401(k) plan sponsors: More disclosures to help you meet your fiduciary responsibilities

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Creating a retirement benefit in the form of a 401(k) plan should be exactly that–a benefit and not a burden. As a plan sponsor, you have choices among many qualified organizations and a wide variety of products and services to help in the administration of a 401(k) plan. However, one part of this benefit has also become a burden to plan sponsors: fiduciary responsibility. One important aspect of this role is understanding the expenses related to the plan investments and administration–understanding, in short, the total cost to you as the sponsor and to your employees who invest their savings in the plan.

A 401(k) plan sponsor and its participants should both have a clear understanding of the costs for services provided. Our goal is simple: to help our clients and the industry get the information they need to make prudent decisions as plan sponsors and participants. It has long been our policy to disclose retirement-plan-administration service costs and expenses and to help plan sponsors communicate these details in a way that facilitates the decision making of participants regarding their retirement benefit.

So what does fee transparency mean? There are two perspectives:

1) The plan sponsor and fiduciary, who needs details on the total cost of the administration of the plan and its investment expenses in order to benchmark service-provider options and make apples-to-apples comparisons of services and costs.

2) The plan participants who want to know about the costs associated with the administration of the plan and any transactions, because these expenses will affect their retirement savings.

In this paper we explore the disclosure efforts by the federal government over the last decade, review some of the currently pending proposals, and offer some of our insights for the future.

WHERE DID IT BEGIN?

Over the last several years, federal agencies have issued proposed regulations intended to help retirement-plan sponsors and participants understand the true cost of retirement plans, including the associated fees. In 1998, the Department of Labor (DOL) published *Study Of 401(k) Plan Fees and Expenses*, which showed that 401(k) plan assets had grown by then to over $1 trillion since their inception in 1978. The report concluded that plan sponsors and participants were not, in fact, being provided with adequate information regarding plan fees and expenses and the report highlighted two problem areas: 1) the fees and expenses associated with 401(k) investments were often not fully disclosed to plan-level decision makers and plan participants, and 2) plan sponsors did not have the information needed to determine the total cost of the administration of a retirement plan.

Without a good understanding of either, how could a plan sponsor, and a plan fiduciary, make decisions related to the selection of a 401(k)-plan service provider?

WHERE ARE CONGRESS AND THE DOL GOING WITH THIS?

Beginning in 2007, Congress and the DOL elevated the priority of the concept of fee transparency and full disclosure, and defined what it should look like for plan sponsors. Essentially they broke the project down into three components:

- Information to be filed with the Internal Revenue Service (IRS) or DOL
- Disclosures by service providers to plan sponsors
- Disclosures to plan participants

To address the first component, Form 5500 (an annual informational return filed with the IRS and shared with the DOL) will include a revised Schedule C (Service Provider Information) that will require disclosure of various details related to fees, expenses, and other types of compensation generated from or otherwise related to the retirement plan. Prior to these revisions, some direct expense-related information had been required; however, the revised schedule includes both direct and indirect types of compensation paid to service providers that had not previously been required to be disclosed to plan sponsors (indirect compensation is most often related to plan investments). The DOL feels that the required disclosures will mitigate potential conflicts of interest and reduce the situations in which third parties provide recommendations to plan sponsors that may not be in the best interest of plan participants. The revised Form 5500 Schedule C will go into effect for the 2009 plan year.

To address the second component, in December 2007 the DOL released a proposed set of additional disclosures under ERISA Section 408(b)(2). Section 408(b)(2) currently provides an exemption from the prohibited-transaction rules for fees paid to vendors considered to be reasonable and necessary for the administration of a retirement plan. The proposed amendment to Section 408(b)(2) will require that service providers disclose direct and indirect compensation and that bundled providers

WHAT IS A BUNDLED PROVIDER 401(k) PLAN?
See the Milliman white paper *A 401(k) Plan That Works—The Bundled Unbundled Solution* for more details on the issues related to bundled service providers.

For more information on the importance of plan designs to generate adequate savings, refer to Milliman's white paper *Savings rates: Hybrid tools for better retirement mileage*.

estimate the amount of this compensation. In addition, service providers must disclose and describe any conflicts of interest that may be present and related to the services they provide for a plan sponsor. The service provider must also provide, on an ongoing basis, the information necessary for the plan sponsor to understand the expenses related to the plan; service providers must also comply with the ERISA reporting requirements. This is an attempt to make transparent some of the hidden payments and revenue sharing that may not necessarily be disclosed today.

Finally, in July 2008, the DOL issued their latest proposal that will require certain disclosures be made to participants who have investment control over their 401(k)-type plan account. The information required will be related to the plan investments and any related expenses. Additionally, plan fiduciaries must disclose, at least quarterly, the total amount of fees charged to a participant's account during the quarter. The DOL provided a sample format in which the data should be provided. The format includes investment returns and expenses (investment management expenses and any termination charges). While this proposal was slated to go into effect January 1, 2009, it is generally expected to be postponed to a later date.

Even as the regulatory process unfolds, members of Congress are committed to increased disclosures. During the 110th Congress, hearings were held and bills were introduced to provide greater transparency about plan fees and expenses. Interest is expected to remain high when the 111th Congress convenes in 2009.

WHAT SHOULD PLAN SPONSORS BE LOOKING FOR?

If you are a plan sponsor and a fiduciary, it is your responsibility to have a thorough understanding of the services provided to your plan and any associated fees and expenses paid to these service providers, whether directly billed, allocated to participants, or paid by revenue sharing. In addition, sponsors should have a clear understanding of the level of revenue sharing generated from plan assets and how it is utilized. It's your duty to ask for a fully itemized statement from your service provider(s) showing this information.

The information you should ask for, at a minimum, includes:

- How much does record-keeping, compliance, and reporting cost?
  - Is it per participant or is it a fee that is a percentage of plan assets on a global level? Are there any per-transaction charges?
  - Ask your service provider(s) for a complete breakdown of the expenses related to the plan.
  - If there are sub-vendors, ask your primary vendor(s) for details on how much they are paying, or any soft compensation they are getting from their own vendors. Sometimes advisors may receive software or analytics for bringing assets to a custodian.
- What are the expense ratios for each of the plan investments?
  - If you have access to brand name mutual funds, your expense ratio should match what is published in a prospectus.
    - If your vendor provides something different, this is a possible indication that the vendor is charging plan administration expenses to the plan, and not disclosing it.
  - Ask for a projection, in actual dollars, of how much the management expense is for each plan investment.
- Is there any compensation created by the plan investments and is it being fully disclosed and fair for the services provided?
  - If you have a vendor that never sends you an invoice for services, and tells you the plan is free, chances are that either revenue sharing is being paid by the plan investments, or expenses are being deducted from the returns of the plan investments.
  - This type of payment may come in the form of 12b-1, sub-transfer agent (T/A) payments. or administration expenses factored in the fund's price (or NAV).
- Benchmark your plan and investments
  - There are many surveys available that provide average plan-administration-related expenses and statistics.
  - There is a wealth of information related to the plan investments.
- Bring in an independent third party to review fees and expenses
  - If you do not believe that you are getting factual comparative information from your vendor, you might consider hiring an independent third party—there are many independent investment advisors and consultants who can provide an analysis of the plan-related expenses.

We believe that the Form 5500 changes and the DOL proposals regarding disclosure to plan sponsors are steps in the right direction, but they have been too long in coming—the DOL study came out 10 years ago and the industry is still getting around to disclosure. Do the DOL proposals do enough to provide plan sponsors with an understanding of the fees and expenses associated with their 401(k) plan? The answer is a definite maybe. Plan sponsors will still have to do the digging to get what they need for the Form 5500, and bundled service providers will have some degree of flexibility in their interpretation of the disclosure requirements, specifically as to what has to be provided to plan sponsors. Ultimately, the onus of responsibility falls into the hands of the plan sponsor.

WHAT ADDITIONAL DISCLOSURE SHOULD BE PROVIDED TO PLAN PARTICIPANTS?

There are two schools of thought here:

1) The more information, the better
2) Too much information can be confusing and discouraging

We believe that, while plan sponsors have the responsibility of selecting the record-keeping and administrative-services provider, each participant generally must make the decision as to where to direct investments. In our view, participants need to have a specific understanding of the net expenses associated with each fund. We also believe that participants should have a general understanding of the administrative costs of operating the plan, including any transactional costs they may incur (e.g., for loan and distribution processing).

Participants should also have access to information about any potential conflicts of interest between service providers and the plan sponsor, and how much revenue sharing is associated with each investment. This information will most likely be disclosed on Form 5500 and directly to plan sponsors, who have ultimate oversight for the retirement plan.

We also feel that the information provided to plan participants should be in a straightforward easy-to-read format. The proposed DOL model comparative provides some basic information related to the plan investments, breaking them into categories (bond, stock, active management, passive management) and detailing management expenses, any maintenance expenses, and trailing charges related to the investments. However, it does not break out the direct charges to the participant.

It may be worth consideration, for disclosure to participants, to include the items from the DOL model comparative chart related to investment expenses and return information and to also include those expenses directly charged to the participant. The expenses charged directly to the participant would include any fees allocated or charged to their account for the administration of the plan (e.g., record-keeping, consulting, and audit expenses) and any transactional charges.

EXAMPLE OF A PARTICIPANT EXPENSE DISCLOSURE STATEMENT

For illustration purposes in Figure 1 on the following page, we present a sample of how expenses related to the management of the plan investments, plan administration charges and transactional expenses could be provided to plan participants. This information would be specific to each participant in the plan and included along with the participant statement each quarter. In the sample we will assume that the participant has a $40,000 account balance, is invested equally in the four investment options offered by the plan, and takes a new loan during the quarter and a hardship distribution. The plan charges a portion of the administration expenses to participants ($2 per month and 0.05% annually).

WHAT IS REVENUE SHARING?

Revenue sharing represents amounts paid by mutual fund companies to other service providers for shareholder services provided to the plan and participants. Examples of such services include recordkeeping, administration, and compliance services, as well as education and enrollment materials for participants. These payments often come in the form of 12b-1 or Sub T/A payments.

WHAT'S NEXT?

There are almost too many options out there for plan sponsors to consider in building a retirement benefit plan that will help to meet the retirement savings needs of their employees, that will align with their corporate objectives, and that will satisfy their responsibilities as a plan sponsor and fiduciary. Some of the options are easy to understand–such as, should we have an employer match and how much–while others, such as understanding the expense structure of various services providers, have been quite difficult to determine.

The DOL has been working on requiring more disclosure related to the fees, expenses, and hidden reimbursements related to 401(k) plans. The new Form 5500 requirements will go into effect during 2010, for the 2009 plan year. Two other DOL regulations are currently pending as proposed–disclosures by service providers to plan sponsors and disclosures to participants. The DOL is in the process of assessing comments, and we expect that the rules will be finalized in 2010. However, plan sponsors and participants will be illserved if the final regulations leave loopholes for service providers to continue to hide conflicts of interest and hidden payments (whether direct or indirect).

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FIGURE 1

INVESTMENT EXPENSES

THESE EXPENSES ARE RELATED TO THE MANAGEMENT OF THE PLAN INVESTMENTS AND PAY FOR THE INVESTMENT MANAGERS WHO MANAGE EACH INVESTMENT. THEY ARE ESTIMATED BASED ON YOUR ACCOUNT BALANCE AT THE END OF THE QUARTER AND THE ANNUAL INVESTMENT MANAGEMENT EXPENSE.

INVESTMENT	CATEGORY	ANNUAL INVESTMENT MANAGEMENT EXPENSE	QUARTER END ACCOUNT BALANCE	APPROXIMATE QUARTERLY EXPENSE CHARGED TO YOUR ACCOUNT
Fund A	Money Market	0.50%	$10,000	$12.50
Fund B	US Bond Fund	0.65%	$10,000	$16.25
Fund C	US Equity Fund	0.85%	$10,000	$21.25
Fund D	Foreign Equity Fund	1.00%	$10,000	$25.00
APPROXIMATE INVESTMENT EXPENSES				$75.00

PLAN ADMINISTRATION EXPENSES

THESE EXPENSES ARE RELATED TO THE ADMINISTRATION OF YOUR 401(k) PLAN. THEY PAY FOR RECORD-KEEPING, ADMINISTRATION, AUDITING, EDUCATION, COMPLIANCE, AND COMMUNICATIONS. YOUR ACCOUNT IS CHARGED A PORTION OF THE EXPENSES NECESSARY TO ADMINISTER THE PLAN.

DESCRIPTION OF PLAN ADMINISTRATION EXPENSE	EXPENSE DETAIL	FORMULA	APPROXIMATE QUARTERLY COST TO PARTICIPANT
Per-participant Charge	$2 per month	$2 X 3 months	$6.00
Asset-based Administration Fee	0.05% annually	0.05%/12 X 3 months	$5.00
PLAN ADMINISTRATION EXPENSES			$11.00

TRANSACTIONAL EXPENSES

THESE EXPENESE ARE RELATED TO ANY TRANSACTIONS PROCESSED DURING THE QUARTER. FOR EXAMPLE, LOAN ORIGINATION OR WITHDRAWALS.

DESCRIPTION OF TRANSACTION	EXPENSE DETAIL	# OF TRANSACTIONS	APPROXIMATE QUARTERLY COST TO PARTICIPANT
Loan Origination	$50	1	$50.00
Hardship Withdrawal	$35	1	$35.00
TRANSACTIONAL EXPENSES			$85.00
Total Quarterly Participant Expense			$171.00
Expense as a percent of your account			0.43%

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