/2004-02-27-index_x.htm).

85. See, e.g., Chris Lott, *Mutual Funds—Index Funds and Beating the Market*, INVESTMENT FAQ, May 26, 1999, <http://invest-faq.com/articles/mfund.html> (“If you look at the records, there are very, very few funds and investors who consistently beat the [market] . . . .”); John Waggoner, *Index Funds Easy, but Be Careful*, USA TODAY, Aug. 3, 2006, [http://www.usatoday.com/money/perfi/columnist/waggon/2006-08-03-index-funds\\_x.htm](http://www.usatoday.com/money/perfi/columnist/waggon/2006-08-03-index-funds_x.htm) (“The average managed stock fund rarely beats a broad-based market index, such as the Standard & Poor's 500, over a long period.”).

86. Walter Updegrave, *The Joy of Index Funds*, CNN MONEY, June 12, 2007, <http://money.cnn.com/2007/06/11/pf/expert/expert.moneymag/index.htm>.

87. See John F. Waskik, *Hardy Perennials: Tax-deferred Annuities Grow in Popularity*, BARRON'S, Feb. 12, 1990, at 29.

88. See 15 U.S.C. § 78c(a)(23(A)) (2000).

89. See U.S. GOV'T ACCOUNTABILITY OFFICE, LESSONS CAN BE LEARNED FROM SEC NOT HAVING DETECTED VIOLATIONS AT AN EARLY STAGE 7 (2005); See also 17 C.F.R. § 275.206(4)-2 (2006).

tracks them at a participant level.<sup>90</sup> The record keeper generates participant statements, maintains an Internet access portal, and initiates transactions and uploads associated instructions to the custodian to act upon.<sup>91</sup>

8. Sales people, brokers, and insurance agents may receive finders fees for bringing new business to the players described above.<sup>92</sup> Generally, finders fees come from the fund institutions.<sup>93</sup> These individuals may also receive trail commissions, such as 12(b)-1 fees or negotiated loyalty incentive compensation, intended to compensate these individuals for ongoing services they render.<sup>94</sup>
9. Fiduciary investment advisors may be compensated from plan assets for rendering advice or other services to fiduciaries and participants.<sup>95</sup> Fiduciary advisors are generally paid from plan assets after submitting an invoice to a plan trustee. However, many fiduciary advisors are paid directly from the plan sponsor and are not compensated from plan assets.<sup>96</sup>
10. Consultants may be compensated from plan assets for providing a wide variety of services including plan maintenance, compliance, and other services that a plan sponsor believes are necessary.<sup>97</sup>

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90. See John F. Wasik, *401(k) Fees Are Still Exorbitant Buried Secrets*, BLOOMBERG.COM, <http://www.b-b-f-i.com/401k.html> (last visited Nov. 12, 2007); see also James J. Dolan, *The Omnibus Account Problem: You Can't Monitor What You Can't See*, ACCESS DATA, Oct. 2004, <http://www.accessdc.com/wregister.aspx?id=3> (must register to download) [hereinafter Dolan, *Omnibus*].

91. See generally Charles Jaffe, *Don't Be Alarmed by Notice from Fund Firm—But Do Read It*, BALTIMORE SUN, Apr. 17, 2005, at 6D (describing record keeper duties).

92. Gretchen Morgenson, *S.E.C. Inquiry to Encompass 401(k) Plans*, N.Y. TIMES, July 7, 2004, at C1.

93. MCHENRY CONSULTING GROUP, *supra* note 14, at 11.

94. ECONOMIC SYSTEMS, INC., *supra* note 63, at 29 (stating providers pay out commissions “to compensate the sales force at all points” and trail commissions “are paid on assets under management . . . and continue (to be paid) as long as the plan continues.”).

95. U.S. Securities & Exchange Commission, *Investment Advisers: What You Need to Know Before Choosing One*, <http://www.sec.gov/investor/pubs/invadvisers.htm> (last visited Nov. 12, 2007) [hereinafter *Investment Advisers*].

96. *Id.*

97. *Id.*



11. Peripheral companies such as “educators” or “communications specialists” often share in commissions with brokers and insurance agents. In some cases they are paid from plan assets after an invoice has been submitted and approved by a trustee.
12. CPA firms may be paid from plan assets for accounting and annual auditing services.<sup>98</sup> This is generally handled through invoicing the trustee.<sup>99</sup>
13. A plan may have its own legal counsel, and a plan may pay for such counsel from plan assets in the same way a CPA firm would be paid—through an invoice to a trustee.<sup>100</sup>
14. Insurance premiums may be paid from plan assets to indemnify fiduciaries.<sup>101</sup> A plan may not indemnify fiduciaries for failures of duty.<sup>102</sup> However, a plan may purchase insurance from a commercial insurer, which in-turn can provide insurance coverage for fiduciaries.<sup>103</sup>

### C. Historical Exploration of 401(k) Fees

“Unfortunately there are [employer] fiduciaries who fell asleep at the switch; there are brokers who will charge excessively high fees; . . . and *there are plan providers who support all this*,” says Fred Reish, a Los Angeles attorney specializing in retirement-plan law. “This is all one big ball of wax.”<sup>104</sup>

Modern fee structures, as they relate to qualified retirement plans, have been developed over the past thirty years. A historical exploration of the development of the current fee environment yields a significant amount of insight and perspective. Potentially the most

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98. Sheldon M. Geller, *Investment Advisory Services Under ERISA*, CPA J., Sept. 2000, at 42, 46–48, available at <http://www.nysscpa.org/cpajournal/2000/0900/features/f94200a.htm>.

99. *Id.* at 46–48.

100. *Id.*

101. See generally Bernard Bell, *401(k) “Excessive Fees” Lawsuits: Fiduciary Liability Policies Likely to Cover Plan Fiduciaries*, POLICYHOLDER PERSPECTIVE (Heller Ehrman, LLP, New York, NY), Winter 2007, at 1, 1–3, available at <http://www.hellerehrman.com/docs/en/Policyholder%20Perspective%20Winter%202007.pdf> (discussing 401(k) plan fiduciaries and breaching fiduciary duties).

102. *Id.*

103. *Id.*

104. Tom Lauricella, *Up for Review: 401(k) Industry*, WALL ST. J., Dec. 28, 2006, at C1.

important and sobering revelation is that neither the retirement industry alone, nor the media alone, will ever be able to root out the problem. Not even legislation will entirely solve it. In my opinion, this problem will never be solved as long as we operate under the existing defined contribution paradigm—which can only be changed by educated plan sponsors. The legitimacy of this bold assertion, as startling as it may sound, rests upon the hypothesis that the current fee culture is symbiotic with the record-keeping industry as a whole, and that only by changing the way participant records are kept can these fees be flushed out and ultimately eliminated—to the participant's ultimate benefit.

In the mid-to-late 1970s, several independent elements (technology, creation of the Individual Retirement Account (IRA) and 401(k), added investment ease through mutual funds, and greater access to information)<sup>105</sup> combined to cause the mutual fund and brokerage industries to overlook critical and fundamental requirements to help participants replace income at retirement. The retirement plan industry created a culture that valued new asset deposits over participant welfare. Viewing in hindsight all that has transpired collectively, overlooking these fundamentals appears to be the foundation for today's retirement savings crisis and hidden fee status.

#### D. Evolutionary Context and Development of Modern 401(k) Fees

Prior to ERISA, fees associated with managing qualified retirement plans were clearly stated and relatively simple to monitor.<sup>106</sup> There are two primary reasons for this. First, most qualified plan assets were professionally managed portfolios consisting of individual securities, real property, and other marketable investments.<sup>107</sup> Not only did very few individual accounts exist prior to ERISA, there was no opportunity for “shaving” a little off the top of each individual investment (such as with mutual funds and other similar investment

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105. JIM SAXTON, JOINT ECON. COMM., U.S. CONG., *THE ROOTS OF BROADENED STOCK OWNERSHIP* 5–7 (2000), available at <http://www.house.gov/jec/tax/stock/stock.pdf>.

106. See Johannes Ledoleter & Mark L. Power, *A Study of ERISA's Impact on Private Pension Plan Growth*, J. RISK & INS., June 1984, at 225, 228–29 (describing increases in costs associated with managing qualified retirement plans that are attributable to various provisions of ERISA).

107. See J. David Cummins et al., *Effects of ERISA on the Investment Policies of Private Pension Plans: Survey Evidence*, J. RISK & INS., Sept. 1980, at 447, 448 tbl.1.

vehicles today) in order to pay service providers.<sup>108</sup> Such practices were simply not practical or even possible.

Investment portfolio managers would receive compensation directly from the plan sponsor, or they would be paid from available cash in the trust. Record keeping was done on a pooled, aggregate basis rather than a daily valued share/unit basis, which allowed fees to be easily reported and journaled to the income statement's gain/loss account. Further, all brokerage firms received fixed commissions for buying and selling underlying assets in the trust, and the commissions received could not be shared with others as they are today. Therefore, all compensation paid to service providers and brokers was up front and clearly stated.

Second, participants did not choose from a menu of funds, rather they received allocations of contributions and investment earnings to their account.<sup>109</sup> This account was the same for all participants under the plan and was professionally managed.<sup>110</sup> Therefore, investment return disparity did not exist,<sup>111</sup> and record keeping was simple. No investment education meetings were needed. No investment election forms to track and manage were required. Expensive voice response or online account access systems were not needed. Expensive trading platforms integrated with daily record-keeping systems were not needed. In short, the operational environment was relatively simple and costs were low—and known.

#### **E. 1974—Creation of the IRA as the Genesis of the Modern Fee Environment**

The genesis of the modern fee environment occurred in, somewhat ironically, 1974—the same year the ERISA was enacted.<sup>112</sup> ERISA created the IRA for individuals who did not have the privilege of participating in employer-sponsored plans.<sup>113</sup> At that time, an indi-

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108. *Fitzgerald Statement*, *supra* note 17, at 1–3.

109. See generally BROOKS HAMILTON & SCOTT BURNS, NAT'L CTR. FOR POLICY ANALYSIS, REINVENTING RETIREMENT INCOME IN AMERICA 8 (2001), available at <http://www.ncpa.org/pub/st/st248/st248.pdf> (describing traditional defined benefit plans).

110. *Id.*

111. *Id.*

112. Sarah Holden et al., *The Individual Retirement Account at Age 30: A Retrospective*, PERSPECTIVE, Feb. 2005, at 1, 1, available at <http://www.ici.org/pdf/per11-01.pdf>.

113. *Id.* at 3.

vidual could invest up to \$1,500 (not to exceed 15% of their earnings) each year, receive a tax deduction for this investment, and also receive tax-favored treatment on the earnings thereon.<sup>114</sup> The creation of the IRA brought about a completely new paradigm and environment within the brokerage and mutual fund industry. This new environment is best described by Fredman and Wiles: “[A] generation ago, mutual funds were like the earliest mammals—small, vulnerable creatures that scurried about the undergrowth of the investment landscape. Since then, of course, funds have evolved into financial giants with heavy footsteps that reverberate throughout the stock and bond jungles.”<sup>115</sup>

By making the IRA the preferred venue for the average American’s savings, the brokerage industry could capitalize on a new source of continuous deposits. A mere one million IRA deposits per year of one thousand dollars or more would equate to at least a billion dollars of new annual investment inflow. Internalizing this fact, mutual fund companies scrambled to position themselves as the preferred recipient of these billions. In order for mutual funds to uniquely position themselves with brokerage firms, who had distribution venues through their sales forces, funds needed to give the brokerage firms something in return—their trade execution business.<sup>116</sup> By placing their trades with a given brokerage firm, funds obtained preferred access to the brokerage firm’s sales force.<sup>117</sup>

This proved to be a coup for both the mutual fund industry and the brokerage industry. Billions of dollars of new deposits began to flow into mutual funds through the sales efforts of brokers, making mutual funds the staple investment vehicle of the investing-for-retirement public.<sup>118</sup> However, it was not until 1981, with the passage of the Economic Recovery Tax Act of 1981 (ERTA ’81), that the floodgates fully opened, making IRAs universally available to any person

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114. JANE G. GRAVELLE, CONG. RESEARCH SERV., INDIVIDUAL RETIREMENT ACCOUNTS (IRAS): ISSUES AND PROPOSED EXPANSION 16 (2003), available at [http://openocrs.cdt.org/rpts/RL30255\\_20030311.pdf](http://openocrs.cdt.org/rpts/RL30255_20030311.pdf).

115. ALBERT J. FREDMAN & RUSS WILES, *HOW MUTUAL FUNDS WORK* 325 (2d ed. 1998).

116. See John Howat & Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure*, 12 *FORDHAM J. CORP. & FIN. L.* 685, 688 (2007).

117. See *id.*

118. See James D. Cotterman, *Enjoying the “Pay Off” for All Your Hard Work-or-Personal Money Management for Lawyers*, 69 *N.Y. ST. B.J.* 40, 64 (1997).

with earned income sufficient to make a tax-deductible investment of two thousand dollars (up to 100% of income).<sup>119</sup>

About this same time, something else was brewing that would add fuel to the fire in a completely unexpected way. In 1978, Congress passed the Revenue Act, which created the 401(k) plan as we know it today.<sup>120</sup> These plans were then sanctioned by the IRS in 1981.<sup>121</sup> With IRA mainframe platforms already in place, brokerage firms were ready to transition from a billion dollar flow of new IRA deposits to mutual funds, to hundreds of billions of dollars in deposits to 401(k) plans in a matter of years and over a trillion in a matter of a few decades.<sup>122</sup> Since then, competition for 401(k) dollars has become fierce.

In order to compete, new “bells and whistles” were (and are) created to entice plan sponsors to choose one vendor’s 401(k) platform over another.<sup>123</sup> As Scott Adams has observed, “[t]echnological innovations will cause most companies to produce identical products and services. For companies to survive, they will have to become experts at confusing the public into thinking their generic products are better than their competitors’ generic products.”<sup>124</sup> These bells and whistles were costly, and additional revenues were required to support a broker or vendor’s ability to grow and compete.<sup>125</sup> The demand for additional revenues led providers to legitimize the new services, which justified the added fees.<sup>126</sup> The modern fee structure began to take form.

With 401(k) and IRA plans gaining popularity and associated momentum (and subsequently other individual account plans such as 457, and 403(b) plans), both new and existing companies were needed, including brokerages, third-party administrators, and in-house mu-

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119. McKen V. Carrington, *Accommodation of Family Status in the Tax Treatment of Retirement Plans*, 12 T. MARSHALL L. REV. 47, 65 (1986).

120. Bradley P. Rothman, *401(k) Plans in the Wake of the Enron Debacle*, 54 FLA. L. REV. 921, 930 (2002).

121. Salvatore J. Papa, *The Current Crisis of I.R.C. § 401(k): Is Providing Investment Advice the Proper Solution?*, 38 NEW ENG. L. REV. 371, 378 (2004).

122. INV. CO. INST., 2004 MUTUAL FUND FACT BOOK 94 (2004).

123. See Colleen E. Medill, *The Individual Responsibility of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L. J. 1, 84 (2000).

124. Chris Burand, *Provide Good Service to Set Your Agency Apart*, 74 AM. AGENT & BROKER 10, 10 (2002) (quoting Scott Adams).

125. James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 913 (2005) (noting purchases through a broker include services which are considered implicit in the cost of the transaction).

126. *Id.* at 914.

tual fund administration (bundled operations) consultants, to service the burgeoning demand, and strategies were crafted to pay for these services.<sup>127</sup> By the early 1990s, the pitch was “give us your assets, and we’ll throw in administration services for free.”<sup>128</sup> When this pitch became commonplace, the additional fees had been conceived, investigated, implemented and tested, with great financial success—at least to the financial service provider.<sup>129</sup>

However, a fundamental flaw existed. IRA deposits belong to, and come from, the individual. 401(k) contributions are employer contributions made to a trust pursuant to a cash-or-deferred-arrangement (CODA).<sup>130</sup> Yet 401(k) investments would be handled as though they were IRAs; because IRAs are not subject to ERISA’s prudence requirements, a subtle conflict with ERISA was created. This is a problem because elective deferral CODA employer contributions are subject to the same fiduciary requirements that apply to traditional pension plans.<sup>131</sup> Because hidden fees do not exist in defined benefit portfolios, per se, they should not exist in defined contribution plans either. Requiring participants to direct their own investments creates an environment where the exclusive benefit provision of ERISA can be easily violated through hidden fees.

Notwithstanding ERISA creating IRAs, IRAs are not subject to ERISA’s rigorous fiduciary and reporting requirements for qualified plans (plans governed by code § 401(a)).<sup>132</sup> As § 401(a) individual account plans (such as 401(k) and profit-sharing plans) began to proliferate, no care was taken by the industry to ensure service providers recognized and developed their operational infrastructure to accom-

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127. See EMPLOYEE BENEFITS SEC. ADMIN., *supra* note 83, at 1–23 (describing strategies to pay for the service).

128. U.S. DEP’T OF LABOR, REPORT OF THE WORKING GROUP ON EMPLOYER ASSETS IN ERISA EMPLOYER-SPONSORED PLANS (1997), available at <http://www.dol.gov/ebsa/publications.acemer.htm#mod> (explaining that the sponsor investment model requires investors to turn assets over, including fees, to be controlled by the plan manager).

129. Sarah Holden et al., *401(k) Plans: A 25-Year Retrospective*, PERSPECTIVE, Nov. 2006, at 1, 9, available at <http://www.ici.org/pdf/per12-02.pdf> [hereinafter *Retrospective*] (noting plan design, including fee rates, influences contribution rates).

130. See 26 U.S.C. § 401(k)(2) (2000).

131. Pamela Perdue, American Law Institute-American Bar Association Continuing Legal Education, *Current Pension and Employee Benefits Law and Practice*, (July 3, 2006), in SM046 ALI-ABA 785, 787 (a CODA is a pre-ERISA pension plan to which the IRC applies).

132. NAT’L UNDERWRITER CO., ERISA FACTS I-11, I-12 (2006).

modate the inherent differences between IRAs and qualified plans under § 401(a).<sup>133</sup> In other words, 401(k) plans piggy backed upon established IRA mainframe platforms and took on the characteristics of the non-ERISA-governed IRA. Failure to separate the way these entirely different plans were sold, implemented, and operated created a dilemma within the retirement plan industry that has yet to be adequately recognized, addressed, or solved. The dilemma involves the disconnect and blurring of proper strategies, standards, and governance between those entities (service providers) who are subject to the “fiduciary standard”<sup>134</sup> compared to those who are subject to the “suitability standard.”<sup>135</sup>

The operational platform required to sustain a successful IRA industry was effectively duplicated to support the growing 401(k) and other individual account plan phenomena without thought to whether the IRA platform would be appropriate for ERISA-governed plans.<sup>136</sup> Failure to consider this subtle difference resulted in the creation of abusive, misleading, and falsely justified fees (and lower rates of return caused by the embrace of an IRA-like investment culture within 401(k) plans, such as the supposed need of participants to personally direct plan investments, often to their own financial detriment) in § 401(a) individual account plans that are subject to the rigorous ERISA reporting and compliance regulations.

#### F. The Birth of Hidden Fees

Shortly after the creation of the IRA, but before the creation of the 401(k) as we know it, an interesting change occurred within the brokerage and mutual fund industry. As part of the Securities Acts Amendments of May 1975 (SAA ‘75), fixed commission rates were eliminated on the purchase and sale of securities through brokerage

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133. *Retrospective*, *supra* note 129, at 4–6.

134. 29 U.S.C. § 1104(a)(1) (2000).

135. FINRA, NASD Manual: Rule 2310: Recommendations to Customers (suitability), [http://finra.complinet.com/finra/display/display.html?rbid=1189&element\\_id=1159000466](http://finra.complinet.com/finra/display/display.html?rbid=1189&element_id=1159000466) (last visited Nov. 12, 2007). Suitability, or the so-called “Know Your Client Rule,” is intended to ensure practitioners broadly understand client’s objectives with their money in each of their accounts; it is not a fiduciary standard. See Investor Glossary, Know Your Client, <http://www.investorglossary.com/know-your-client.htm> (last visited Nov. 12, 2007).

136. See *Retrospective*, *supra* note 129, at 1–6.

firms.<sup>137</sup> With hundreds of billions of securities trades each year, the revenue made available by SAA '75 would forever change the mutual fund and retirement plan industry. The significance of the elimination of fixed commission rates would prove to be one of several core issues of debate regarding fees in retirement plans. The elimination of fixed commission rates would ultimately allow brokerage firms to charge excess commissions, thereby creating "at play" revenue, commonly referred to as soft dollar revenue.<sup>138</sup> These soft dollars, coupled with the urgent need to compete and the creation of the 12(b)-1 in 1980<sup>139</sup> created the perfect fee storm, which has existed until now with little or no notice by federal regulators, plan sponsors, participants, or the general public.

#### **IV. How Participant Retirement Income Is Being Squandered on Excessive, Unnecessary, and Hidden Fees**

The hidden fee problem is the result of a fundamentally errant approach to plan management. These flaws are the result of mingling ERISA and non-ERISA defined contribution (individual account plans) operational philosophies beginning in the mid-to-late 1970s.<sup>140</sup>

Mingling ERISA and non-ERISA philosophies has caused the industry and the public to overlook the purpose of ERISA-governed plans, which is to replace participant income at retirement.<sup>141</sup> Overlooking the principle of income replacement was a significant and fundamental ERISA industry lapse that created an environment of emotional participant investing by effectively forcing nonfiduciary, novice individuals to invest their retirement funds with marginal help from others.<sup>142</sup> In other words, allowing participants to direct trust as-

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137. Diane E. Ambler & C. Dirk Peterson, American Law Institute-American Bar Association Continuing Legal Education, *Soft Dollars, Best Execution, and Investment Advisers* (Apr. 18, 1998), in SC88 ALI-ABA 215, 217.

138. *Id.*

139. Rachel McTague, *ICI Survey Shows 92 Percent of '12b-1' Fees Remunerate Intermediaries Who Help Investors*, BNA, Feb. 28, 2005, <http://corplawcenter.bna.com/pic2/clb.nsf/id/BNAP-69WU7Q>.

140. J. David Cummins et al., *Effects of ERISA on the Investment Policies of Private Pension Plans: Survey Evidence*, 47 J. RISK & INS. 447, 449 (1980).

141. Karen S. Gerstner, *Planning for Retirement Plans*, in 3 TEXAS PRACTICE GUIDE, WILLS, TRUSTS AND ESTATE PLANNING 8:66 (Ronald R. Cresswell et al. eds., 2006).

142. MICHAEL B. SNYDER, *Health Care Benefits: Employer Sponsored Health Care*, in BENEFITS GUIDE 3:7 (2007).



sets that would otherwise be subject to, and managed by, prudent and skilled investment experts was a grave mistake for participants.<sup>143</sup> Yet hidden fees are possible exclusively in this environment. Only recently has the industry begun to correctly focus on retirement income within 401(k) plans; nearly thirty years past due.

This mingled hybrid philosophy also allowed an environment of submarket returns to prevail and investment return disparity to flourish, placing millions of unwary plan participants in “harm’s way.”<sup>144</sup> There is an inherent conflict between protecting participants and their beneficiaries, and protecting established systems and associated revenues. The goal of financial service firms is to maximize profits for themselves, not to maximize investment returns for the participants—a fundamental violation of ERISA’s exclusive benefit concept.<sup>145</sup> In an effort to protect its interests, the industry created word games and a philosophical spin to define disclosure, leading fiduciaries to believe they acted responsibly in authorizing certain transactions, platforms, approaches, and fund types. Instead of disclosure meaning possession of facts coupled with understanding, it has evolved to mean legalese—or rarely understood, seldom-read prospectuses.<sup>146</sup> This self-protection is why the fees are hidden. Hidden fees pay for services that cannot be justified when viewed from a prudent, ERISA perspective. Sadly, it appears that the industry has had to obscure the economics of the hidden fee structures and strategies to expand.

To correct the problem of hidden fees, the industry as a whole would need to submit to sweeping changes regarding how defined contribution plans are governed and administered. Subindustries that support the errant culture would disappear. Brokerage firms that receive revenue-sharing commissions as their sole source of income would not survive. Financial services firms that operate under the suitability standard versus the fiduciary standard would no longer be viable. Correcting the hidden fee problem might require barring non-fiduciaries from doing business in a fiduciary-governed industry. Only fee-based professional fiduciaries would then remain. Above

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143. *Id.*

144. HAMILTON & BURNS, *supra* note 109, at 2.

145. Daniel Fischel & John H. Langbein, *ERISA’s Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1159–60 (1988).

146. James A. Fonto, *We’re All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105, 140–80 (1998).

all, the prudent interests of plan beneficiaries would prevail, as ERISA intended.

Plan sponsors, collectively, will enjoy significantly reduced costs once enrollment meetings, participant education, attractively designed color print materials, internet fund trading technology, participant investment advice, and all other specialized services are no longer needed. On average and over the long-run, participants cannot consistently out perform professional, prudent fiduciaries managing portfolios with the goal of obtaining near market returns. The retirement plan industry dishonors the financial future of America's workforce by convincing them that they can. Participants need to be at the market, not strive to beat the market. Without sweeping changes, participant account balances will continue to groan under the strain of industry-fabricated fees designed to serve the financial services industry more than the interests of plan participants.

#### A. The Heart of the Matter

There are two main types of hidden fees. The first type are hidden fees embedded in the fundamental expense ratio. These fees are subshareholder (participant) servicing fees—called “sub-transfer agent fees” (Sub-TA) and account distribution (sales and account servicing 12(b)-1) fees.<sup>147</sup> The second type are hidden fees separate from, and in addition to, the fundamental expense ratio. These fees include (1) transaction costs—commissions between fund managers and brokerage firms; (2) soft dollar “excess commissions” paid to brokerages pursuant to SEC rule 28(e)—embedded and symbiotic with (1); (3) variable annuity charges—such as unitized variable annuity wrap, contract, and mortality charges; (4) “on-the-fly” pass through fees—such as administrator or CPA fees; (5) retail versions of institutional funds—funds that could be purchased at a lower price but are not, due to fiduciary ignorance.<sup>148</sup>

Fees embedded in the expense ratio are technically disclosed, albeit in crude aggregate.<sup>149</sup> This presents a challenge to fiduciaries that have an obligation to know and monitor the portion of the expense ratio that subsidizes various services.<sup>150</sup> Without understanding the

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147. *Hutcheson Statement*, *supra* note 25, at 16–22.

148. *Id.* at 15–20.

149. *Id.* at 19.

150. *Id.* at 12–13.

purpose of each extra layer of cost, a fiduciary may inadvertently permit excessive services resulting in payment for services participants do not need, use, or benefit from. Layers of the expense ratio that are in excess of what is necessary to manage the fund (such as record-keeping Sub-TA or marketing 12b-1 fees) must only be permitted if it can be shown they exist for the purpose of protecting and building the retirement security of those in the plan.

Fees or costs not included in the expense ratio, such as brokerage commissions (transaction costs), are not known to plan sponsors generally, nor do most plan sponsors even contemplate their existence.<sup>151</sup> Other fees not included in the expense ratio, such as on-the-fly pass throughs and service fees from an accountant or lawyer that are paid from plan assets, are generally only known by those few involved in the transaction itself.<sup>152</sup>

Thus, there are varying degrees of disclosure, obscurity, and understanding of the various fees and costs; yet, understanding these costs is vital to building a successful retirement system. Given that the most brilliant fund managers cannot predict the future or consistently outperform the market (because they are the market), fees and costs remain one of the few variables with legitimate predictive power. Thus, long-term investing success is largely dependent upon knowledge of all fees and costs affecting an investment fund, portfolio, or strategy.

## B. Critical Questions

The development of these fees directly relates to the connection between the proliferation of individual account plans (IRAs and 401(k)s) and the growth of the mutual fund industry.<sup>153</sup> Significant questions surround these fees, not only because they are difficult to quantify for fiduciary due diligence and monitoring purposes, but also because they exist for reasons other than providing valuable, exclusive benefits to plan participants and beneficiaries. Questions relevant to this issue include:

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151. *Id.* at 13–14.

152. *Id.* at 20.

153. See Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1428–29 (2002).

- Why are these fees relatively new? (Why did they not exist prior to ERISA?)
- What services justify these fees?
- Has the justification yielded material results for participants and beneficiaries? (Are participants consistently earning “near market” returns?)
- Why has the retirement plan industry endeavored to obscure these fees? (What are they trying to hide?)
- Why is the industry willing to endure litigation and potential legislation before acknowledging there is a problem?
- If these fees are truly justified and legitimate, should they not be clearly shown on an invoice or statement? (In other words, why are they hidden?)

In short, the question fiduciaries should be asking is, “Do these fees exist to pay for reasonable, legitimate, and valuable services that benefit participants of qualified retirement plans and that will enhance their retirement security? Or do they exist to support the financial services industry at the expense of participants?” These are tough questions that are important for plan sponsors, attorneys, and fiduciary practitioners to ask themselves and their service providers.

### C. Hidden Fee Type 1—Sub-Transfer Agent Fees

[N]othing is less productive than to make more efficient what should not be done at all.

—Peter Drucker<sup>154</sup>

The mutual fund and brokerage industry has insisted ERISA-governed 401(k) plans be handled in the same manner as non-ERISA IRAs because not doing so would require the fund industry to forsake established operational systems. This practice has been blindly accommodated by purchasers. A more prudent approach would be to adhere to a traditional ERISA-based platform. Understanding how hidden fees have come to be, it is reasonable to question whether participant directed accounts should exist at all, yet the SEC estimates bil-

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154. Peter Drucker, *Drucker on Management: Permanent Cost Cutting*, WALL ST. J., Jan. 11, 1991, at A10.

lions of dollars would need to be spent tracking and preventing these hidden abuses.<sup>155</sup>

The issue of hidden fees is directly related to the ability of a participant to direct his or her own investments within the plan and hence is tied to the record-keeping systems that enable participants to do so. The statistical data reveal the philosophical error of requiring participant direction within ERISA-governed plans has been devastating to the individual participant through yield disparity,<sup>156</sup> account value attrition through gaming,<sup>157</sup> playing to the ego and emotion of the individual participant,<sup>158</sup> increases in paperwork, and an increase in systems to handle the records and transactions.<sup>159</sup>

As explained in Part III.E, 401(k) and other individual account plans originally piggybacked effectively upon the mainframe IRA infrastructure that existed within the brokerage industry.<sup>160</sup> Instead of rethinking whether the IRA philosophy of participant directed funds (compared to the traditional prudently managed portfolio approach used in traditional defined benefit and money purchase pension plans) was correct with respect to ERISA, brokerages and mutual fund companies added additional clay to the sculpture. The problem of hidden fees was perpetuated and exacerbated by subcontracting the accounting of participant shares to third parties called sub-transfer agents.

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155. Dolan, *Omnibus*, *supra* note 90.

156. See HAMILTON & BURNS, *supra* note 109, at 15. One plan had a yield of 18.3% for the whole plan, but had an individual yield range of negative 12.8% to 52.1%. *Id.*

157. Matthew D. Hutcheson, *Why Individually Directed Accounts Are a Dumb Idea*, 15 EMP. BENEFIT NEWS 49, 49–54 (2001).

158. See, e.g., Sap-Img, *Emotional Investing Hurts*, <http://www.sap-img.com/stock-market-investment/emotional-investing-hurts.htm> (last visited Nov. 12, 2007); Advanced Futures Inc., *Emotions of a Trader*, <http://www.advancedfutures.com/cbot/3.asp> (last visited Nov. 12, 2007). *Emotions of a Trader* deals with those individuals actively buying individual securities. This is not the same as trading mutual funds within a closed fund menu. Advanced Futures Inc., *supra*. However, I believe that investment trader emotion exists in both and cannot be materially distinguished by investors, though different types of investments are being traded. Trading individual securities or mutual funds can create the same anxieties for investors.

159. See, e.g., SunGard, *About SunGard*, <http://www.sungard.com/sungard/default.aspx?id=4> (last visited Nov. 5, 2007). SunGard, a corporation providing recording and processing systems, “[s]upport[s] the accounting and management of more than \$25 trillion in invested assets and process[es] more than [five] million trades each day.” *Id.*

160. See *supra* notes 135–38 and accompanying text.

A transfer agent is usually a bank or trust company (or the mutual fund itself) that executes, clears, and settles a security buy or sell order, and maintains shareholder records (for example, accounts for title of share ownership).<sup>161</sup> When certain functions of the transfer agent are subcontracted to a third party, that third party becomes a sub-transfer agent.<sup>162</sup> Payment to these parties for this subcontracted service has come to be known as sub-transfer agent fees.<sup>163</sup>

Sub-transfer agent fees exist solely to support the participant-directed account culture. Sub-transfer agent fees are generally paid flat dollar, per participant, per fund.<sup>164</sup> For example, many funds will pay a third-party administrator ten dollars per participant, per fund.<sup>165</sup> Other funds will pay a percentage of assets—such as five to ten basis points.<sup>166</sup> However, some funds pay up to twenty-two dollars per participant, per fund or thirty-five basis points.<sup>167</sup>

The problems with sub-transfer agent fees is not how much is being paid to the service provider. Rather, the problems are being unaware who is receiving the payments and whether the payments fairly represent the value of the service being rendered. The DOL has made it very clear that a plan sponsor must understand the value and associated compensation of each individual servicing company, thereby making the cost of the parts more important than the cost of the whole.<sup>168</sup>

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161. U.S. Securities & Exchange Commission, Transfer Agents, <http://sec.gov/answers/transferagent.htm> (last visited Nov. 12, 2007).

162. Within the context of this article, a sub-transfer agent would be one of the following entities: (1) a third-party administrator; (2) a bank or trust company performing recordkeeping services; or (3) some other entity tracking the number of shares held for the benefit of a specific participant within an individual account plan.

163. Anne Tergesen, *Does Your 401(k) Cost Too Much?*, BUS. WK., June 7, 2004, [http://www.businessweek.com/magazine/content/04\\_23/b3886145.htm](http://www.businessweek.com/magazine/content/04_23/b3886145.htm).

164. Joanne Sammer, *401(k) Fees Under the Gun*, BUS. FIN., Feb. 2007, <http://www.businessfinance-mag.com/channels/career/careerHR/article.html?articleID=14755>.

165. See, e.g., MCHENRY CONSULTING GROUP, *supra* note 14, at 4.

166. See, e.g., STANCORP EQUITIES, INC., PLAN SPONSOR'S GUIDE TO RETIREMENT PLANS FEES 3-4 (2007), available at [http://www.standard.com/pensions/publications/rp-13438\\_fees\\_guide.pdf](http://www.standard.com/pensions/publications/rp-13438_fees_guide.pdf).

167. Matthew D. Hutcheson, Address at the Institute of Management and Administration Audio Conference: Negotiating 401(k) Plan Fees (Nov. 10, 2003) (transcript available for purchase at the Institute of Management and Administration, <http://www.ioma.com/audioconferences/59.html>) [hereinafter IOMA Audio Conference].

168. EMPLOYEE BENEFITS SEC. ADMIN., *supra* note 83, at 3. Many plan sponsors are not fully aware that their record keepers—fund companies included—are re-

In the mid-1980s, the budding third-party administration industry developed balance forward accounting software that ran on micro-processors, which, for the most part, was affordable enough for even the smallest developing company.<sup>169</sup> Larger firms had installed mainframe systems that were robust enough to provide subaccounting for multiple fund accounts (for example, a menu of funds within a participant account as compared to a single professionally managed account).<sup>170</sup> Shifting the accounting of each individual, and that individual's fund choices, to a third party allowed the mutual fund to maintain a more streamlined and affordable omnibus account.<sup>171</sup> As a result, the mutual fund was able to streamline its operation by maintaining a single account in the name of the trust and feed aggregate transaction data to a sub-transfer agent for subaccounting processing.

Sub-transfer agents were burdened by the strain of subaccounting for an ever increasing number of funds offered within plans.<sup>172</sup>

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ceiving sub-transfer agent fees. In such cases, plan sponsors believe the record keeper is being paid  $X$ , when in reality they are being paid  $X+TA$ , where  $X$  is fees a plan sponsor believes they are paying and  $TA$  is sub-transfer agent fees, which are built into fund management fees and are used as a subsidy. Sub-transfer agent fees should be understood by plan sponsors so they can properly measure and assess the cost-to-value ratio with respect to all service providers.

169. D.J. Power, *A Brief History of Spreadsheets*, DSSRESOURCES.COM, Aug. 30, 2004, <http://www.dssresources.com/history/sshistory.html>.

170. A Mutual Fund Omnibus Account is a mutual fund account held in the name of a broker/dealer, bank, or trust that is acting on behalf of its customers or beneficial owners. See TIM O'SULLIVAN, ET. AL., TOWERGROUP, THE MOVE TOWARDS OMNIBUS ACCOUNTS—EVOLUTION OR REVOLUTION? 2 (2004), [http://www.pfpc.com/news/pdfs/Speak\\_Eng/Service\\_Qaulity.pdf](http://www.pfpc.com/news/pdfs/Speak_Eng/Service_Qaulity.pdf). Subaccounting occurs when the mutual fund performs execution, clearing, and/or custody of securities for customers on a nondisclosed basis. The management of customer positions held in omnibus at another institution, including client activity, tax reporting, communications, and other responsibilities as outlined by the Securities and Exchange Act of 1934 Rules 17a-3 and 17a-4. See *id.* ERISA and the advent of robust mainframe computers coincide with each other. Mainframe systems are powerful enough to track millions of participant accounts. See *The History of the Mainframe Computer*, VikingWaters, <http://vikingwaters.com/htmlpages/MFHistory.htm>.

171. See *Mutual Fund Reform: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 4 (statement of William W. Gurley); COALITION OF MUTUAL FUND INVESTORS, ANALYSIS OF REDEMPTION FEE POLICIES BY THE FIFTY LARGEST MUTUAL FUND GROUPS 1 (AUG. 3, 2004), <http://www.investorscoalition.com/CMFIRedemptionFeeStudySummary.pdf>.

172. See Massimo Massa, *Why So Many Mutual Funds? Mutual Fund Families, Market Segmentation and Financial Performance* (1998), available at <http://ssrn.com/abstract=239851>. The challenge is not felt only by sub-transfer agents, but by all parties involved in managing funds and plans. Service providers tolerate the additional challenge of managing the increasing number of funds within a plan because of the revenue sharing created through sub-transfer agent agreements.

They bore responsibility for handling participant transfers between funds within the plan and providing media through which participants could access their accounts via telephone or the Internet.<sup>173</sup> The need to efficiently handle this unprecedented demand required ever more sophisticated technology, and therefore sub-transfer agents demanded higher fees.

These subaccounting software platforms have evolved to the point where they can link to virtually any brokerage, mutual fund, or trading/clearing platform.<sup>174</sup> By so linking, they enable their users (the firm) to capture sub-transfer agent dollars from the participating mutual funds. An estimated one hundred million shareholder accounts, or approximately 40% of all mutual funds, are in sub accounts at financial or record-keeping intermediaries at this writing.<sup>175</sup> Approximately two billion dollars per year is paid to third parties for subaccounting services.<sup>176</sup>

There are potential costly and ERISA-violating problems inherent in omnibus accounts with underlying participant directed subaccounts. First, “[o]nly the omnibus account is subject to the oversight and review of the fund’s board of directors.”<sup>177</sup> Second, investment company compliance personnel cannot monitor the transactions occurring at the subaccount level because the shareholder information is not disclosed to them—only information on the omnibus account itself.<sup>178</sup> Third, the emergence of omnibus accounts—coupled with participant direction—has provided an environment where the receipt of sub-transfer agent revenue can be hidden from plan sponsors.<sup>179</sup> It is this same environment that provided a scenario where unscrupulous

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173. To provide conventional 401(k) services, such as account management activity through the telephone and Internet, a sub-transfer agent (TPA/Record Keeper) must have access to robust record keeping systems. Software companies that enable sub-transfer agents, commonly called “third-party record keepers,” to provide services that are to a large degree financed through the sub-transfer agent revenue business model include Sungard “Relius,” [http://www.relius.net/Products/Qnt\\_whatitis.aspx](http://www.relius.net/Products/Qnt_whatitis.aspx), Investlink Technologies, Inc. <http://www.invlink.com/pands.html>, and SunGard Omni, <http://www.sungard.com/omni/default.aspx?id=4>.

174. See, e.g., <http://www.sungard.com/omni/default.aspx?id=717>.

175. See O’SULLIVAN, ET. AL., *supra* note 170, at 4.

176. James J. Dolan, CEO, Access Data, Address at NICSA Boston Conference (Sept. 22, 2004), available at [http://www.accessdc.com/resource\\_center/Access\\_Data\\_NICSA\\_9.23.04.ppt](http://www.accessdc.com/resource_center/Access_Data_NICSA_9.23.04.ppt).

177. Dolan, *Omnibus*, *supra* note 90.

178. *Id.*

179. See *id.*



traders could hide late-trading and market-timing abuses. Finally, the omnibus structure obscures who is trading within a fund and how often a particular shareholder may be trading. Without subaccount transparency, the mutual fund compliance department cannot prove or disprove rapid-fire traders are using their access to mutual fund trading via the Internet for their own gain, hurting long-term investors.<sup>180</sup>

SEC Rule 22c-2 demands transparency of these fees so investment companies can see what is happening at the subaccounting level—the participant level.<sup>181</sup> The error of trying to make something more efficient that should not be done at all has come back to haunt the industry in more than one way. Record-keeping costs continue to increase, transaction errors are rampant, and poor participation and overall account performance are now hallmarks of the industry.<sup>182</sup> The SEC believes that developing tools to capture this information will cost one billion dollars a year for at least three years, and hundreds of millions annually subsequently, to monitor everything.<sup>183</sup>

Sub-transfer agent fees are revenues at play, meaning they can be paid to third parties for subaccounting practices.<sup>184</sup> They can also be captured and credited back to the trust for the benefit of the participants.<sup>185</sup> Plan sponsors may be limited in the number or type of funds to which they have access due to restrictions placed on a fund that does not pay sub-transfer agent fees.<sup>186</sup> That in-turn could impede the fiduciaries' ability to select the fund they deem most appropriate for the participants in the plan. At-play dollars belong to the participant, and therefore fall under the jurisdiction of the named fiduciaries of the plan.<sup>187</sup> If the named fiduciaries do not know that a third party is receiving these sub-transfer agent fees, they cannot

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180. *Id.*

181. THOMPSON HINE, *SEC Adopts Mutual Fund Redemption Fee Rule*, INVESTMENT MGMT. BULL., Mar. 2005, at 1, 1–2, available at [http://www.thompsonhine.com/news/nl/cs\\_march2005\\_1.pdf](http://www.thompsonhine.com/news/nl/cs_march2005_1.pdf).

182. See Dolan, *Omnibus*, *supra* note 90.

183. *Id.*

184. Tergesen, *supra* note 163.

185. FREDMAN & WILES, *supra* note 115, at 369.

186. ADVISORY COUNCIL ON EMPLOYEE WELFARE & PENSION BENEFIT PLANS, U.S. DEP'T OF LABOR, REPORT OF THE WORKING GROUP ON PLAN FEES AND REPORTING ON FORM 5500, at 3 (2004), available at [http://www.dol.gov/ebsa/pdf/ac\\_111804\\_report.pdf](http://www.dol.gov/ebsa/pdf/ac_111804_report.pdf).

187. See *id.* at 4.

monitor them, evaluate the worthiness of the compensation in view of services rendered, and take action as needed.

In many cases, trustees are unaware that sub-transfer agent fees are being paid in addition to hard dollar amounts<sup>188</sup> (invoiced to the plan or plan sponsor by a third party), effectively enriching the third party for unearned services. This is a violation of the exclusive benefit rule because plan assets are being used for purposes other than to provide benefits to participants or pay reasonable fees (to which the plan sponsor or fiduciaries have agreed pursuant to the hard dollar billing—but not more).<sup>189</sup> Some third parties construct their fee schedule around revenue sharing, stating that these fees will offset billed amounts and do show the offset against billable amounts on invoices.<sup>190</sup>

#### **D. Hidden Fee Type 2—Account Distribution (Sales) Based on SEC Rule 12(b)-1**

SEC Rule 12(b)-1 was enacted in 1980,<sup>191</sup> and there are two types of 12(b)-1 fees: (1) sales commission 12(b)-1 fees, paid to a registered representative for selling mutual funds for an individual or within a plan; and (2) servicing 12(b)-1 fees, paid to a person or entity who services an account after the sale.<sup>192</sup> This rule is partially responsible for the proliferation of mutual funds in individual account plans.<sup>193</sup> Again, referring to the mutual fund relationship with the distribution medium (sales force) of the brokerage firm, the rule creates a conflict of interest between the brokerage firm and the mutual fund, thereby rendering each unable to devote their loyalties to the plan partici-

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188. *See id.* at 3.

189. *See id.* at 4, 7, 12.

190. Practice Tip: Questions to ask your consultant, third-party administrator, mutual fund company, investment advisor, and/or broker:

1. Do you or any other entity receive sub-transfer agent revenue?
2. If yes, is this revenue offset directly against stated costs as described in a service agreement?
3. Do invoices reflect the offset against what otherwise would be fees paid directly by the employer via invoice?

191. Distribution of Shares by Registered Open-End Management Investment Company, 17 C.F.R. § 270.12b-1 (2006).

192. Investment Company Institute, About Investing: Background Information About 12b-1 Fees, [http://www.ici.org/funds/abt/ref\\_12b1\\_fees.html](http://www.ici.org/funds/abt/ref_12b1_fees.html) (last visited Nov. 12, 2007).

193. John D. Rea & Brian K. Reid, *Trends in the Ownership Cost of Equity Mutual Funds*, 4 INV. CO. INST. PERSPECTIVE 1, 12 (1998).

pants. More than half of all mutual funds have a 12(b)-1 feature.<sup>194</sup> These fees are disclosed in the prospectus,<sup>195</sup> but very few plan sponsors understand their significance to themselves, the participants, and the trustees.

Fiduciary audits I have performed discovered plans with otherwise high-quality mutual funds with high 12(b)-1 fees. The same mutual fund could have been procured with no 12(b)-1 fee or, at a minimum, a lower one. This again points out the conflict between the suitability standard and the fiduciary standard. Nonfiduciary sales people, who are not plan fiduciaries, carefully showcase products with high commissions to the unknowing plan sponsor or trustee. Conversely, an acting Registered Investment Advisor fiduciary would be obligated to disclose fees in writing, invoice the plan sponsor or plan for those stated fees, and credit any 12(b)-1 fees back to the trust.<sup>196</sup> The clear difference shows the crisis that exists in the industry. Plan sponsors do not know there is a difference; mutual funds are mutual funds to them.

Another seldom considered 12(b)-1 issue is that of unfair fee subsidy disparity. Fee subsidy disparity is often referred to by the fiduciary community as the “hidden tax” paid by participants with large account balances.<sup>197</sup> If the average 12(b)-1 fee is thirty-five basis points, participants with balances over forty thousand dollars can be viewed as subsidizing the participants of *other plans*.<sup>198</sup>

Compare two hypothetical plans, Plan A and Plan B. Each has fifty million dollars in assets, both have identical mutual funds and service providers, each paying 3% (1.50% in trading costs, and 1.50% in fund management fees<sup>199</sup>). Further, assume that 40% of the fund management fee pays for revenue sharing arrangements (brokers, record keepers, insurance agents, and others), and 60% is kept by the fund manager. Plan A has 500 employees and Plan B has 2500 employees. Are costs consistent for all employees as a percentage of their account balances? Yes, of course. But what are the real economics?

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194. Investment Company Institute, *supra* note 192.

195. *Id.*

196. Sheldon M. Geller, *ERISA Fiduciary Responsibilities and Registered Investment Advisors*, CPA J. ONLINE, Jan. 2007, <http://www.nysscpa.org/cpajournal/2007/107/essentials/p56.htm>.

197. MCHENRY CONSULTING GROUP, *supra* note 14, at 4.

198. IOMA Audio Conference, *supra* note 167.

199. Kasten, *supra* note 59, at 50–62.

Look at the following example of a comparison between the two hypothetical plans:

**Table 2**

Fee/Cost element	Plan A	Plan B
Gross fund fees and commissions	\$1,500,000	\$1,500,000
	(\$50,000,000 x 3%)	(\$50,000,000 x 3%)
	\$300,000	\$300,000
Revenue sharing	1.50% x 40% x \$50,000,000)	1.50% x 40% x \$50,000,000)
Revenue Sharing borne by each participant	\$300,000 ÷ 500 participants = <b>\$600 per participant</b>	\$300,000 ÷ 2500 participants = <b>\$120 per participant</b>

The participants of Plan A are paying for the overhead of Plan B. Consider another illustration: Would Toyota sell its new Camry to employees of larger companies for one-third the cost of what employees of smaller companies would be required to pay? Of course not. Yet, identical plans with identical assets really cost vastly different amounts on a per participant basis. How can the value that each participant receives be reconciled with what is actually paid?<sup>200</sup>

200. Practice note: Fiduciaries might critically consider the influence 12(b)-1 fees have had on general plan economics and the impact to participants and beneficiaries.

Practice Tip: Questions to ask your consultant, company, investment advisor and/or broker:

1. Are you operating under a suitability or a fiduciary standard? In other words, are you a nonfiduciary registered representative or are you a fiduciary registered investment advisor?
2. If you are a registered representative, are you receiving 12(b)-1 fees?
3. If yes, what is the annual value of the 12(b)-1 gross revenue you receive? (Obtain this information in writing. Compare with original information received at time trustees proceeded with these particular investments.)
4. Can our same funds be purchased for a different share class with a lower 12(b)-1 fee?
5. Were our assets placed in this particular share class for a reason?
6. If yes, please explain. Was it because this share class paid higher 12(b)-1 fees?

Finally, ask yourself:

7. If yes, has this caused us to breach our fiduciary duty for failing to properly investigate and pay only those fees that were appropriate and reasonable? Are we in continued fiduciary jeopardy by allowing a nonfiduciary sales person guide us with respect to fiduciary decisions?

### E. Hidden Fee Type 3—Transaction Costs

Anyone trying to objectively examine the level of mutual fund brokerage commissions is immediately struck by the difficulty of obtaining data on these commissions.<sup>201</sup>

Transaction costs are difficult to understand. They are out-of-sight, out-of-mind. Yet they are one of the largest expenses a participant bears.<sup>202</sup> Actively traded funds have higher transaction costs than passive funds. Every time a mutual fund manager buys and/or sells the underlying securities within the fund, the participants' return is decreased by the cost of those trades.<sup>203</sup>

The fact [is] that the costs of actively managing a given number of dollars will exceed those of passive management. Active managers must pay for more research and must pay more for trading. Security analysts (e.g. the graduates of prestigious business schools) must eat, and so must brokers, traders, specialists and other market-makers. Because active and passive returns are equal before cost, and because active managers bear greater costs, it follows that the after-cost return from active management *must be lower* than that from passive management.<sup>204</sup>

Utilizing indexed funds will significantly decrease trading costs. As I have stated previously, “[s]ince these index funds do no research and little trading, the costs of holding their portfolios are extremely small, some ranging as low as 0.10 percent a year.”<sup>205</sup> Some commentators have set forth ways to estimate trading costs.<sup>206</sup> However, the only way to accurately uncover these hidden fees is to first identify specific funds, and then obtain the supplement to those funds' financial statements.<sup>207</sup> Uncovering the true cost of trades within any plan becomes increasingly difficult if the plan is not invested in mutual funds but in another mutual fund-like vehicle, such as a variable annuity contract.<sup>208</sup>

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201. JASON KARCESKI ET AL., PORTFOLIO TRANSACTIONS COSTS AT U.S. EQUITY MUTUAL FUNDS 5 (2004), available at [http://www.zeroalphagroup.com/news/Execution\\_CostsPaper\\_Nov\\_15\\_2004.pdf](http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf).

202. *Id.* at 14 tbl.2.

203. *Id.* at 18 tbl.4.

204. Sharpe, *supra* note 30, at 7 (emphasis added).

205. *Hutcheson Statement*, *supra* note 25, at 13.

206. BankUnited Financial Services, Understanding Mutual Funds: Mutual Fund Management & Costs, <http://moneyfitness.com/mc6/topic.php?b=24548730-o&c=42&h=506,3,2,374,406> (last visited Nov. 12, 2007).

207. Al Otto, *The Nuts & Bolts of 401(k) Fees*, THE MCHENRY GROUP, Jan. 17, 2006, [http://www.enebuilder.net/mchenrygroup/e\\_article000515390.cfm?x=b11,o,w](http://www.enebuilder.net/mchenrygroup/e_article000515390.cfm?x=b11,o,w).

208. *Id.*

Notwithstanding the specific nature of the underlying investment vehicles, we know the average 401(k) utilizes funds with higher than average costs.<sup>209</sup>

Management fees in this industry (mutual funds added to 401(k) plans) run about 1.6% for the average equity fund. By the time you add in portfolio turnover costs, which nobody discloses, and you add the impact of sales charges and opportunity costs because funds aren't fully invested, and out-of-pocket fees, you are probably talking about another 1.4% of cost, bringing that 1.6% management fee or expense ratio up to 3% a year. That is an awful lot of money. . . . In other words, the average mutual fund has to earn 3% a year just to break even.<sup>210</sup>

There are three basic elements of transaction costs. The first element is brokerage commissions. The more turnover (buying and selling of underlying securities within the fund), the higher the total commissions paid by those invested in the fund.<sup>211</sup> Brokerage commissions can be found (with difficulty) in a fund's "Statement of Additional Information" (SAI),<sup>212</sup> a supplement to a fund's annual report.<sup>213</sup>

Spreads are the second element in transaction costs. A stock is always bought at a slightly higher price than it is sold, to provide the market maker with a profit.<sup>214</sup> The more liquid the company, the lower the spread.<sup>215</sup> The less liquid the company, the higher the spread.<sup>216</sup> Finally, market impact costs also form a part of transaction costs. This economic slippage is caused by the sale itself; if a fund wishes to sell a large amount of stock, this significant burden may lower the price of the stock.<sup>217</sup>

To understand retirement plan economics, one must add the fund's expense ratio to the transaction costs. Only then will one possess an accurate picture of total overall costs. However, because transaction costs are not included as part of a fund's prospectus, they are effectively hidden from the view of fiduciaries and participants alike.

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209. Brown et al., *supra* note 33, at Abstract ("[T]he 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." (emphasis added)).

210. Brokamp, *supra* note 34 (quoting John Bogle).

211. KARCESKI ET AL., *supra* note 201, at 3.

212. *Id.* at 4.

213. *Id.* at 3.

214. *Id.* A market maker connects a willing buyer with a willing seller.

215. Vasiliki Plerov, *Qualifying Fluctuations in Market Liquidity: Analysis of the Bid-ask Spread*, PHYSICAL REV., Apr. 2005, at 71, 71.

216. *Id.*

217. KARCESKI ET AL., *supra* note 201, at 3.

The Spring 2007 *Journal of Pension Benefits* described a study on the negative impact of transaction costs, stating, “[t]he 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.”<sup>218</sup> If the average annual cost of an equity fund is 3.09%, what can we conclude from the National Bureau of Economic Research’s findings that the vast majority of 401(k) plans have a *higher* cost than the average equity funds? The logical conclusion is that when the hidden transaction costs are added to the expense ratio, the actual cost born by participants in the vast majority of 401(k) plans is higher than 3.09%.

Plan sponsors may consider retaining the services of an independent expert to measure trading costs within a plan. However, a plan sponsor should understand that any such analysis will take a substantial amount of work. Currently, calculating and combining fund expense ratios with additional transaction costs must be performed manually.

#### F. Hidden Fee Type 4—SEC 28(e) Soft Dollars

SEC Rule 28(e) potentially encourages turnover and the cost of trading, and is symbiotic with, and inherent in, hidden fee type 3—transaction costs. It also brings risk to unwary fiduciaries. The following explanation delves into the secrecy of commission sharing through soft dollar brokerage.

Prior to ERISA, mutual funds used the excess commission (soft dollars) on a securities transaction to buy additional goods or services from their chosen brokerage firm.<sup>219</sup> For example, if a trade costs 3.5 cents per share (trade execution, clearance, and settlement)<sup>220</sup> and the brokerage fixed commission was 5 cents per share, the excess 1.5 cents could either be used to purchase additional goods or services from the broker that directly benefited the account holder, or be credited back

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218. Kasten, *supra* note 59, at 50–51 (emphasis added).

219. John Tamny, *Stay Soft on ‘Soft Dollars,’* AMERICAN, June 14, 2007, <http://www.american.com/archive/2007/june-0607/stay-soft-on-soft-dollars>.

220. Press Release, Office of Pension & Welfare Benefit Programs, U.S. Dep’t of Labor, Statement on Policies Concerning Soft Dollar and Directed Commission Arrangements (May 22, 1986), available at <http://www.occ.treas.gov/ftp/bulletin/2007-7c.pdf> [hereinafter Soft Dollar Release].

to their rightful owners, the account holders. Excess brokerage commissions were handled the same way for all mutual funds.<sup>221</sup>

After ERISA, the practice of using soft dollars in IRAs would remain the same.<sup>222</sup> But with respect to participants and beneficiaries within a qualified plan, a conflict clearly existed with the traditional use of soft dollars and ERISA sections 403(c)(1), 404(a)(1), 406(a)(1)(D), 406(b)(1), and 406(b)(3).

ERISA 403(c)(1) states that the assets of a plan shall never inure to the benefit of any employer, and shall be held for the *exclusive* purposes of providing benefits to participants in the plan and their beneficiaries, and defraying reasonable expenses of administering the plan.<sup>223</sup> Using soft dollars for purposes other than the exclusive purpose of providing benefits to participants and beneficiaries and paying operational costs of the plan itself is a fiduciary breach.<sup>224</sup>

ERISA 404(a)(1) states that a fiduciary must act prudently and *solely* in the interest of the participants and beneficiaries.<sup>225</sup> Using soft dollars to buy loyalty of brokerage firms, consultants, or other parties-in-interest to the plan is a fiduciary breach.<sup>226</sup> ERISA 406(a)(1)(D) states that a fiduciary *shall not* transfer to, or use by or for the benefit of a party-in-interest, any assets of an ERISA-governed plan.<sup>227</sup> The use of soft dollars could effectively be a transfer to a party-in-interest, thereby creating a fiduciary breach.<sup>228</sup>

As a result of the Securities Acts Amendments of 1975, Section 28(e) was added to the Securities Exchange Act of 1934.<sup>229</sup> With fixed commission rates no longer the law, Section 28(e) created a safe harbor for brokerage firms who exercise no investment discretion, as de-

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221. THE OFFICE OF COMPLIANCE, INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS 16-17 (1998).

222. See I.R.C. § 408 (2000) (containing none of the fiduciary requirements applicable to ERISA-qualified plans found in I.R.C. §§ 403(c)(1), 404(a)(1), 406(a)(1)(b), 406(b)(1), and 406(b)(3) (2000)).

223. 29 U.S.C. § 1103(c)(1) (2006).

224. See Soft Dollar Release, *supra* note 220, at 1-2.

225. 29 U.S.C. § 1104(a)(1).

226. Soft Dollar Release, *supra* note 220, at 1-2.

227. 29 U.S.C. § 1106(a)(1)(D).

228. See *id.* § 1106(a)(1)(D) (prohibiting transfer of plan assets to party-in-interest); *id.* § 1002(14)(b) (defining party-in-interest as any individual providing services to an ERISA plan); see also Soft Dollar Release, *supra* note 220, at 2-3.

229. Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 21(1)(e), 89 Stat. 97, 161-62 (codified as amended at 15 U.S.C. § 78bb (2006)) (limiting brokers' fiduciary duties to setting reasonable commission rates).



fined under Section 3(a)(35) of the 1934 Act<sup>230</sup> (acting under suitability standard versus fiduciary standard), to charge mutual funds a commission that is more than it costs to actually execute, clear, and settle a securities transaction without violating the law or fiduciary duties.<sup>231</sup> This excess commission could be used to purchase additional services from the brokerage firm in the form of presumably valuable investment research. In order to receive protection under the safe harbor, the mutual fund must act in good faith to ensure the excess commission was “reasonable in relation to the value of brokerage and research services provided by the broker-dealer.”<sup>232</sup>

#### 1. LACK OF REGULATORY OVERSIGHT AND ILLEGAL USE OF SOFT DOLLARS

The SEC was effectively compelled to address the issue of soft dollar abuses before the Congressional Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services. This occurred on June 18, 2003, shortly after H.R. 2420, the “Mutual Funds Integrity and Fee Transparency Act of 2003” was presented to the House of Representatives by Chairman Baker, Ranking Member Kanjorski, and other members of the Subcommittee.<sup>233</sup> According to the testimony of Paul F. Roye, Director, Division of Investment Management of the SEC, the Mutual Funds Integrity and Fee Transparency Act would:

- Provide investors with disclosures about estimated operating expenses incurred by shareholders, soft dollar arrangements,

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230. 15 U.S.C. § 78c(35). The Securities Act of 1934 defines an individual with management discretion as one who

(A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) make[] decisions . . . even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence . . . as the Commission, by rule, determines in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations there under.

*Id.* § 78c(35).

231. *Id.* § 78bb(e)(1).

232. *Id.* § 78bb(e)(1); see Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, 71 Fed. Reg. 41,978 (July 24, 2006) (to be codified at 17 C.F.R. § 241).

233. See *The Mutual Funds Integrity and Fee Transparency Act of 2003: Hearing on H.R. 2240 Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 1–3 (2003) (statement of Rep. Richard Baker, Chairman, Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises).

portfolio transaction costs, sales load breakpoints, directed brokerage and revenue sharing arrangements.

- Provide investors with disclosure of information on how fund portfolio managers are compensated.
- Require fund advisers to submit annual reports to fund directors on directed brokerage and soft dollar arrangements, as well as on revenue sharing.
- Recognize fiduciary responsibility and obligations of fund directors to supervise these activities and ensure that they are in the best interest of the fund and its shareholders.
- Require the SEC to conduct a study of soft dollar arrangements to assess conflicts of interest raised by these arrangements, and examine whether the statutory safe harbor in [S]ection 28(e) of the Securities Exchange Act of 1934 should be reconsidered or modified.<sup>234</sup>

While it is commendable the SEC has decided to act on this issue, seventeen years earlier the DOL issued ERISA Technical Release 86-1 (ETR 86-1) notifying the public of this very issue.<sup>235</sup> The nature of ETR 86-1 was to “reflect the views of the Pension and Welfare Benefits Administration (PWBA) with regard to ‘soft dollar’ and directed commission arrangements pursuant to its responsibility to administer and enforce the provisions of Title I of ERISA.”<sup>236</sup> An excerpt from ETR 86-1 states:

It has come to the attention of PWBA that ERISA fiduciaries may be involved in several types of “soft-dollar” and directed commission arrangements which do not qualify for the “safe harbor” provided by Section 28(e) of the 1934 Act. In some instances, investment managers direct a portion of a plan’s securities trades through specific broker-dealers, who then apply a percentage of the brokerage commissions to pay for travel, hotel rooms and other goods and services for such investment managers which do not qualify as research with the meaning of Section 28(e). In other instances, plan sponsors who do not exercise investment discretion with respect to a plan direct the plan’s securities trades to one or more broker-dealers in return for research, performance evaluation, and other administrative services or discounted commissions. The Commission (SEC) has indicated that the safe harbor of Section 28(e) is not available for directed brokerage transactions.<sup>237</sup>

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234. *See id.* at 141–42 (statement of Paul F. Roye, Director, Division of Investment Management of the Security and Exchange Commission).

235. *See id.* at 141; Soft Dollar Release, *supra* note 220, at 1.

236. Soft Dollar Release, *supra* note 220, at 1.

237. *Id.* at 2.

Subsequent SEC investigations have shown that illegal 28(e) revenues have been used by consultants to make certain services available to mutual funds.<sup>238</sup> Among them, conferences and other similar group meetings where the consultant invites both the “client” (a 401(k) plan sponsor/trustees) and representatives of the mutual funds who want to sell their funds to the client of the consultant.<sup>239</sup> In other words, the mutual fund pays the consultant a significant amount of money to be invited to meetings where the consultant’s clients will be in attendance. Also cited were sales and marketing support to the mutual fund’s staff,<sup>240</sup> “objective looking” performance reports that paint the mutual fund in the best light, and facilitate the sale of that fund to clients of the consultant,<sup>241</sup> other “image enhancement” or “sales facilitation” services,<sup>242</sup> and charges for the loyalty of consultant or brokerage firm.<sup>243</sup>

### G. Hidden Fee Type 5—Variable Annuity Wrap Fees

A variable annuity is an investment contract between a plan and an insurance company where (normally) a series of ongoing deposits

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238. Press Release, Found. for Fiduciary Studies, Guide to SEC Probe of Consultant Pay-to-Play Schemes (Jan. 16, 2004), available at, <http://www.fi360.com/press/pdfs/paytoplay.pdf>.

239. *Id.* at 1–2.

240. *Id.* at 2.

241. *Hutcheson Statement*, *supra* note 25, at 11.

242. *Id.*

243. *Id.*

Practice Note: Illegal 28(e) revenue practices hurt plan participants and their beneficiaries, and violate ERISA Sections 403(c)(1), 404(a)(1) and 406(a)(1)(D). Fiduciaries need to know whether these activities are going on within their plans to protect the participants and themselves from harm. Illegal 28(e) soft dollars are the most difficult fee to uncover; therefore it is incumbent upon fiduciaries to investigate this issue thoroughly, asking relevant, clear, and concise questions of brokerage firms, consultants, and the mutual funds themselves. It may require an independent fiduciary audit to ultimately uncover such activities. If illegal 28(e) soft dollars are found to exist within your plan, consult with legal counsel immediately.

Practice Tip: Questions to ask your consultant, investment advisor, and/or broker:

1. Do you receive benefits from 28(e) soft dollars from mutual funds within our plan?
2. If yes, what exact benefits do you/have you received?
3. Exactly how many 28(e) soft dollars are attributed to our plan?

are made to accumulate resources sufficient to pay a future benefit.<sup>244</sup> Variable annuities can be sold by insurance agents who have little or no formal investment or fiduciary training,<sup>245</sup> and are separate vehicles that invest in mutual funds—they are not mutual funds in and of themselves. Variable annuities offer a variety of investment options that typically include mutual funds investing in stocks, bonds, and cash,<sup>246</sup> and gains on variable annuities are tax-deferred.<sup>247</sup> A fee is associated with obtaining this tax-deferred benefit—the insurance component—which provides the tax deferral.<sup>248</sup> Therefore, one must ask whether putting a variable annuity in an ERISA-governed vehicle is necessary, or even wise. An administrator could buy a lower-cost mutual fund using the inherent benefits of a 401(k) and still get the tax deferral. Paying the insurance company for the tax deferral may not be prudent.

Variable annuities generally have higher expenses than comparable mutual funds, and these fees are assessed in such a way that each component service is wrapped up into one aggregate fee.<sup>249</sup> Accordingly, this aggregate fee is called a “wrap” fee. The wrap fee hides six individual component fees and services, which are: (1) investment management fees; (2) surrender charges; (3) mortality and expense risk charge; (4) administrative fees; (5) fees and charges for other features; and (6) bonus credits.

Investment management fees are management fees of the mutual fund contained within the variable annuity.<sup>250</sup> Note that trading costs are in addition to this fee and are extremely difficult to discover in variable annuity contracts. An insurance company assesses a surrender charge if withdrawals are made from a variable annuity within a certain period of time after units are purchased within the annuity.<sup>251</sup> The charge reimburses the insurance company for upfront commis-

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244. See U.S. SEC. & EXCH. COMM’N, VARIABLE ANNUITIES: WHAT YOU SHOULD KNOW 2 (2005), available at <http://www.sec.gov/pdf/varanntty.pdf> [hereinafter VARIABLE ANNUITIES].

245. See Joseph B. Treaster, *Variable Annuity Guide: A Simple, Complex Idea*, N.Y. TIMES, Apr. 13, 2004, at G9.

246. See VARIABLE ANNUITIES, *supra* note 244, at 2.

247. *Id.* at 3.

248. See Ellen E. Schultz, *Safe but Sorry: America’s Most Expensive Cash*, WALL ST. J., Apr. 2, 1993, at C1.

249. *Id.*

250. *Id.*

251. See VARIABLE ANNUITIES, *supra* note 244, at 9.

sion payments to a broker or insurance agent.<sup>252</sup> The surrender charge usually starts out higher and decreases over the length of the surrender period.<sup>253</sup>

The mortality and expense risk charge is equal to a percentage of the account value—typically 1.25% per year over the investment management fees—but could be more or less depending on who is purchasing the annuity.<sup>254</sup> The insurer may deduct charges to cover record-keeping and other administrative expenses.<sup>255</sup> It is common to see fees of twenty-five or thirty dollars per year, or a percentage of each participant's account value, typically in the range of 0.15% per year.<sup>256</sup> Other charges and fees are stated in the annuity contract, and are actuarially computed based on age, health, and other factors and hence differ from participant to participant.<sup>257</sup> Examples of these fees are a stepped up death benefit, a guaranteed minimum income benefit, and long-term care insurance.<sup>258</sup> Finally, some insurance companies offer bonus credits, which is a credit back to the account of some percentage of each purchase—typically ranging between 1% and 5% of each deposit.<sup>259</sup> These types of accounts often have higher expenses, and the expenses can be larger than the credit.<sup>260</sup> Bonus credits are generally “purchased” with higher surrender charges, longer surrender periods, and higher mortality and expense risk charges.<sup>261</sup>

#### H. Where Does Department of Labor Regulation 404(c) Come In?

On October 13, 1992, the DOL recognized the conflict between fiduciary duty and the culture of individual account plan sales being driven by nonfiduciaries. The DOL attempted to bridge the gap between nonfiduciary behaviors in fiduciary governed plans by issuing DOL Regulation § 2550.404c-1 (Regulation 404(c)).<sup>262</sup> This regulation was subsequently sold to the public (by the retirement plan industry)

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252. Melanie Dufour, *Top 10 Variable Annuity Providers*, THESTREET.COM, May 30, 2007, <http://www.thestreet.com/funds/ratings/10359664.html>.

253. *Id.*

254. *Id.*

255. VARIABLE ANNUITIES, *supra* note 244, at 9–11.

256. *Id.*

257. *Id.*

258. *Id.* at 7–11.

259. *Id.* at 13–15.

260. *Id.* (noting that higher expenses may outweigh the benefits of bonus credits offered).

261. *Id.*

262. 29 C.F.R. § 2550.404c-1 (2000) (ERISA § 404(c) Plans).

as a fiduciary protection tool. Regulation 404(c) successfully convinced fiduciaries of the potential liability caused by the nonprudent, nontraditional, non-ERISA “IRA-type” participant-directed culture rapidly becoming the standard in all 401(k) plans.

However, Regulation 404(c) may have actually created a false sense of security with most 401(k) trustees and other fiduciaries. The effort to educate participants with respect to their duties is honorable, yet such efforts have not yielded positive results for the participant and have greatly increased the plan sponsor’s burden to pay for and manage these efforts. Obtaining protection under Regulation 404(c) requires full compliance; a costly “all or nothing” effort.<sup>263</sup> Of all of the plans I have audited, none have fully complied with Regulation 404(c), rendering vain all efforts with respect to the original intent of protecting the fiduciary. This well-intended band-aid further reveals the flaw in the current system and culture. Fiduciaries who try to protect themselves will fail. Fiduciaries who protect participants will succeed. That is the true intent of ERISA.

In my opinion, Regulation 404(c) has been one of the most misleading and damaging regulatory allowances ever granted.<sup>264</sup> It should be eliminated immediately, and fiduciaries should be held to the high standards ERISA, courts, and the other regulatory pronouncements originally envisioned and contemplated. Fiduciaries should be all too eager to embrace their responsibilities and discharge them with honor and loyalty for all the reasons expressed in this article.<sup>265</sup>

## VI. Conclusion and Recommendation

Participant directed accounts, their management, and the associated errant industry culture are the sources of the current fee problem. To eliminate hidden fees, the nonfiduciary participant-directed IRA suitability culture must be rooted out of all ERISA-governed plans. Failure to treat all plans subject to Internal Revenue Code (IRC)

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263. *Id.* § 2550.404c-1 (for example, under § 2550.404c-1(b)(2)(i), sixteen conditions must be fulfilled for a plan to be considered under the control of a participant or beneficiary).

264. See, e.g., Matthew D. Hutcheson, *A Conversation with a Fiduciary*, MORNINGSTAR, June 7, 2007, <http://advisor.morningstar.com/articles/doc.asp?docID=13155>; see also Hutcheson, *supra* note 15, at 11–14.

265. For a more detailed discussion on DOL Regulation 404(c), see Hutcheson, *supra* note 15, at 11–14.

§ 401(a), and hence subject to ERISA's fiduciary standard, the same has now placed some 401(k) service providers and fiduciaries at risk. They find themselves in the crosshairs of highly effective litigators, the SEC, the DOL, and state Attorneys General<sup>266</sup> for violations of the exclusive benefit and other fiduciary rules. Most fiduciaries have not discovered that the fee problem begins deep inside the operational structure of the industry, and until this fact is universally internalized, the problem will remain within 401(k) plans. The 401(k) industry itself is now being viewed with suspicion and has taken a serious credibility and public image hit.

Some legal experts and other expert fiduciaries have concluded modern services for individual account plans are sold to plan sponsors as a need to justify the platform that in turn justifies additional fees.<sup>267</sup> Statistics show not only that these new costs place a heavy strain on participant accounts, but that participant-direction itself has proven to be a costly failure, hurting millions of future retirees.<sup>268</sup>

It has taken serious litigation initiatives to bring this topic into the homes of the people it affects. Regular folks get it now, and vendors should consider the consequences of an indignant public.<sup>269</sup> It is likely litigation will continue as long as the 401(k) industry insists on defending an inappropriate economic and philosophical model. It is advisable for the industry to settle these lawsuits, and seek direct guidance from an independent steering committee to fix the system and restore trust with the investing public.

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266. See, e.g., Office of the New York State Attorney General Andrew M. Luomo, *Investors and Securities*, <http://www.oag.state.ny.us/investors/investors.html> (last visited Nov. 12, 2007).

267. HAMILTON & BURNS, *supra* note 109, at 2-3.

268. *Bogle Statement*, *supra* note 50, at 400.

269. Public awareness of the fee problem is growing. See, e.g., Jim Abrams, *Feds Press for Better Fee Disclosure*, COLUMBUS DISPATCH, Dec. 5, 2006, <http://www.dispatch.com/business-story.php?story=dispatch/2006/12/03/20061203-E2-02.html>; Jim Abrams, *Participants in 401(k) Plans Left Mostly in Dark About Fees*, SEATTLE TIMES, Dec. 1, 2006, [http://seattletimes.nwsourc.com/html/business/2003456055\\_retireslippage01.html](http://seattletimes.nwsourc.com/html/business/2003456055_retireslippage01.html); Jim Abrams, *Sponsor Fees May Be Chipping Away at Your 401(k) Savings*, NASHUA TELEGRAPH, Dec. 1, 2006, <http://www.nashuatelegraph.com/apps/pbcs.dll/article?AID=/20061201/BUSINESS/212010304>; Mary Dalrymple, *Frightening Fine Print*, Dec. 1, 2006, <http://www.fool.com/personal-finance/general/2006/12/01frightening-fine-print.aspx>; Edward Epstein, *Dems Set to Take On Pension, Health Industries*, S.F. CHRON., Dec. 1, 2006, <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2006/12/01/MNG33MN8O51.DTL&feed=rss.news>; Lauricella, *supra* note 104; Sammer, *supra* note 164; Brian Tumulty, *Congress to Probe 401(k) Charges*, HONOLULU ADVERTISER, Dec. 2, 2006, <http://the.honoluluadvertiser.com/article/2006/Dec/02/bz/FP612020327.html>; Wasik, *supra* note 90.

It is the fiduciary's solemn duty to prevent the use of plan assets for any purpose other than for the exclusive benefit of participants and beneficiaries, or for paying reasonable administrative fees. Until the problem, not just its symptoms, is dealt with, full disclosure must be demanded and provided in a more rigorous fashion. Full disclosure with respect to fees *must* mean:

- a. The fiduciaries have been told everything about the services, fees, and expenses of the plan in *writing*. Neither the industry nor fiduciaries should fear providing information to plan participants if requested. Rhetoric exists that seeks to use fear, uncertainty, and doubt as a tool to withhold certain relevant information from decision makers, whoever they may be. The argument is, "if we are forced to provide too much information to participants, they will stop investing in the plan." Such arguments are unintelligent rhetoric. When nutritional information was added to food products, consumers did not stop eating. On the contrary, they became more informed consumers. It is true that participants may stop investing in those products that have been obscuring relevant data, but they will not stop altogether. Rather, they may contribute more as the retirement plan industry builds trust with plan sponsors and participants.
- b. The fiduciaries *understand* the significance of what was disclosed in writing. In other words, the disclosure is made verbally and in writing—a dialogue is entered into, logged in fiduciary minutes confirming that understanding, and that comprehension was the primary objective of the disclosure.
- c. Until fiduciaries have in their possession *information sufficient to analyze and comprehend*, there is no full disclosure.

Soft dollars, sub-transfer agent fees, and revenue sharing obscure a fiduciary's ability to act prudently, with knowledge and understanding. This lack of knowledge can materially affect the quality of a participant's future. Hidden fees are, in some cases, an illegal transfer of plan assets to a party-in-interest, thereby violating the exclusive benefit rule. Further, the way hidden fees are structured and ultimately collected can, in fact, impede a fiduciary's ability to select the investment strategy that is best for the participants within a plan. Fiduciaries must demand clarity and full disclosure of all fees, even



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those of which the broker or consultant may not themselves be aware. Fiduciaries, with the assistance of fiduciary service providers, should consider the history of how hidden fees came to be and consider the merits of a traditional ERISA fiduciary approach.