

Uncovering and Understanding Hidden Fees in Qualified Retirement Plans
2nd Edition – Published February 1, 2007

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ABSTRACT

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. That understanding will help create a more secure retirement for American workers.

- Notwithstanding the obscure nature of retirement plan economics there is a rigorous way to determine the costs of any such plan.
- Directors, officers, and executives of plan sponsors have a fiduciary duty to know, manage, and control all of the fees assessed to plan assets.
- Modern fee structures are the result of mingling fiduciary and non-fiduciary philosophies. Hidden and excessive fees can be corrected by embracing an “independent fiduciary only” approach toward plan management.
- 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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Background

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 BNA and the author, 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 emailed 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 of the paper, 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.

Introduction

The level of concern over 401(k) fees is steadily increasing. The fact that the industry is not effectively working toward resolving those concerns could be indicative of an entrenched system that is unwilling or unable to change. Consider the following, from John Bogle, founder of the Vanguard Investment Group, speaking on PBS' Frontline:¹

"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."

While the debate rages over hidden or excessive fees, what we know for sure is that the conventional 401(k) plan is burdened with unnecessary services, and those services drive unnecessary fees – many of which are hidden.

The United States has not yet adopted the common-sense view common in other countries, 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 the Directors, officers and executives of the business that sponsors the plan, whose primary duty is to the company's shareholders. However, in the U.S., those roles are merged, resulting in the sorts of egregious pension fund scandals that make headlines, 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 that executives are 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.² Although almost everyone understands at a visceral level that the industry is receiving undisclosed compensation, the methods used to extract those fees are complex and difficult for busy executives at 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. This point will be made in greater detail in the remainder of the paper.

Since there is a significant difference between the duties of a truly independent fiduciary and the profit motives of financial services firms, the 401(k) industry simply isn't getting "getting it done" for America's workforce. The results just aren't there. At the heart of the issue is a profit-oriented, non-fiduciary 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 quoted 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 ‘Fidelity retail mutual funds consistently rank against their... peers as among the lowest priced mutual funds.’”³

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. Defying fundamental economic principles, the 401(k) industry has temporarily gotten away with dictating prices because information is not fully-disclosed, and is not available equally to buyers and sellers. Since 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 United States Government Accountability Office (GAO) reported the following:

*“[The Department of] Labor has authority under ERISA to oversee 401(k) plan fees and certain types of business arrangements that could affect fees, **but lacks the information** it needs to provide effective oversight.”⁴ (emphasis added)*

If the Department of Labor 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 U.S. Department of Labor, 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.

And 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 dig deeper in order to cut through the Gordian knot that has bound down the retirement income security of millions of American workers over recent decades. As will be explained later in this paper, there is much at stake for plan sponsors, their Directors and officers, plan participants, and for society as a whole. There may be no bigger socio-political problem than the 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 and unravel a tightly 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.”⁵

“Revenue sharing” is a euphemism for kickbacks from one financial service firm to another. However, it is not the only hidden fees charged by those in the 401(k) industry. There are other sources of fees and costs charged by financial services firms that have

two dramatic and negative effects on employers and employees alike: (a) Hidden fees impair the retirement income security of plan participants; and, (b) Unknown costs expose the Directors, officers and executives of plan sponsors with legal liabilities about which they are almost universally unaware. Until employers acknowledge that there are elements of their plans that they do not understand, and that their lack of understanding puts both the plan sponsor and the participants at risk, the 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.

“Millions of 401(k) participants and thousands of sponsors, particularly in small- and medium-sized plans, are adversely affected by a form of revenue sharing instituted by service providers to reduce the above-line costs of plan administration.”⁶

“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.”⁷ (\$12 trillion update added)

Markets work most efficiently, and most fairly, when buyers and seller 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 that 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 toward the uneven playing field and the damages to retirement incomes that result.

Sadly, it has taken aggressive legal action to bring this issue to a head. Almost prophetically, Joe Faucher of Reish, Luftman, Reicher, & Cohen, predicted in his article entitled, “Excessive 401(k) Plan Fees and Costs: The Coming Storm in ERISA Litigation?”⁸, that it could very well take such litigation to effectuate change. The current litigious environment will be discussed later in this paper.

The remainder of this paper is organized into five parts: Part I discusses fiduciary philosophy and why the current fee environment results in large part from the lack of independent fiduciary oversight; Part II explores industry fee practices and associated fiduciary responsibilities; Part III provides historical context regarding the development of the current fee structure; Part IV discusses the influence that Department of Labor Regulation 404(c) has had on fees; and, Part V presents some concluding thoughts on a solution.

PART I – PHILOSOPHY

Although some would argue otherwise, it is the author’s 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. Studies 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.”*⁹

If this assertion is true, then any cost incurred to try to beat the market is wasted money, ultimately reducing retirement incomes. ERISA stands for **Employee Retirement Income Security**. Therefore, securing participants’ retirement income should be the objective of all retirement plans subject to ERISA.¹⁰

Nobel Laureate William Sharpe asserts that the difference between market returns and actual returns is costs.¹¹

The first question must be, “What represents ‘market returns?’” Based upon the literature regarding modern portfolio theory, a 60/40 balance of diversified large cap equity and multi-sectored bond funds reflects the author’s definition of the “market.” Therefore, “market returns” reflect the investment returns on such a portfolio. There exists a wide array of low-cost Exchange Traded Funds (ETF’s) and index mutual funds enabling investment in the market generally, thereby avoiding the costs of active management and its associated overhead, fees, and costs. In short, by purchasing index-tracking equity and bond ETF’s 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.**

Since it certainly costs something to prudently administer an effective 401(k) plan, the next 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, i.e., 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. Conversely, failing to earn such returns on a consistent basis is an indicator of excessive fees and costs.

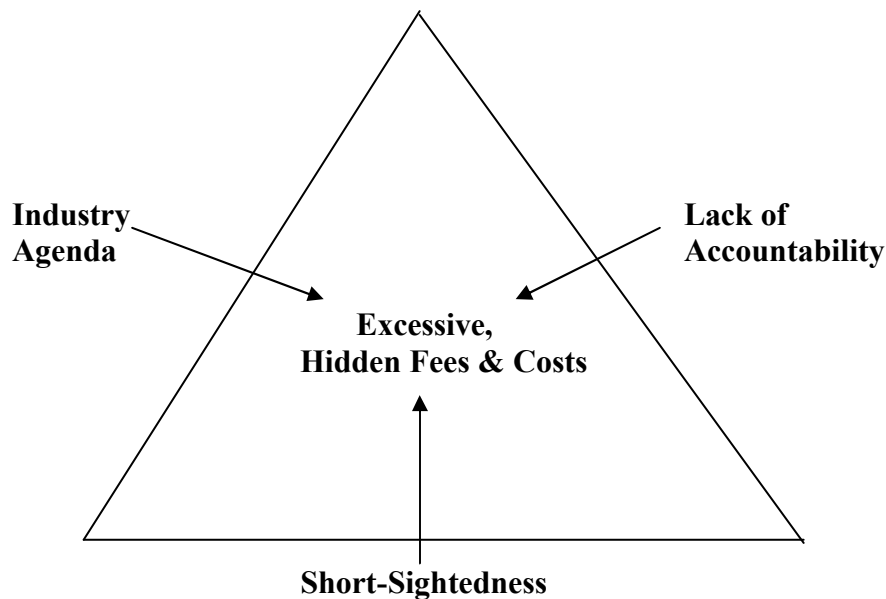
In order to differentiate their services and provide investment features that may be personally appealing to the directors, officers and executives—the decision-makers—of a plan sponsor, Wall Street firms layer in costs that diminish the long-term retirement income security of plan participants. Despite the marketing “sizzle” of lifestyle funds, self-directed investment tools, trading features, and the like, the fact remains that the vast majority of plan participants are singularly unqualified to make investment decisions—particularly in light of the fact that the vast majority of professionally managed funds consistently under-perform the market.

Plan sponsors (whose Directors, officers and executives have almost always, knowingly or not, served as “fiduciaries” under Department of Labor regulations), 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.

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 that are held by plans sponsors. In sum, the plan sponsor takes on the responsibility for the retirement income security of plan participants and their beneficiaries. To properly fulfill its duties, the fiduciary cannot take into consideration the interests of the sponsoring company, any service providers to the company, or any other non-participant 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. Yet those fiduciary duties are difficult to fulfill at 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.

The “Sponsor’s Trap”

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. That trap is bounded by the following three forces:



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. In many instances, financial firms are granted absolute discretion regarding investment decisions for plan participants. 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 have been entrusted to invest. Every dollar they receive in fees—whether hidden or disclosed—is a dollar that is no longer available to support the retirement income of a U.S. worker. Within that context, and with trillions of dollars under their control, it is not surprising that such firms have powerful economic incentives to offer only those products and services that maximize their own economic performance—often at the expense of plan participants. 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, explained, “*There are four ways in which you can spend money. (a) 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. (b) 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. (c) 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! (d) 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.*”¹²

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. The financial services firms are spending someone else’s money—i.e., the savings of the American worker—on themselves; and they 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, can’t see through the haze well enough to know how much of the participants’ money is being spent on financial services. In short, the 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 now, can have devastating financial effects in the future in two respects: First, the individual lives of American workers are debilitated by the lack of a secure and adequate retirement income in the future; and, Second, society as a whole will undoubtedly suffer as those retirees are unable to participate in a meaningful way in the economy due to the lack of an adequate retirement income. One sub-optimal plan hurts individuals; yet many such plans can 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 can’t be expected to see the horizon, i.e., the long-term implications of their decisions today, when they can’t 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 this issue of excessive fees, the following comments from industry leaders should be read together:

Costs Lower Returns –

1. John Bogle observes, “[*There is an*] obvious and documented inverse relationship that clearly links mutual fund costs and mutual fund returns.”¹³

2. William Sharpe adds, “*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.*”¹⁴

Individual Investors Under-Perform the Market –

3. “*The average stock investor lags the market by about 5% per year.*”¹⁵
4. “*During the past 20 years...the average fund investor (i.e. participant) earned just 3%’ adds John Bogle.*”¹⁶

Since the stock market has returned approximately 12% over the past 20 years, then the combination of fees and poor investment decisions have cost individual mutual fund investors somewhere between 5% and 9% annually. John Bogle attributes 3% to the overhead and operating costs of the mutual funds themselves,¹⁷ with the remainder resulting from poor investment decisions. Since most investment decisions are made by the mutual fund managers themselves, the under-performance of those funds should also be viewed as a cost to investors in those funds. The remainder of the under-performance can be attributed to the self-directed investment decisions of individual participants.

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 associated fees. It is impossible to determine that answer within today’s circumstances.

PART II – SUMMARY OF INDUSTRY FEES AND FIDUCIARY DUTIES

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”*¹⁸

It is a fundamental truth that plans, and therefore participants, are paying the costs of investing. Most, 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, ‘SubTA’ 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, **‘kickbacks’**.”*¹⁹ (emphasis added)

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.

Such fees are significant, too. The author has consistently found that the “low cost” plans cost 3% of plan assets annually. More expensive plans can cost 5% or more per year. This is substantially greater than what most employers understand their costs to be. High and/or hidden fees in retirement plans are an important component of the overall costs, and must be understood by plan fiduciaries at the micro level, and by the Department of Labor as a matter of public policy if both groups are to fulfill their duties.²⁰

A Simple Example

When evaluating costs, one must start at the very beginning. All charges, fees, costs, etc. impact the return participants receive, and hence are all relevant to the dialogue. 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. For example, a mutual fund manager will pay the broker who clears the trades within the fund itself. The costs associated with this arrangement are between the mutual fund and the broker, and are therefore not normally disclosed to the plan sponsor. 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 those undisclosed charges are subject to fiduciary jurisdiction. The fiduciaries are responsible 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. The failure to understand the nature and scope of such arrangements is a fiduciary breach. It is correctly called fiduciary misfeasance.²¹

In their own defense, employers may claim they had nothing but honorable intentions, and that they 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.²² Therefore, plan sponsors should demand to know how much funds cost to operate, not only in management fees, but also in trading costs. Below is a simple example of the costs borne by typical 401(k) plans.

A potential guideline for determining brokerage costs of U.S. Equity Mutual Funds has been suggested to be 43.4% of the expense ratio. In other words, if a fund’s management fee is 1%, then the brokerage (trading) costs would be an additional 43.4 basis points (.434%).²³ However, this rule of thumb is difficult to apply to all plans due to their diversity. See Table 1 for an example of typical fees charged to plan assets. Technically, the costs associated with trading the funds in the reference study were .75%,²⁴ a full .30% higher than the rule of thumb. Other studies suggest trading costs actually are closer to the fund management fee. These are good examples of why there is a problem with 401(k) fees. It’s incredibly difficult to identify exactly what is being charged. It is a little known fact that specific trading (brokerage) costs can be found in the supplement to the financial statements of a fund entitled “Statement of Additional Information (SAI)” - sadly, multiple funds are often bundled together into a single report. This is not the prospectus or the financial statements themselves, but a supplement to those statements,

which may require substantial investigation and research to uncover with respect to an individual fund.

Table 1 – A simple example of 401(k) fees and costs in a “growth” portfolio

An example of an average “low cost” plan

Fee/Cost item	Amount as % of plan assets
Spread costs	.51% ²⁵
Trading costs (buying/selling underlying securities within funds) (Note: The .35% example used is generously low. Two industry experts have publicly stated that trading costs are closer to equaling the fund management fee. In other words, “The average expense ratio would double if the funds disclosed trading costs.” ²⁶ In this example, the trading costs would be 1.13%, and the total plan expense would increase to 3.77% . Even this appears to still be on the “low” side over total 401(k) fees.)	.35% ²⁷
Fund management fees/costs (including embedded revenue sharing if any)	1.13% ²⁸
Custodial fees	.05% ²⁹
Investment advisor & participant education fees	.75% ³⁰
Administration fees charged to plan	.15% ³¹
CPA audit and legal fees charged to plan	.05% ³²
Total annual charge to plan assets	2.99%

This is a very simple example of a “low cost” plan. Note it is approaching 3% of plan assets annually. Plans that utilize higher cost funds will obviously cost more. Costs in plans that utilize variable annuity contracts will most likely be even higher.

Notwithstanding the above examples, the author has seen plans costing in excess of 5% annually, yet 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 on to 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, one that requires the involvement of a professional with substantial experience and expertise in these matters.

Who Gets Paid. . . and Why

In a conventional 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. Brokerage firm for clearing trades of the funds. Payments taken as commissions out of plan assets. Not seen by participants or fiduciaries.
2. The fund company for providing “research services” to shareholders. These “research services” are paid for by rebates from the brokerage firms’ commissions received above (#1), and are also not seen by participants or fiduciaries.
3. The fund company for managing the fund. These costs are revealed in the funds’ prospectus. The average U.S. stock fund costs between 1% and 1.3% of assets within the fund annually. 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. Funds can cost much less (50% to 75% less) by utilizing an indexing approach, with lower risk and reasonably predictable results over the long-term.
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.
5. The clearing agent clears and consolidates trades from multiple fund institution and aggregates the associated data for efficient import into a custodian’s record keeping system.
6. The custodian holds funds in account for the benefit of the trust, and provides electronic data feeds to record keepers and third party administrators to process and post to individual participant accounts held in sub-accounts at the record keeper level.
7. The record keeper or third party administrator is paid to take aggregate or omnibus accounts at the custodial level and tracks them at a participant level. The record keeper generates participant statements, maintains an Internet access portal, and initiates transactions and uploads associated instructions to the custodian to act upon.
8. Sales people, brokers, insurance agents, etc., may receive finders fees for bringing new business to the players described above. Generally finders fees come from the fund institutions. These individuals may also receive trail commissions intended to compensate these individuals for ongoing services they render.
9. Fiduciary investment advisors may be compensated from plan assets for rendering advice or other services to fiduciaries and participants. 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.

10. Consultants may be compensated from plan assets for providing a wide variety of investment, plan maintenance, compliance, and other services that a plan sponsor believes is necessary.
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. Certified Public Accounting firms may be paid from plan assets for accounting and annual auditing services. This is generally handled through invoicing the trustee.
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.
14. Insurance premiums may be paid from plan assets to indemnify fiduciaries. To clarify, a plan may not indemnify fiduciaries for failures of duty. However, a plan may purchase insurance from a commercial insurer, which in-turn can provide insurance coverage for fiduciaries.

PART III – HOW PARTICIPANT RETIREMENT INCOME IS BEING SQUANDERED ON EXCESSIVE, UNNECESSARY, AND HIDDEN FEES

1. The hidden fee problem is the result of a fundamentally errant approach to plan management.
2. These flaws are the result of mingling of ERISA and non-ERISA defined contribution (“individual account plans”) operational philosophies, beginning in the mid-to-late 1970’s.
3. 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.
4. 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 non-fiduciary, novice individuals to invest their retirement funds with marginal help from others. In other words, allowing participants to direct trust assets that would otherwise be subject to, and

- managed by, prudent and skilled investment experts was a grave mistake for participants, yet all hidden fees are possible exclusively in this environment. Only recently has the industry begun to correctly focus on retirement income within 401(k) plans. It's nearly thirty years past due.
5. This mingled hybrid philosophy also allowed an environment of sub-market returns to prevail and investment return disparity³³ to flourish, placing millions of unwary plan participants in "harm's way."
 6. 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.
 7. 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, fund types, etc. Instead of disclosure meaning possession of facts coupled with understanding, it has evolved to mean legalese or rarely understood, seldom-read prospectuses.
 8. 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.
 9. 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. Sub-industries 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 all, the prudent interests of plan beneficiaries would prevail, as ERISA intended.
 10. Plan sponsors, collectively, will save billions of dollars once enrollment meetings, participant education, attractively designed color print materials, Internet fund trading technology, participant investment advice and all other specialized services would no longer be 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.

11. 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.

Historical Exploration of 401(k) Fees

Modern fee structures, as they relate to qualified retirement plans, have been developed over the past thirty years. This paper explores the specific types of fees that are frequently considered to be “hidden” because of their difficulty in being recognized, quantified and monitored. It also addresses their historical genesis and development, significance to a retirement plan’s overall operational structure, fiduciary responsibilities, and their ultimate impact on the participant’s financial future.

An historical exploration of the development of the current fee environment yields a significant amount of interesting insight and perspective. Potentially, the most 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 solve it. In the author’s 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.

*“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.”³⁴ (emphasis added)*

In the mid-to-late 1970’s, several independent elements (technology, creation of the IRA and the 401(k), added investment ease through mutual funds, access to information, etc.), combined to cause the mutual fund and brokerage industries to overlook critical and fundamental requirements to help participants replace income at retirement. In other words, 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.

Let's Get to the Heart of the Matter

Specific fees that are considered to be “hidden” are:

- Trading costs, commissions between fund managers and brokerage firms
- Soft dollar “excess commissions” paid to brokerages pursuant to Securities Exchange Commission (“SEC”) rule 28(e)
- Sub-shareholder (participant) servicing fees - called “sub-transfer agent fees” (“Sub-TA”)
- Account distribution (sales) based 12(b)-1 fees
- Account servicing based 12(b)-1 fees
- Unitized variable annuity wrap fees
- Variable annuity mortality costs
- “On-the-fly” pass through fees
- Retail versions of institutional funds (i.e. funds that could be purchased at a lower price but are not, due to fiduciary ignorance)

Trading costs and 28(e) fees are hidden because they are only openly known between the fund managers and the brokerage firms who clear the associated trades. While 12(b)-1 and wrap fees are “disclosed,” they are considered to be hidden because plan sponsors and lay trustees do not fully understand what they are, why they are being assessed, whether or not they are justified, and what to do about them if they exist. The author will address these fees in greater detail later in this paper. Sub-shareholder (or “Sub-TA”) fees are technically disclosed. However, they are disclosed as an embedded component of the gross fund expense ratio. Unitized variable annuity wrap fees are disclosed in such a way as to obscure “who-gets-what” and therefore prevent a fiduciary from properly assessing the value of the underlying services and comparing them to other available services that might deliver better results at a lower cost.

Critical Questions

The development of these fees directly relates to the connection between the proliferation of individual account plans (IRAs, 401(k) etc.) and the growth of the mutual fund industry. Significant questions surround the above 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 for providing valuable benefits for the exclusive benefit of plan participants and beneficiaries. Questions relevant to this issue include:

- Why are these fees relatively new? (i.e., 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, shouldn't they 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 and other tough questions are important for plan sponsors, attorneys, and fiduciary practitioners to ask themselves and their service providers.

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. 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. Not only did very few individual accounts exist prior to ERISA, there was no opportunity for "shaving"³⁵ a little off the top of each individual investment (such as with mutual funds and other similar investment vehicles today) in order to pay service providers. 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 (vs. 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. This account was the same for all participants under the plan, and was professionally managed, therefore investment return disparity³⁶ did not exist. Record keeping was simple. No investment education meetings were needed. No investment election forms to track and manage were required. Expensive voice response systems or online account access were not needed. Expensive "trading platforms" integrated with daily recordkeeping systems were not needed. In short, the operational environment was relatively simple and costs were low (and known).

1974 - Creation of IRA is the Genesis of the Modern Fee Environment

The genesis of the modern fee environment was, somewhat ironically, 1974—the same year the Employee Retirement Income Securities Act (ERISA) was enacted. ERISA created the Individual Retirement Account for individuals who did not have the privilege of participating in employer-sponsored plans.

Practice Note: Notwithstanding IRAs having been created by ERISA, they are not subject to ERISA’s rigorous fiduciary and reporting requirements for qualified plans (plans governed by code § 401(a)). As 401(a) individual account plans (401(k), profit sharing, etc.) began to proliferate, no care was taken by the industry to ensure service providers recognized and developed their operational infrastructure to accommodate the inherent differences between IRAs and qualified plans under § 401(a). 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, operated etc., 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**”³⁷ compared to those who are subject to the “**suitability standard**.”³⁸ In other words, the operational platform required to sustain a successful IRA industry effectively duplicated their platform to support the growing 401(k) and other individual account plan phenomenon without thought for whether the IRA platform would be appropriate for an ERISA governed plan. 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 - i.e. the supposed need of participants to personally direct plan investments, to their own financial detriment) in §401(a) individual account plans that are subject to the rigorous ERISA reporting and compliance regulations. This dilemma will be discussed in greater detail later in this paper.

At that time, an individual 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.³⁹ 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.”⁴⁰

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 \$1,000 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, they needed to give the brokerage something in return: their trade execution business. By placing their trades with a given brokerage firm, they obtained preferred access to the brokerage firm's sales force. This proved to be a coup for both the mutual fund industry and the brokerage industry. Billions of new deposits began to flow into mutual funds through the sales efforts of brokers, making mutual funds the staple investment of the investing-for-retirement public. 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 with earned income sufficient to make a tax deductible investment of \$2,000 (up to 100% of income).

About this same time, something else was brewing that would add fuel to the fire in a completely unexpected way. In 1978, the Revenue Act that created the 401(k) plan as we know it today was passed, then sanctioned by the IRS in 1981. With IRA mainframe platforms already in place, brokerage firms were ready to go from a billion dollar flow of new IRA deposits to mutual funds, to hundreds of billions in of dollars in deposits to 401(k) plans in a matter of years, and over a trillion in a matter of a few decades.⁴¹ Since then, competition for 401(k) dollars has become fierce, and 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.

"Technological 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."⁴²

These bells and whistles were costly, and additional revenues were required to support a broker or vendor's ability to grow and compete. The demand for additional revenues forced providers to construct ways to capture new forms of fees by legitimizing the new bell-and-whistle services, which would in turn justify the added fees. The modern fee structure began to take form.

With 401(k) and IRA gaining popularity and associated momentum (and subsequently other individual account plans such as 457, 403(b) etc.), both new and existing companies were needed, including brokerages, third party administrators, in-house mutual fund administration (bundled operations) consultants, etc. to service the burgeoning demand, and strategies were crafted to pay for these services. By the early 1990s, the common pitch was "give us your assets, and we'll throw in administration services for free." By the time this pitch was commonplace in the industry, the additional fees had been conceived, investigated, implemented and tested, with great financial success - at least to the financial service provider. However, a fundamental flaw existed. IRA deposits belonged to, and came from, the individual; 401(k) contributions were employer contributions made to a trust pursuant to a cash-or-deferred-arrangement (CODA). Yet 401(k) investments would be handled as though they were IRAs; and since 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 and were subject to the same fiduciary requirements that apply to traditional pension plans. Since 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. .

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 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" revenue, commonly referred to as "soft dollar" revenue. 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. These soft dollars, coupled with the urgent need to compete and the creation of the 12(b)-1 in 1980 (see subhead, Hidden Fee Types 4 and 5, below), 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.

Hidden Fee Type 1 – Trading Costs – i.e. Brokerage Commissions

Trading costs are difficult to understand. They are out-of-sight, out-of-mind. Yet they are one of the largest expenses a participant bears.

*"Anyone trying to objectively examine the level of mutual fund brokerage commissions is immediately struck by the difficulty of obtaining data on these commissions."*⁴³

Actively traded funds 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.

*"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 analysis (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."*⁴⁴ (emphasis added)

Utilizing indexed funds will significantly greatly decrease trading costs.

A recent Knight Ridder News Service article by Todd Mason quoted John Bogle as saying “The average expense ratio of 1.3% would double if the funds disclosed trading costs.”⁴⁵ Why? Haven’t all of the years of paid research created a treasure chest of knowledge? Shouldn’t trading costs be decreasing as technology and knowledge increase?⁴⁶

As stated earlier, some have set forth ways to estimate trading costs, 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. 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.

“These [trading costs] are incurred by the fund as it buys and sells securities. Trading costs money, and it comes out of your money. On average, a fund with a 100% annual turnover gives up nearly 1% in transaction costs. Transaction costs are not incorporated in a fund’s ‘total expense ratio.’ They are taken directly out of shareholder assets.”⁴⁷ (emphasis added)

“The average expense ratio of 1.3% would double if the funds disclosed trading costs.”⁴⁸ (emphasis added)

“William Harding, an analyst with Morningstar, says the average turnover ratio for managed domestic stock funds is 130 percent.”⁴⁹

If turnover is 130%, then trading costs average 1.3% of assets, coupled with the average fund management fee of 1.3%, the base fund cost for a conventional growth fund held in a 401(k) is 2.6% of assets, **before** other expenses, fees, and costs are factored in.⁵⁰ (emphasis added)

Shouldn’t fund management fees be going down by now? What ever happen to economic efficiencies created by technology?⁵¹

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.

Hidden Fee Type 2 - SEC 28(e) Soft Dollars

Note that SEC rule 28(e) potentially encourages turnover and the cost of trading. 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 on a securities transaction 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)⁵², 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 (hereafter called 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 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.

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.

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 (e.g. acting under “Suitability” standard vs. “Fiduciary” standard; see Footnotes 37 and 38) to be able to charge a mutual fund a commission that was more than what it costs to actually execute, clear and settle a securities transaction *without violating the law or fiduciary duties*. 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.”⁵³

Lack of Regulatory Oversight and Illegal Use of Soft Dollars

The Securities and Exchange Commission 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.

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, 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 assure that they are in the best interest of the fund and its shareholders.
- Require the SEC to conduct a study of soft dollar arrangement 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.”⁵⁴

Subsequent SEC investigations⁵⁵ have shown that illegal “28(e)” revenues have been used by 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.

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:

Q: Do you receive benefits from 28(e) soft dollars from mutual funds within our plan?

Q: If yes, what exact benefits do you/have you received?

Q: Exactly how many 28(e) soft dollars are attributed to our plan?

Hidden Fee Type 3 - Sub-Transfer Agent Fees

“Nothing is less productive than to make more efficient what should not be done at all” - Peter Drucker.

The mutual fund and brokerage industry has insisted that 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. The practice has been blindly accommodated by purchasers. A more prudent approach would be to adhere to a more traditional ERISA-based platform. With the facts of how hidden fees have come to be, it is very reasonable to question whether participant directed accounts should exist at all, yet billions are spent trying to make the process more efficient.

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 reveals that the philosophical error of requiring participant direction within ERISA-governed plans has been devastating to the individual participant in the form of yield disparity,⁵⁶ account value attrition through gaming,⁵⁷ playing to the ego and emotion of the individual participant,⁵⁸ the increase in paperwork, and the increase in systems to handle the records and transactions.⁵⁹

As explained previously in this paper, originally 401(k) and other individual account plans effectively “piggy backed” upon the mainframe IRA infrastructure that existed within the brokerage industry. To allow for 401(k) participant accounts, financial institutions holding 401(k) assets would maintain a separate account for each individual participant. This proved to be quite costly, especially as larger companies began to adopt 401(k) plans. Instead of re-thinking whether or not 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 soon to be perpetuated and exacerbated by sub-contracting the accounting of participant “shares” to third parties called “sub-transfer agents.”

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.

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.⁶⁰

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.⁶¹

(Note: Many plan sponsors are not fully aware that their record keepers—fund companies included—are receiving 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.)

In the mid-1980’s, 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. Larger firms had developed proprietary mainframe systems that were robust enough to provide sub-accounting for multiple fund accounts (i.e. a menu of funds within a participant account as compared to a single professionally managed account). 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. In other words, the mutual fund was able to streamline their operation by maintaining a single account in the name of the trust, and feed aggregate transaction data to a sub-transfer agent for sub-accounting processing.

Sub-transfer agents were burdened by the strain of sub-accounting for an ever increasing number of funds offered within plans. They bore responsibility for handling participant transfers between funds within the plan, providing media through which participants could access their accounts via telephone or the Internet. The need to more efficiently handle this unprecedented demand required ever more sophisticated technology, therefore demanded higher fees.

These sub-accounting software platforms have evolved to the point where they can link to virtually any brokerage, mutual fund or trading/clearing platform. By so linking, they

enable their users (the firm) to capture sub-transfer agent dollars from the participating mutual funds. 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.⁶²

There are potential costly and ERISA-violating problems inherent in omnibus accounts with underlying participant directed sub-accounts.

- Only the omnibus account is subject to the oversight and review of the fund's board of directors.⁶³
- Investment company compliance personnel cannot monitor the transactions occurring at the sub-account level, because the shareholder information is not disclosed to them - only information on the omnibus account itself.
- 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. It is this same environment that provided a scenario where unscrupulous traders could hide late trading and market timing abuses.
- The omnibus structure obscures who is trading within a fund, and how often a particular shareholder may be trading. In other words, without sub-account 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.⁶⁴

SEC rule 22c-2 demands transparency of these fees, so investment companies can see what is happening at the sub-accounting level - e.g. the participant level. This error in philosophy 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 philosophy. The SEC believes that developing tools to provide this capture information will cost \$1 billion a year for at least 3 years, and hundreds of millions annually after that to monitor it.⁶⁵

Significance of Sub-Transfer Agent Fees

- Sub-transfer agent fees are revenues "at play," meaning they can be paid to third parties for sub-accounting practices. They could also be "captured" and credited back to the trust for the benefit of the participants.
- Plan sponsors may be limited in the number or types of funds to which they have access due to restrictions placed on a fund that does not pay sub-transfer agent fees. That 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.
- If the named fiduciaries do not know that a third party is receiving these Sub-TA fees, they cannot 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-TA fees are being paid in addition to hard dollar amounts (invoiced to plan or plan sponsor by third party), effectively enriching the third party for unearned services. This is a violation of the exclusive benefit rule, as plan assets are being used for purposes other than to provide benefits to participants or to pay reasonable fees (to which the plan sponsor or fiduciaries have agreed pursuant to the hard dollar billing - but not more).
- Some third parties construct their fee schedule around revenue sharing, stating that these fees will offset billed amounts, and they do show the offset against billable amounts on invoices.

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

Q: Do you or any other entity receive sub-transfer agent revenue?

Q: If yes, is this revenue offset directly against stated costs as described in a service agreement?

Q: Do invoices reflect the offset against what otherwise would be fees paid directly by the employer via invoice?

Hidden Fee Types 4 and 5 - Account Distribution (Sales) Based 12(b)-1

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. For example, .5% could be paid as a sales 12(b)-1, and .5% could be paid as a servicing 12(b)-1, so long as the sum of the two does not exceed 1%. 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.⁶⁶ These fees are disclosed in the prospectus, but very few plan sponsors understand their significance—to them, the participants, and the trustees. Fiduciary audits performed by the author have 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, or at a minimum, a lower 12(b)-1 fee. This again points out the conflict between the suitability standard and the fiduciary standard. Non-fiduciary sales people, who are not plan fiduciaries, carefully place products with high commissions to the unknowing plan sponsor or trustees. 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. The clear difference shows the crisis that exists in the industry. Plan sponsors don’t know there is a difference. Mutual funds are 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 large account balances. If the average 12(b)-1 fee is 35 basis points, participants with balances over \$40,000 can be viewed as subsidizing the other participants of **other plans!**⁶⁷

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 fees⁶⁸). 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

The participants of Plan “A” are paying for the overhead of Plan “B”. Consider an illustration: Would Toyota sell its new Camry to employees of larger companies for 1/3 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?

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:

Q: Are you operating under a suitability or a fiduciary standard? In other words, are you a non-fiduciary registered representative or are you a fiduciary registered investment advisor?

Q: If you are a registered representative, are you receiving 12(b)-1 fees?

Q: 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.)

Q: Can our same funds be purchased for a different share class with a lower 12(b)-1 fee?

Q: Were our assets placed in this particular share class for a reason?

Q: If yes, please explain. Was it because this share class paid higher 12(b)-1 fees?

Finally, ask yourself:

Q: 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 non-fiduciary sales person guide us with respect to fiduciary decisions?

Hidden Fee Type 6 - 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 a 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. A fee is associated with obtaining this tax-deferred benefit - the insurance component, which provides the tax deferral. 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.⁶⁹ (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 purchase 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.⁷⁰
- **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.⁷¹
- **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 15% per year.⁷²

- **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.⁷³
- **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.*⁷⁴

PART IV – WHERE DOES DEPARTMENT OF LABOR REGULATON 404(c) COME IN?

On October 13, 1992, the Department of Labor recognized the conflict between fiduciary duty and the culture of individual account plan sales being driven by non-fiduciaries. The Department of Labor attempted to bridge the gap between non-fiduciary behaviors in fiduciary governed plans by issuing DOL regulation §2550.404c, and this regulation was subsequently sold to the public (by the retirement plan industry) as a fiduciary protection tool. 404(c) successfully convinced fiduciaries of the reality of potential liability that could be caused by the non-prudent, non-traditional, non-ERISA “IRA-type” participant-direction culture that was rapidly becoming the standard in all 401(k) plans. However, 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 404(c) requires full compliance - a costly ‘all or nothing’ effort. Of all of the plans audited by the author, none have fully complied with 404(c), rendering vain all efforts with respect to their original intent of protecting the fiduciary. This well intended band-aid further reveals the flaw in the 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 the author's opinion, 404(c) has been one of the most misleading and damaging regulatory allowances ever granted. It should be eliminated immediately, and fiduciaries should be held to the high standards ERISA, courts, and the other regulatory pronouncements had 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 paper.

PART V – CONCLUSION AND RECOMMENDATIONS

Participant directed accounts, all that is required to manage them, and the associated errant industry culture is the source of the problem. To eliminate hidden fees, the non-fiduciary participant directed IRA “suitability” culture must be rooted out of all ERISA governed plans. Failure to treat all plans subject to IRC §401(a), (and hence subject to ERISA’s fiduciary standard), the same way has now placed some 401(k) service providers and fiduciaries at risk. They find themselves in the cross hairs of highly effective litigators, the Securities and Exchange Commission, the Department of Labor, and state Attorneys General⁷⁵ for violations of the exclusive benefit and other fiduciary rules. Most fiduciaries have not made the connection 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 hit to its credibility and to its public image.

Some legal experts and other expert fiduciaries⁷⁶ have concluded that modern services to individual account plans were sold to plan sponsors as a “need” to justify the platform that would in turn justify additional fees. Statistics show that not only do 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.⁷⁷

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.⁷⁸ It is likely that the litigation will continue if the 401(k) industry insists on defending an inappropriate economic and philosophical model. It would be advisable for them to settle these lawsuits, and seek direct guidance from an independent steering committee to fix the system, and restore trust with the investing public.

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**.
- b. The fiduciaries **understand** the significance of what was disclosed in writing. In other words, the disclosure is made verbally and in writing - AND 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 not full disclosure.

Soft dollars, sub-transfer agent fees and revenue sharing obscure a fiduciary's ability to act prudently, with knowledge and understanding. That 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, 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 those of which the broker or consultant may not themselves be aware. Fiduciaries should consider the history of how hidden fees came to be, and consider the merits of a traditional ERISA fiduciary approach, with the assistance of fiduciary service providers.

End.

¹ John Bogle, PBS Frontline – Can You Afford to Retire? May 16, 2006
<http://www.pbs.org/wgbh/pages/frontline/retirement/interviews/bogle.html>

² 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. http://www.freerisa.com/5500/InstantView.asp?mainID=10721358&Show=DOL_H

³ Wall Street Journal 2006. <http://users2.wsj.com/lmda/do/checkLogin?mg=wsj-users2&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB116605020943649462-search.html%3FKEYWORDS%3Dfidelity%2Binvestments%26COLLECTION%3Dwsj%2F6month>

⁴ United States Government Accountability Office, Report to the Ranking Minority Member, Committee on Education and the Workforce, House of Representatives. November 2006. Page 2

⁵ Hutcheson/Lansing/Meigs - Institute of Management and Administration

⁶ Ibid

⁷ Statement by Senate Governmental Affairs Subcommittee on Financial Management, The Budget, and International Security. November 3, 2003, Senator Peter G. Fitzgerald (R- IL)

⁸ http://www.reish.com/publications/article_detail.cfm?ARTICLEID=506

⁹ Richard A. Ferri, CFA; Serious Money. Introduction, page. 1999

¹⁰ 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 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.*”

¹¹ The Arithmetic of Active Management, William F. Sharpe. Page 2

<http://www.stanford.edu/~wfs Sharpe/art/active/active.htm>. The Financial Analysts' Journal Vol. 47, No. 1, January/February 1991.

¹² http://en.wikiquote.org/wiki/Milton_Friedman

¹³ The Battle for the Soul of Capitalism. John C. Bogle. Pages 153 and 154.

¹⁴ The Arithmetic of Active Management, William F. Sharpe. Page 2
<http://www.stanford.edu/~wfs Sharpe/art/active/active.htm>. The Financial Analysts' Journal Vol. 47, No. 1, January/February 1991.

¹⁵ Jeremy J. Siegel, Stocks for the Long Run, Irwin Press, 1994, pg. 292

¹⁶ Statement of John C. Bogle to Senatorial Committee on Banking, Housing and Urban Affairs, February 26, 2004. Page 19.

¹⁷ John C. Bogle Before the United States Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security November 3, 2003
http://johncbogle.com/speeches/JCB_FMBIS1103.pdf - Page 13. "As the trained, experienced investment professionals employed by the industry's managers compete with one another to pick the best stocks, their results average out. Thus, the average mutual fund *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."

¹⁸ United States Government Accountability Office, Report to the Ranking Minority Member, Committee on Education and the Workforce, House of Representatives. November 2006. Page 2

¹⁹ Jim Johnson, broad e-mail communication via jjohnson@mcak.com. January 17, 2007

²⁰ http://www.forbes.com/forbes/2006/1211/135_print.html

²¹ "Fiduciary Misfeasance" is an excellent descriptive term. It is attributed to Scott Simon.
(<http://www.prudentllc.com>)

²² Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983)

²³ Portfolio Transaction Costs at U.S. Equity Mutual Funds. Karceski, University of Florida; Livingston, University of Florida; O'Neal, Wake Forest University. July 2004. Page 13.

²⁴ (.51% spread + .35% brokerage commissions) divided by fund expense ratio of 1.15% = .747%

²⁵ Mutual fund trading costs. John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, 027-99. The Rodney L. White Center for Financial Research. The Wharton School, University of Pennsylvania
<http://finance.wharton.upenn.edu/~rlwctr>. Table 8, page 41.

²⁶ Knight Ridder News Service article by Todd Mason quoting John Bogle

²⁷ Ibid

²⁸ Ibid

²⁹ Example consistent with the results of an actual fiduciary fee audit performed by Author

³⁰ Ibid

³¹ Ibid

³² Ibid

³³ Hamilton/Burns - "Reinventing Retirement Income in America," National Center for Policy Analysis. <http://www.ncpa.org/pub/st/st248>

³⁴ Wall Street Journal. Up for Review: 401(k) Industry. Tom Lauricella. December 28, 2006; Page C1

³⁵ Statement by Senate Governmental Affairs Subcommittee on Financial Management, The Budget, and International Security. November 3, 2003, Senator Peter G. Fitzgerald (R- IL)

³⁶ Hamilton/Burns - "Reinventing Retirement Income in America," National Center for Policy Analysis. <http://www.ncpa.org/pub/st/st248>

³⁷ ERISA §404(a)(1), 29 U.S.C. §1404(a)(1)

³⁸ NASD suitability requirement - Securities and Exchange Commission ("SEC" Rule 405 - 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.

³⁹ Jane G. Gravelle, Report for Congress. March 11, 2003. Individual Retirement Accounts (IRAs): Issues and Proposed Expansion. Congressional Research Service - the Library of Congress

⁴⁰ Fredman/Wiles: How Mutual Funds Work, Chapter 25. New York Institute of Finance 1998

⁴¹ Investment Company Institute, 2004 Mutual Fund Fact Book.

⁴² Scott Adams, the creator of the Dilbert cartoon

⁴³ Portfolio Transaction Costs at U.S. Equity Mutual Funds. Karceski University of Florida, Livingston University of Florida, O'Neal Wake Forest University. July 2004. Page 5.

⁴⁴ The Arithmetic of Active Management, William F. Sharpe. Page 2 <http://www.stanford.edu/~wfs Sharpe/art/active/active.htm>. The Financial Analysts' Journal Vol. 47, No. 1, January/February 1991.

⁴⁵ http://www.accessmylibrary.com/coms2/summary_0286-11697325_ITM. "Acerbic moral compass (Interview)"

⁴⁶ In Mutual Funds, You Get What You Don't Pay For: "The more the fund manager takes, the less the owner makes. Yet despite the obvious and documented inverse relationship that clearly links mutual fund costs and mutual fund returns, costs have risen all through the industry's modern history. Management fees and operating expenses have increased from a mere \$15 million in 1950 to \$37 billion in 2004. That 2,400 fold increase far surpassed the near 1,600 fold increase in equity fund assets. (There is no evidence, for example, that it takes any more security analysts and portfolio managers to run a fund with say, \$5 billion of assets than a fund with \$1 billion of assets.) The Battle for the Soul of Capitalism. John C. Bogle. Pages 153 and 154.

⁴⁷ Mark Carhart. "Persistence in Mutual Fund Performance," Journal of Finance March 1997. Co-chair of the quantitative research group at Goldman Sachs

⁴⁸ Knight Ridder News Service article by Todd Mason quoting John Bogle. See footnote 37

⁴⁹ <http://www.bankrate.com/brm/news/investing/20020306a.asp>

⁵⁰ Ibid

⁵¹ In Mutual Funds, You Get What You Don't Pay For: "The more the fund manager takes, the less the owner makes. Yet despite the obvious and documented inverse relationship that clearly links mutual fund costs and mutual fund returns, costs have risen all through the industry's modern history. Management fees and operating expenses have increased from a mere \$15 million in 1950 to \$37 billion in 2004. That 2,400 fold increase far surpassed the near 1,600 fold increase in equity fund assets. (There is no evidence, for example, that it takes any more security analysts and portfolio managers to run a fund with say, \$5 billion of assets than a fund with \$1 billion of assets.) The Battle for the Soul of Capitalism. John C. Bogle. Pages 153 and 154.

⁵² Technical Bulletin. U.S. Department of Labor May 22, 1986. ERISA Technical Release 86-1

⁵³ Ibid

⁵⁴ Ibid

⁵⁵ SEC investigation of pay-to-play schemes. Center for fiduciary studies commentary see <http://www.fi360.com/press/pdfs/paytoplay.pdf>

⁵⁶ Hamilton/Burns - "Reinventing Retirement Income in America," National Center for Policy Analysis. <http://www.ncpa.org/pub/st/st248>

⁵⁷ Employee Benefit News, March 2001, "Individually Directed Accounts Are a Dumb Idea"

⁵⁸ Emotional investing. <http://www.sap-img.com/stock-market-investment/emotional-investing-hurts.htm>. <http://www.advancedfutures.com/cbot/3.asp>. (The second article deals with those individuals who are actively buying individual securities. This is not the same as trading mutual funds within a closed fund menu. However, the author believes 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.)

⁵⁹ The leader in participant-directed software technology generated over \$3 Billion in revenue during 2006. <http://www.sungard.com/corporate/3q200610q.pdf>

⁶⁰ Hutcheson/Lansing/Meigs - Institute of Management and Administration ("IOMA) November 10, 2003 Audio Conference

⁶¹ The Department of Labors booklet "A Look at 401(k) Plan Fees" http://www.dol.gov/ebsa/publications/401k_employee.html

⁶² <http://www.accessdc.com/res.aspx?i=1>, and, http://www.accessdc.com/resource_center/Access_Data_NICSA_9.23.04.ppt

⁶³ The omnibus account problem: You Can't Monitor What You Can't See. James J. Dolan, President and CEO, Access Data Corporation. (<http://www.accessdc.com/wregister.aspx?id=3>)

⁶⁴ Ibid

⁶⁵ Ibid

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- ⁶⁶ Institute of Business and Finance. Fredman and Wiles. How Mutual Funds Work, page 369
- ⁶⁷ Hutcheson/Lansing/Meigs - Institute of Management and Administration (“IOMA) November 10, 2003 Audio Conference
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- ⁶⁹ SEC variable annuities: What you should know. <http://www.sec.gov/investor/pubs/varanny.htm>
- ⁷⁰ Ibid
- ⁷¹ Ibid
- ⁷² Ibid
- ⁷³ Ibid
- ⁷⁴ Ibid
- ⁷⁵ <http://www.oag.state.ny.us/investors/investors.html>, <http://googleppc.stockbroker-fraud.com/news.htm>
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- ⁷⁷ Statement of John C. Bogle to Senatorial Committee on Banking, Housing and Urban Affairs, February 26, 2004.
- ⁷⁸ Public awareness of the fee problem is growing:
- Wall Street Journal, 401(k) Industry Up for Review
([http://finance.yahoo.com/retirement/article/102190/Up_for_Review:_401\(k\)_Industry](http://finance.yahoo.com/retirement/article/102190/Up_for_Review:_401(k)_Industry))
 - Bloomberg, 401(k) Fees are Still Exorbitant, Buried Secrets
(http://www.bloomberg.com/apps/news?pid=20601039&sid=an13g70hwYis&refer=columnist_wasik)
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(http://www.kansascity.com/mld/kansascity/news/consumer_news/16135414.htm?source=rss&channel=kansascity_consumer_news)
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