Written Testimony of

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on

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INTRODUCTION

Very few matters of social importance are more complex than the one before you today. This particular issue is not only about uncovering obscure dollars unscrupulously extracted from the account balances of America's workforce, but it is also about correcting the culture that has permitted the problem to thrive in the first place. This written testimony will explain what the culture is, why it exists, how it has evolved over time, how it violates basic economic principles, the integrity of rules of fiduciary prudence, the exclusive benefit rule under ERISA, and other common sense practices that are critical for delivery of expected results from employer defined contribution retirement plans.

The American Worker Is Hurt by What He Can't See

> "*If we make a few rough calculations, the importance of the topic will be very clear. The SEC estimates in Concept Release 33-8349, that 1% of the average fund's investment return disappears each year due to brokerage expense, execution costs, and transaction spreads. Other industry sources indicate that an additional .50% slips away via "revenue sharing payments." The impact on the average American is profound.*
>
> "*Consider two thirty year old workers who each invest $3,000 annually into their 401(k) programs. American #1's 401(k) program is run according to stringent fiduciary principles and earns 7.5% annually. However, American #2's 401(k) is operated by conflicted, sales driven entities and only earns 6% annually after the aforementioned return erosion. The table below details the results.*

Year	American # 1 – Fiduciary 401(k) Earning 7.5%	American # 2 - Hidden Fee 401(k) Earning 6%
10	$45,624	$41,915
20	$139,658	$116,978
30	$333,463	$251,405
40	$732,902	$492,143
47	$1,244,260	$766,694

> "*Even though both employees contributed the same amount and took the same investment risk, American #2 must work an additional seven years to make up for the lack of fiduciary oversight in his 401(k) plan."*[1]

The difference in hidden fees costs American worker #2 nearly **$500,000** during the illustrated period of time. This issue is about real people, real money, and the quality of their lives later in life. Consider the impact on American worker #2's ability to pay for health care, prescription drugs, home repairs or even groceries. If actuarial tables hold true, today's retiree may need to be prepared to live a quarter century longer than his grandparents did.

BACKGROUND

A "401(k)" is a Qualified Retirement Plan

Qualified retirement plan assets pursuant to Internal Revenue Code ("IRC") section 401(a) are held in trust pursuant to IRC §501(a) and the Employee Retirement Income Security Act ("ERISA") §403(a) *exclusively* for the future benefits of participants and beneficiaries. 401(k) plans enable employees to take wages and bonuses in cash, or *defer* them into the trust, and hence are often referred to as "employee deferrals." All sources of contributions, whether from the employer or employee, plus investment earnings of "401(k)" plan investments are subject to the same rules of trust administration, governance, and fiduciary prudence that apply to all employee benefit plans defined by ERISA §3(3), including traditional profit sharing, and traditional pension plans.

ERISA – Employee *Retirement Income Security*

The purpose of a retirement plan, including 401(k) plans, is to provide *future income* for retired American workers. Those who are charged with the management of a qualified retirement plan must do so with an eye single to this purpose and none other. Such an individual is a "fiduciary."

Rules of Fiduciary Prudence

As it relates to the issue at hand, the following fiduciary axioms have consistently held true:

- Fiduciary based decisions secure future retirement income.
- Non-fiduciary based decisions diminish future retirement income.
- Hidden and excessive fees exist in part because both types of decisions (fiduciary based and non-fiduciary based) exist simultaneously within 401(k) and other similar plans, complicating and obscuring a fiduciary's ability to understand his duties and to properly discharge them.

This written testimony will focus solely on 401(k) and similar plan assets held in trust, pursuant to IRC §501(a) and ERISA §403(a). Therefore, rules of Fiduciary Prudence are a fundamental component of this discussion because trusts are governed and managed by fiduciaries. True prudent fiduciary practices should deliver optimal results. Poor or partial fiduciary practices will deliver sub-optimal or even poor results.

Fiduciary principles and ideals are not obscure, nor are they difficult to learn and understand. In fact, modern rules of fiduciary prudence have existed for nearly two hundred years. However, in the United States, the primary way fiduciary responsibilities are taught to sponsors of retirement plans is through the financial industry. Since an important element of fiduciary governance is monitoring those who provide services to a retirement plan, strangely enough, we have accepted a system where those being

monitored are teaching those who are doing the monitoring, and doing so according to their philosophies and standards, with a particular objective in mind.

The current 401(k) culture essentially couples the "fox teaching the rooster how to guard the hen house" with a perceived governmental "get out of jail free card" (i.e. DOL regulation 404(c)). The effect of adopting these two "cultural" elements has, over time, caused 401(k) plans to be governed through the blending of fiduciary and non-fiduciary practices and philosophies.

Therefore, resolving the issue of hidden, obscure, and excessive fees is wholly dependent on bifurcating fiduciary elements and practices from the non-fiduciary ones within the 401(k) industry. Then, logic will reveal that any fees paid for non-fiduciary services and practices are unnecessary, and hence excessive. Furthermore, these are the fees that are hidden because they simply cannot be justified when viewed through the lens of true fiduciary prudence. In short, if fiduciaries eliminate non-fiduciary practices in their 401(k) plans, they will immediately eliminate hidden and excessive fees. To argue otherwise would suggest that 401(k) plans are only "partially" subject to fiduciary prudence, and hence are only a "partially" qualified plan.

Conceptually, it is as simple as that – but in practice, it is far more difficult.

Complexity

The hidden fee problem in 401(k) and similar plans is actually a mysterious Gordian knot consisting of trust law, tax law, public policy, doctrines of fiduciary prudence, financial principle, economic principle, and perhaps the lack of discipline to defer control and gratification until actual retirement. It is difficult to see the ends of the rope, and very few know how to unravel it. In addition, many who might discern how to unravel it have strong incentives not to do so.

It is widely accepted that 401(k) and similar arrangements are the way most Americans will invest for retirement. Therefore, it is incumbent upon us all to be absolutely certain there are no unnecessary obstacles (whether intentional or unintentional) to its long-term success. As it stands today, there is competition between prudent practices aimed at efficiently securing the retirement income of America's workforce, and non-fiduciary services created for business purposes of service providers.

Obstacles to a Clear Understanding

- Conflicting and/or ambiguous Governmental messages that confuse qualification rules under IRC §401(a) with rules of fiduciary prudence and process as defined by Department of Labor regulation, case law, and other regulatory pronouncements.

- "Exemptions" given to fiduciary and non-fiduciary firms or individuals to receive compensation from trust assets without being legally held to a strict fiduciary standard of conduct. In other words, non-fiduciary motives in 401(k) plans have created a non-fiduciary operating environment. (The "Merrill Exemption" is one example)[2]

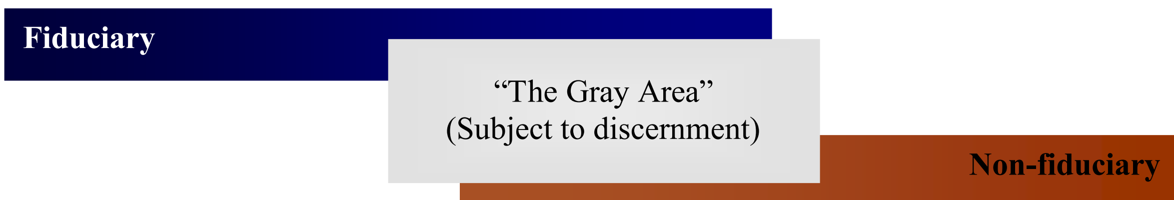
- ERISA has imposed a federal fiduciary duty and responsibility on business executives and board directors who serve as "ERISA Fiduciaries" requiring them to act *exclusively* in the best interest of plan participants and beneficiaries. A growing chorus of benefit industry gurus believes that such executives and directors had a *pre-existing* fiduciary duty and responsibility to the owners of the business. Query: Has ERISA unintentionally imposed an incurable conflict of interest? That is, can any person faithfully serve the best interest of two conflicting masters? Plan participants may believe they are out of harm's way and protected, as fiduciary oversight is mandated by ERISA, but increasingly these fiduciaries appear to be like a sightless watchdog that doesn't bark.

- Fiduciary ignorance, fear, uncertainty, and doubt, which leads to non-fiduciary decisions and practices.

Identifying non-fiduciary practices, and their associated costs

Decisions and/or functions that are clearly fiduciary in nature include proactively monitoring costs, selecting a proper number of efficient investments necessary to construct an appropriate portfolio, and operating the plan in exact accordance to its purpose – which is to deliver retirement income to its beneficiaries.

Decisions and/or functions that are clearly imprudent include purchasing high cost investments and services when their identical match is available at perhaps less than half the cost, or turning a blind eye to obvious mishandling of trust assets by non-fiduciaries (i.e. the participants) and, at the same time, claiming for themselves protection from fiduciary liability under 404(c).



There are other decisions and/or functions that fall into a gray area. Such decisions or functions might be prudent, or they might not be.

The significance of this explanation is that some fees are obviously necessary and prudent. Some fees are hidden and imprudent and pay for excessive or unnecessary

services. Finally, there are fees that could be improper in some plans, and acceptable in others, and it takes an experienced, discerning eye to recognize the differences.

Excessive is as excessive does

The following examples show the interplay between various imprudent, hidden, and excessive fees as influenced by the 401(k) culture described above.

Even at this time, a blatant non-fiduciary based feeding frenzy is taking place at the expense of American workers' 401(k) plans.

> *"The 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 nation's household, college, and retirement savings."*[3] *($12 trillion update added)*

Most experts agree that trust fiduciary laws are nominally default rules,[4] and hence should be simple to adhere to and operate under. However, managing 401(k) plans is anything but simple. It's a jumbled mess because non-fiduciary investment sales people have infiltrated, and now control what was intended to be a purely fiduciary function.

It would be simple to obtain optimal results. Then why isn't it happening?

For example, the S&P 500 Index consistently outperformed 98% of fund managers over the past three years, 97% over the past 10 years ending October 2004, and 94% over the past 30 years.[5]

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."[6] 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. "Over long periods, this difference in return amounted to substantial differences in wealth."[7] 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."[8]

Then why do literally hundreds of thousands of 401(k) plan fiduciaries do just the opposite? It's because they are "guided" to particular decisions by non-fiduciaries (i.e. brokers, registered representatives, insurance agents, etc.) in pursuit of compensation which very frequently is in the form of hidden and excessive fees.

MAKING SENSE OF IT ALL

Following are some of the usual hidden costs found in 401(k) plans.

Hidden Costs #1 – Undisclosed Trading Costs

The assets held in account for the benefit of participants and beneficiaries do not belong to them. These assets are owned by an "entity," **which is the trust**. The participants are entitled to *future* benefits from the trust. This is an important concept in trust governance. In other words, if the investments belonged to the participants right now, there would be no need for fiduciaries. Therefore, the fiduciaries are charged with making decisions for the future benefit of others, based on what they deem appropriate for the participants and beneficiaries, in a similar way a member of the House of Representatives makes decisions for their constituents. The decision is based upon what they judge to be in their constituents' best interests.

> "*The new prudent investor rule directs the trustee to invest based on risk and return objectives reasonably suited to the **trust**.*"[9]

A major flaw in the 401(k) system, therefore, is allowing non-fiduciaries (in this instance, plan participants themselves) to control trust assets by choosing without skill from a large array of investment choices, carefully presented in such a way as to generate additional brokerage (trading) commissions by encouraging "active" trading within participant accounts. In other words, emotional reactions of participants who lack investment expertise trigger undisciplined and imprudent investment decisions in the trust, when a simple 60% stock, 40% bond portfolio described above is well within the reach of every single participant. The brokerage and investment fund industries not only fully understand that participants are making imprudent investment decisions, but are *counting on participant ignorance to generate revenue*. This is a substantial and hidden cost that participants are almost universally unaware, and have no concept of how it is reducing the future retirement income they would otherwise receive. The average actively traded mutual fund experiences approximately 80% turnover per year, meaning that 80% of the underlying stocks and/or bonds are sold each year. It is estimated that for every 1% in turnover, there is 1% in added brokerage commission cost. Hence, the average mutual fund has an added cost of .8% (otherwise known as 80 "basis points"). This is the first hidden and unnecessary cost.

It becomes easier to understand why so many 401(k) plans primarily offer (1) actively managed investment choices, and (2) more funds than are necessary to construct a prudent, low cost portfolio. It also demonstrates rampant ignorance that exists in the fiduciary ranks – in plans large and small.

> "*TheStreet.com profiled a fund last year that had a 5 star rating, a 1% expense ratio, and **800 bps** in brokerage expense.*"[10]

Reducing net returns through unnecessary and excessive brokerage expenses is a non-fiduciary and imprudent practice that runs counter to the principles set forth in ERISA, which is to secure the retirement of American workers. Consider the chaos that would result if Congress gave each citizen 15 laws to choose from. Individually, we might pick and choose those we deem appropriate for us and, in turn, adhere only to the particular laws we chose. The principle of fiduciary prudence is that fiduciaries make decisions for all individuals to whom they are responsible based upon what is in their best interest, whether they like it or not. As unpopular as this concept is, we must not equivocate on protecting participants and beneficiaries from their own lack of knowledge.

The current 401(k) culture has eroded the principles of true fiduciary governance through the begging, pleading, lobbying, or through other ways and means, fiduciaries collectively have drifted from “protecting their future retirement security” to “give them what they want whether it’s good for them or not.”

Hidden Costs #2 – SEC Rule 28(e) “Soft Dollar” Revenue Sharing

SEC Rule 28(e) legalized charging “excess” brokerage commissions. 28(e) permits hidden cost #2 to exist, and is symbiotic with Hidden Cost #1 above. Rule 28(e) violates fundamental fiduciary rules by permitting plan assets to be used for purposes other than for the exclusive benefit of the participants and beneficiaries. 28(e) Soft Dollars are generated by active securities trading within mutual funds and similar investment vehicles. Allowing “Soft Dollars” to go un-captured and un-credited back to the 401(k) trust is not a fiduciary practice, and the historical problems caused by soft dollars are self evident.

It’s important to take a moment to explain how 28(e) excess commissions came to be. Shortly after the creation of the IRA, but before the creation of the 401(k) as we know it, a change occurred within the brokerage and mutual fund industry. As part of the Securities Acts Amendments of May 1975 (SAA ‘75), fixed commission rates on the purchase and sale of securities through brokerage firms were eliminated. 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. This would ultimately allow brokerage firms to charge excess commissions, thereby creating “at play” dollars that actually belonged to the participants, which is commonly referred to as “soft dollar” revenue or “SEC Rule 28(e)” excess commissions. With hundreds of billions of securities trades each year, the excess commissions made available by SAA ‘75 would forever change the investment and retirement plan industry. These soft dollars, coupled with the urgent need to compete in the 401(k) industry and the creation of the 12(b)-1 in 1980 created the “perfect fee storm,” which until now has existed with little or no notice by Federal regulators, plan sponsors, participants, or the general public.

As a result of the Securities Acts Amendments of 1975, Section 28(e) was added to the Securities Exchange Act of 1934. With fixed commission rates no longer the law, Section 28(e) created a safe harbor for brokerage firms who exercise *no investment discretion* as defined under Section 3(a)(35) of the 1934 Act to be able to charge a fund a commission

that was more than what it actually costs to execute, clear, and settle a securities transaction *without violating the law or fiduciary duties*. A brokerage firm may also choose not to operate within the safe harbor, further obscuring costs and making even more difficult for a fiduciary to fulfill their ERISA mandate to know and monitor fees, commissions, costs, expenses, etc.

"*It can be difficult for all but the most sophisticated investors to understand and effectively monitor an adviser's use of soft dollars outside the safe harbor, and to understand their impact on the adviser's expenses and trading activity. Moreover, the 1998 OCIE (Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission) Report noted that disclosure by advisers concerning their use of soft dollars was not very effective; less than half of the advisers examined provided disclosure 'with sufficient specificity to enable clients or prospective clients to understand what was being obtained.' Even more importantly, OCIE found that, of those advisers who purchased products or services outside the safe harbor,* ***none*** *provided sufficient disclosure*."[11] (OCIE clarification added)

Failing to operate within the safe harbor such as charging excess commissions associated with products and services that were readily and customarily available and offered to the general public on a commercial basis[12] is not necessarily a violation of securities law, nor is it really the point. When qualified retirement plan assets are involved, the practice of charging excess commissions without the knowledge and understanding of the plan fiduciaries is most certainly a violation of the principles of fiduciary prudence and other ideals set forth by ERISA, and are an unnecessary expense borne by participants.

Excess commissions are 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 fund manager 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." Since excess commissions are subject to fiduciary jurisdiction, a fiduciary to the plan must be the one who determines whether excess commissions are reasonable and appropriate for participants to pay, not the fund manager receiving the "benefit" of the excess commissions. From a true fiduciary perspective, it is difficult to justify their existence considering a passive indexing approach requires no research and also consistently outperforms 90% of actively managed approaches that do require research. Considering this, a prudent fiduciary might question the value of such research. The 10% that do outperform an indexing approach statistically are temporarily fortuitous.[13] If you follow the money, modern investment research (in the context of this discussion) arguably exists so fund managers can benefit from 28(e) excess commissions, not to provide consistent market returns to participants.

Actively traded funds inherently have higher trading costs. In other words, 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. Part of the reason for this lies in the fact that "excess" commissions are being charged for non-fiduciary purposes.

SEC rule 28(e) encourages turnover of underlying securities and the associated cost of trading because fund managers receive rebates of excess commissions from the brokerage firms for clearing the Funds' securities trades. This explains why the intelligent approach so widely accepted by the world's most astute investing minds is thrown out the window in 401(k) plans. Brokerage and Fund companies work together to generate excess commissions at the expense of participants, *because they believe they can indiscriminately do so*, not because it is prudent, intelligent, or advisable.

Prior to ERISA, fund managers used "excess" commissions generated from securities transactions to buy additional goods or services from their chosen brokerage firm. For example, if a trade costs 3.5 cents per share (trade execution, clearance and settlement), 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 to their rightful owners, the account holders. Excess brokerage commissions (28(e) soft dollars) were handled the same way for IRAs and qualified plans.

After ERISA, the practice of using such soft dollars in IRAs would remain the same, but with respect to participants and beneficiaries within a qualified 401(k) plan subject to rules of fiduciary prudence, a conflict clearly exists with 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." *Significance: Using soft dollars for purposes other than for the exclusive purpose of providing benefits to participants and beneficiaries and paying operational costs of the plan itself is a fiduciary breach.*

- ERISA 404(a)(1) states that a fiduciary must act prudently and *solely* in the interest of the participants and beneficiaries. *Significance: Using soft dollars to buy loyalty of brokerage firms, consultants or other parties-in-interest to the plan is a fiduciary breach.*

- 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. *Significance: Use of soft dollars could effectively be a transfer to a party-in interest, thereby creating a fiduciary breach.*

Due to the lack of oversight of 28(e) Soft Dollar Revenue in qualified retirement plans, the Securities and Exchange Commission was compelled to address the issue 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. 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, portfolio transaction costs, sales load break points, spreads, directed brokerage (a practice banned in mutual funds by SEC in 2004[14]), 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 assure 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 Section 28(e) of the Securities Exchange Act of 1934 should be reconsidered or modified.

While it is commendable that the SEC has decided to act on this issue, 17 years earlier the U.S. Department of Labor issued ERISA Technical Release 86-1 notifying the public of this very issue. 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 the Employee Retirement Income Security Act of 1974 (ERISA)."

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*."

Directed brokerage arrangements between mutual fund managers and brokerages is now a banned practiced. Prior to its ban, fund managers would direct trades through brokerages' trading desks to reward the brokerage for selling their funds to retail clients. Notwithstanding the ban on directed brokerage, 28(e) excess commission arrangements not only still exist, but are very common.

SEC investigations have shown that "28(e)" excess commissions have been used by "non-fiduciary" consultants to make certain services available to mutual funds.

Among them:

- Conferences and other similar group meetings where the consultant invites both the "client" (i.e. a 401(k) plan sponsor/trustees) and representatives of the mutual funds who want to sell their funds to the client of the consultant. 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.

- Sales and marketing support to the mutual fund's staff.

- "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.

- Other "image enhancement" or "sales facilitation" services.

- Loyalty of consultant or brokerage firm.

Expensive and hidden 28(e) excess commission practices hurt plan participants and their beneficiaries, impede fiduciary oversight, and violate ERISA Sections 403(c)(1), 404(a)(1) and 406(a)(1)(D). 28(e) soft dollars are the most difficult fee to uncover. Like directed brokerage, the practice of charging excess 28(e) commissions should also be banned in all qualified retirement plans.

Hidden Costs #3 – Sub-Transfer Agent Revenue Sharing

The following is a rather lengthy, but important illustration of the widespread practice of subsidized record keeping services through excess mutual fund management fees.

Envision a meeting among three individuals. An employer with 75 employees, wanting to design a brand new plan for their employees; a Registered Investment Representative; and a Record Keeper commonly referred to as a "Third Party Administrator." After the meeting, the employer requests formal proposals from the Investment Representative and the Record Keeper. They leave the employer's office and agree to work together to design a plan that works for all parties. The Registered Representative and the Record Keeper collaborate and develop two proposals for the employer to consider.

The first proposal recommends 6 mutual funds, 4 of which are actively traded mutual funds. As a portion/component of the Funds' Management Fees, the 4 actively traded mutual funds pay a .5% "finders fee" of each new dollar invested to the Registered Representative plus a .5% trail commission - referred to as a 12(b)-1 commission. (A more detailed discussion of 12(b)-1 commission will be forthcoming later in this testimony). The Record Keeper proposes a $4,000 base fee per year, plus $60 per participant per year, paid by the employer.

When the employer does the math, he discovers that if each of his 75 employees contributed $100 per semi-monthly pay period, the Investment Representative would earn $100 x .5% x 75 x 24 = $900 the first year, and every year thereafter, plus an additional .5% on the accumulating balance. This $900 doesn't seem like much, especially when compared to the record keeping fee $8,500 ($4,000 base fee plus $4,500 (75 participants x $60)).

Summary of Proposal A

Cost Item	Investment	Record Keeping
Finders Fees	$900 per year	N/A
Ongoing Commissions	$900 and growing	N/A
Base Fees	N/A	$4,000
Per Head Charges	N/A	$4,500

The employer looks at the record keeping fees, squirms a little, and quietly questions whether the record keeper's services are really worth $8,500 per year. Then he requests Proposal B. Having experienced that reaction before, the Investment Representative and the Record Keeper are prepared to present something more palatable.

The second proposal consists of 12 mutual funds, 9 of which are actively traded. To the employer's delight, proposal B seems much better. The Investment Representative's compensation remains the same, but the Record Keeping fee is cut by 70%! The base fee is reduced to $800 per year, and the per-head charge is reduced to $25.

Summary of Proposal B

Cost Item	Investment	Record Keeping
Finders Fees	$900 per year	N/A
Ongoing Commissions	$900 and growing	N/A
Base Fees	N/A	$800
Per Head Charges	N/A	$1,875

This proposal seemed like the best of both worlds. Twice as many mutual fund options for one-third the cost! The employer thinks participants will love it, and of course he loves it, too. It doesn't occur to the employer that he should question the economics, or whether there are fiduciary implications to going with one proposal vs. another. It seems like a no-brainer, so the decision is made to go with Proposal B.

Fast forward 10 years and the employer now has 150 employees, and $4 million dollars in the plan. As far as the employer is concerned, the economics are still the same as the first day the plan was adopted. However, there was an element the employer didn't understand. Remember the reaction to the $8,500 fee for record keeping fees? The employer wasn't certain if that was a fair fee for services rendered. Maybe it was fair, and if that was the case, the employer might have reduced or cut-back on various optional "elements" of the plan to arrive at a fee that seemed appropriate, all services considered.

The $2,675 in fees associated with Proposal B seemed about right. With the growth of the company and the plan, the fact that plan costs also increased went without saying. Looking back at the original "deal", the employer computes the fees and costs as he thinks it stands today. All things remain the same except for 150 participants instead of 75, and there are $4 million dollars in assets.

Summary of costs 10 years later – Proposal B (the "believed–to-be" costs)

Cost Item	Investment	Record Keeping
Finders Fees	$1,800 per year	N/A
Ongoing Commissions	$20,000 growing	N/A
Base Fees	N/A	$800
Per Head Charges	N/A	$3,750

Paying the record keeper $4,550 ($3,750 + $800 = $4,550) for such an extensive array of services rendered is perceived as being a little low. The employer intuitively knows the record keeper is worth more than $4,550, but is uncertain "how much more." If the record keeper needed more money for their services, they would certainly ask for it, and if they don't request more they must be satisfied. The employer also notices the Investment Representative is now being paid over $20,000 – and given all of the enrollment and investment education meetings – along with all of the reports, trustee meetings, and general education given to the fiduciaries, it might seem "about right."

Luckily for the employer and the participants, the employers' niece happened to be a student of fiduciary prudence and retirement plan economics and something seemed "fishy" to her.

After looking into the economics of "Proposal B" today, the employer's niece reluctantly brought the bad news. Something has gone terribly wrong, and the employer is stunned beyond words. Here's how the ***true*** economics look:

Cost Item	Investment	Record Keeping
Finders Fees	$1,800 per year	N/A
Ongoing Commissions	$20,000 growing	N/A
Base Fees	N/A	$800
Per Head Charges	N/A	$30,150

How could the record keeper be making more money than the Investment Representative? *Ten thousand dollars* more…and growing!

Remember the "collaboration" the Investment Representative and Record Keeper originally entered into? Proposal B involved the payment of Sub-Transfer Agent fees (Revenue Sharing from the Mutual Funds). The increase in funds was not an added benefit to the employer or employees as initially believed. Rather, it was a carefully calculated design element to capture a particular type of revenue sharing based upon two things: (1) The number of funds offered multiplied by (2) the number of participants with assets in those funds.

Assume in this case 8 of the 9 actively traded mutual funds are being utilized by participants. Also assume that the mutual funds each pay $22 per participant per year. The true economics are therefore 150 participants x $22 Sub-Transfer Agent Revenue Sharing x 8 Funds = $26,400. When the existing "per head" fee paid by the employer ($3,750) and the base fee ($800) are added to the Revenue Sharing number, the new total is $26,400 + $3,750 + $800 = $30,950.

The employer is angry for four reasons. First, he feels deceived because he didn't understand the true economics of the plan. Second, he feels his ability was impeded to prudently judge whether the services rendered were worth what the Record Keeper received in actual compensation. Third, he understands now that the "extra" funds had nothing to do with helping participants build a better portfolio. It had everything to do with multiplying the potential revenue sharing – and that has not helped the participants at all. Fourth, the realization that the employer has allowed assets to be improperly spent on services with skewed economics might place him squarely in the cross hairs of an effective litigator. The record keeper may very well have earned every obscure penny, but the issue here is about transparent business practices and it's also about determining whether the additional $25,000 the record keeper received was for services consistent with fiduciary objectives. Although imprudent due to its hidden nature, ironically the fee to the record keeper could be both reasonable, and excessive (vs. reasonable **or** excessive). Reasonable from the stand point of performing the work necessary to fulfill the expectations of their client, yet also excessive from a fiduciary prudence standpoint because services are being performed that have nothing to do with securing the future retirement income of the participants in the plan.

Such is the nature of hundreds of thousands of 401(k) and similar retirement plans across the United States even as you read this. Sub-transfer agent revenue sharing should be banned so that fiduciary based plan services are priced upon unimpeded economic principles.

What is a Sub-Transfer Agent? (and Sub Transfer Agent Revenue Sharing?)

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 (i.e. accounts for "title" of the ownership of the shares). When certain functions of the transfer agent are sub-contracted to a third party, that third party becomes a "sub-transfer agent." Within the context of this paper, 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.
3. Some other entity tracking the number of shares held for the benefit of a specific participant within an individual account plan.

Payment to these parties for this sub-contracted service has come to be known as "Sub-Transfer Agent fees." Sub-Transfer agent fees exist solely to support the participant directed account culture in actively managed mutual funds.

Sub-transfer agent fees are generally paid as a flat dollar, per-participant, per fund. For example, many funds will pay a third party administrator $10 per participant, per fund. Other funds will pay a percentage of assets - such as 5 to 10 basis points. However, some funds pay up to $22 per participant, per fund or 35 basis points. The problems with sub-

transfer agent fees is not how much is being paid to the service provider. Rather, the problem is being unaware who is receiving the payments, and whether or not the payments fairly represent the value of the service being rendered. The Department of Labor 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.

An estimated 100 million shareholder accounts, or approximately 40 percent of all mutual funds, are in sub accounts at financial or record keeping intermediaries at this writing. Approximately $2 billion dollars per year is paid to third parties for sub-accounting services. There are potential costly and ERISA-violating problems inherent in omnibus accounts with underlying participant directed sub-accounts which are beyond the scope of this testimony.

Hidden Costs #4 – Non-Fiduciary Compensation (12(b)-1 commissions)

There are two types of 12(b)-1 fees:

1. Sales commission 12(b)-1 - paid to a registered representative for selling mutual funds for an individual or within a plan.

2. Servicing 12(b)-1 - paid to a person or entity who services an account after the sale.

SEC Rule 12(b)-1 was enacted in 1980. It is partially responsible for the proliferation of mutual funds in individual account plans. Again, referring to the mutual fund relationship with the distribution medium (sales force) of the brokerage firm, it creates a conflict of interest between the brokerage firm and the mutual fund, thereby rendering each unable to devote their loyalties to the plan participants. It permits mutual funds to increase their internal fund expense ratio by up to 1% in aggregate.

The combination of these two commissions may not exceed 1%. For example, the sales 12(b)-1 could be 50 basis points (.5%) and the service 12(b)-1 could also be 50 basis points.

It is common to refer to both sales and servicing revenue as “12(b)-1” fees, not differentiating between the two. More than half of all mutual funds have a 12(b)-1 feature. These commissions are disclosed in the prospectus, but very few plan sponsors understand their significance to the plan, the participants, and the trustees.

The 12(b)-1 commissions are a concern because non-fiduciary sales people carefully place products with high 12(b)-1 commissions within 401(k) plans without the full understanding of the plan sponsor or trustees. Conversely, a Fiduciary Investment Advisor 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. This clear difference in

behavior and reporting shows the crisis that exists in the industry. Plan sponsors don't know there is a difference; mutual funds are simply mutual funds to them.

Another seldom considered 12(b)-1 issue is that of unfair subsidy disparity. Fee subsidy disparity is often referred to by the fiduciary community as the "Hidden Tax" paid by participants with larger than average account balances because 12(b)-1 commissions pay for non-fiduciary services.

Illustration

Let's compare two hypothetical plans, Plan "A" and Plan "B." Let's say each has $50 million 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). 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. Let's also say that Plan "A" has 500 employees and Plan "B" has 2,500 employees.

Are costs consistent for all employees as a percentage of their account balances? Yes, of course. But what are the real economics? Take a look at the following example of a comparison between two hypothetical plans:

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

In this example, the participants of Plan "A" are subsidizing the overhead of Plan "B."

Hidden Costs #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 are made to accumulate resources sufficient to pay a future benefit. Variable Annuities can be sold by insurance agents who have little or no formal investment or fiduciary training. Variable Annuities 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 are typically mutual funds investing in stocks, bonds and cash. Gains on variable annuities are tax deferred whether held in a qualified trust or not, and there are costs associated with this "built-in" tax deferral. The fee associated with obtaining this tax-deferred benefit is an insurance component. Therefore, one must ask whether or not putting a variable annuity in an ERISA-governed vehicle is necessary, or even wise. In other words, you could buy a lower cost mutual fund using the inherent benefits of a 401(k) and still get the deferral of tax. 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. Accordingly, this aggregate fee is called a "wrap" fee. The wrap fee hides individual component fees and services, which are:

- **Investment Management**: Management fees of the mutual fund that is contained within the variable annuity. (Note that trading costs are in addition to the investment management component, and are extremely difficult to discover in variable annuity contracts.)

- **Surrender Charges**: If withdrawals are made from a variable annuity within a certain period of time after units are purchased within the annuity, the insurance company will assess a surrender charge. The charge is used to reimburse the insurance company for the commission payments they paid to a broker or insurance agent upfront. The surrender charge usually starts out higher, and decreases over the length of the surrender period.

- **Mortality and Expense risk charge**: This 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. Consider this in light of what has already been revealed here. The total Plan fees and commissions could easily exceed 4.00% when mortality and expense risk charges are added. (For example, a potential scenario could look like this: 1% brokerage and trading costs, 1% fund manager costs, .15% in administration fees,.75% in sales/distribution commissions, and 1.25% in mortality fees. Total – 4.15%)

- **Administrative Fees**: The insurer may deduct charges to cover record-keeping and other administrative expenses. It is common to see fees of $25 or $30 per year, or a percentage of each participant's account value, typically in the range of an additional .15% per year.

- **Fees and Charges for Other Features**: Stepped up death benefit, a guaranteed minimum income benefit, long-term care insurance etc. These fees are stated in the annuity contract, and are actuarially computed based on age, health, etc., and hence differ from participant to participant.

- **Bonus Credits**: Some insurance companies offer bonus credits, which is a credit back to the account of percentage of each purchase - e.g. 3% of each deposit. These types of accounts often have higher expenses, and the expenses can be larger than the credit. Bonus credits are generally "purchased" with *higher surrender charges, longer surrender periods, higher mortality and expense risk charges*.

Hidden Costs #6 – Administrative "Pass Throughs"

An unfortunate and yet almost universally common in 401(k) plans is an expense borne by all participants for unnecessary services demanded by a vocal minority. A fiduciary is obligated to protect and treat all participants equally. It is a violation of ERISA's exclusive benefit rule that millions of participants unknowingly pay for the undisciplined urges of others to immediately wrest benefit from their retirement plans. Three examples are:

- Easy loans taken against a participant's vested balance
- Open brokerage options
- Investment "advice" services

While some may argue that these plan features are available to all participants equally, and are therefore a reasonable expense to the trust. However, we must not confuse matters of coverage and non-discrimination in benefits rights and features (pursuant to IRC §401(a)(4)) with fiduciary prudence. Plan assets should not be used to pay for services that all Participants do not collectively receive or benefit from plan assets. In hundreds of thousands of companies across the U.S. there are assertive individuals, who are the vocal minority, that want various bells and whistles in their 401(k), and the unsuspecting end up having to pay for it. This subtle violation of the exclusive benefit rule is rampant and costly. Plans with optional benefits that increase the overall cost of plan operation should be paid for by the individual users or by the plan sponsor, not by the plan. These amounts vary from plan-to-plan, but they can be substantial, especially if the fees are "translated" into an asset based charge that goes un-examined year after year.

Hidden Costs #7 – Non-Fiduciary Mish-Mash

To wrap up this discussion, it's important to highlight a few remaining hidden costs. The following is not an all-inclusive list, because there are dozens of variations to each of these items, and even a few other costs that are highly complex and difficult to explain. These are beyond the scope of this hearing, but might be examined as part of a

subsequent hearing. Some of the remaining fees and costs employers of all sizes are struggling to grasp are:

- Share class variances based upon plan size. (i.e. high load share classes in large plans. Common share classes include A, B, C, R, etc.)[15]

- Shadow Index Funds. These are basically funds that closely track passive indexes, but have "actively managed" prices. In other words, they are overly priced index funds, some overpriced by 200% to 300%.

- Suspected Intra-Fund pricing discrimination. (Evidence that this practice is now coming to light, but this is so new that independent fiduciaries are still trying to grasp the full nature and extent of this particular issue.)[16] This is where a mutual fund cuts "deals" with preferred investors, and increases fees to non-preferred clients so that the total fee balances out to what is disclosed in the prospectus. For example, a prospectus of a two hundred million dollar fund might state that the fund management fee is 1% of assets. The fund manager then "discriminates" against clients 2 – 6 by cutting a deal with preferred Client 1 that reduces their fee by half.

	Assets	Actual Fee
Client 1:	$100,000,000	.50%
Client 2:	20,000,000	1.10%
Client 3:	20,000,000	1.10%
Client 4:	20,000,000	1.10%
Client 5:	20,000,000	1.10%
Client 6:	20,000,000	1.10%
Total:	**$200,000,000**	**1.00%**

Clients 2 through 6 are paying for the backroom "deal" between the fund manager and client 1, and will experience lower returns at the same time, a clear example of investment return and cost discrimination. Also, other suspected violations of fiduciary prudence are coming to light where the "deal" isn't with a preferred client, but with the Investment Representative. This has even more serious implications when proven to be true.

Expert fiduciaries are still trying to get their arms around this issue. It's such a startling revelation that independent fiduciaries don't want to believe it, and hence are trying to find other reasonable explanations for their findings, hoping it simply isn't so. However, the economics of 401(k) plans are so defiant, entrenched, and arrogant, that it might very well be happening more often than one would like to think. Like Andrew Fastow, the former CFO of the complex ENRON "special purpose entities," maybe the industry thought no one would ever figure it out.

There is more that can and should be shared with legislators about other activities in the financal markets that adversely affect participants and beneficiaries. I hope this testimony

provides sufficient background to assist in grasping the issues at hand and comprehending the necessity of diligently considering possible solutions.

Possible Solutions

- Require full disclosure of all financial service provider costs and expenses. Create stiff monetary sanctions for any person, entity, or institution to withhold information from named fiduciaries for any qualified plan. This would require full transparency of all service provider activities and costs. It would enable fiduciaries to better understand the basis for their decisions regarding plan operations and investments. With improved understanding, the retirement income security of millions of Americans would be enhanced.

- Require fiduciaries to itemize any and all fees and expenses extracted from plan assets at any level, including trading commissions, spreads, management fees, soft dollar arrangements, finders fees, transfer agent fees, and other expenses, and to disclose those directly to participants on the Summary Annual Report. This will demonstrate to participants that fiduciaries are aware of the costs the plan is bearing, and that they are taking responsibility for those costs.

- Hold **all** individuals or companies who are paid from plan assets to a fiduciary standard. This includes brokers, insurance agents, record keepers, actuaries, and others. Those individuals or professionals unwilling to assume fiduciary responsibility could negotiate payments directly from plan sponsors.

- Require all investment vehicles held in a qualified trust (within the meaning of Internal Revenue Code §501(a) and ERISA §403(a)) to be "revenue sharing free" which would include barring 28(e) soft dollars, 12(b)-1 marketing or servicing commissions, and sub transfer agent fees. When fiduciaries are empowered with full and accurate information about how 401(k) plans really work, they will logically demand transparent pricing, and each service component will be viewed critically and individually and solely upon its own merits. Services not absolutely necessary for building and securing future retirement income will be difficult to justify through a prudent fiduciary lens. Knowledgeable and informed fiduciaries will then be able to confidently determine what fees and costs participants and beneficiaries should bear.

- Eliminate Department of Labor Regulation 404(c). Plan sponsors and service providers have hidden behind this regulatory allowance as a perceived shield from fiduciary liability while ignoring the plight of workers who desperately need guidance and oversight for their investments. Rule 404(c) is non-fiduciary at its core, and it encourages other decisions and behaviors that are not in the interests of securing the retirement incomes of American workers.

Conclusion

Thank you for the invitation to testify before this committee. It is my earnest belief that the workers of America deserve proper protections for the hard earned savings they have set aside in their 401(k) plans – protections which they are denied in the current state of the industry. I also believe that the problems with the industry can be solved rather simply, though it will require confronting powerful economic interests that support the current system. But America's workers deserve better than they have received to date from the providers of financial services. Finally, thank you for beginning the daunting task of tackling this very important and relevant social issue that will affect millions now and in the coming decades.

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[1] Investment Fiduciary, Randy "Bubba" Cloud, founder of CNMLLC. Accredited Investment Fiduciary Auditor and a member of the Revere Coalition, a non-profit fiduciary advocacy group of independent investment fiduciaries.
[2] http://registeredrep.com/news/sec-merrillrule-debate/
[3] Statement by Senate Governmental Affairs Subcommittee on Financial Management, The Budget, and International Security. November 3, 2003, Senator Peter G. Fitzgerald (R- IL)
[4] http://papers.ssrn.com/abstract_id=868761
[5] http://www.ifa.com/Book/Book_pdf/overview.pdf - "Step 5"
[6] Dimensional Fund Advisors, Basic 60/40 Balanced Strategy vs. Company Plans 1987-2003. FutureMetrics, 2004.
[7] http://finance.yahoo.com/expert/article/futureinvest/6953 - "The Truth About Money Management"
[8] Ibid – "The Birth of Indexing"
[9] http://papers.ssrn.com/abstract_id=868761 page 2
[10] "Fee Forensics, The impact of brokerage expense and trade execution in mutual fund portfolios." 2005 Annual Conference of the Center for Fiduciary Studies. Santa Fe, New Mexico.
[11] http://www.sec.gov/rules/petitions/petn4-492.htm. OCIE Report, *supra* note 8, at 40. In addition, the Commission has, on a number of occasions, sanctioned advisers who have used soft dollars to pay for products and services outside the safe harbor without making adequate disclosure. *See, e.g.* , Dawson-Samberg Capital Management, Inc., Investment Advisers Release No. 1889 (Aug. 3, 2000); Marvin & Palmer Assoc., Inc., Investment Advisers Release No. 1841 (Sept. 30, 1999); Renaissance Capital Advisors, Inc., Investment Advisers Act Release No. 1688 (Dec. 22, 1997).
[12] Securities Exchange Act Release No. 12251 (March 24, 1976) (the "1976 Release")
[13] http://www.efficientfrontier.com/ef/997/tough.htm
[14] Directed Brokerage Banned as of August 2004. However, the problem apparently still persists to an unknown degree. http://registeredrep.com/news/american-funds-charged, http://www.sec.gov/rules/final/ic-26591.htm, http://www.ici.org/issues/mrkt/04_nasd_dir_brokerage_final.html, http://findarticles.com/p/articles/mi_hb3396/is_200412/ai_n13131331, http://registeredrep.com/news/directed-brokerage-banned/
[15] http://www.nasd.com/InvestorInformation/InvestorAlerts/MutualFunds/UnderstandingMutualFundClasses/NASDW_006022
[16] A startling extract from an actual forensic fee audit performed by an investment fiduciary: "*We find it noteworthy that the funds in the Plan are paying out more than half of the revenue they receive for 'investment management'. In fact, one fund (fund name deleted) is paying out 150% of the revenue that it discloses by prospectus. Several other funds (mostly name deleted / name deleted funds) pay out more than 70% of their receipts. Obviously, this indicates that they may be making up their lost revenues in some other manner. We spot checked the SAIs of a couple of the Plan's funds and found hidden expenses in excess of .50% for transaction expenses. Some portion of this money goes back to the manager in one form or another (research services, commission rebates, etc.). We estimate that the true investment and recordkeeping cost of the plan is significantly greater than the .94% that is revealed by the basic plan expense ratios*."