CHAPTER 9

The Future of 401(k) Plan Fees

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§ 9.01 INTRODUCTION

The Dow Jones Industrial Average was up 16.3 percent in 2006, and the
Standard and Poor’s 500 was up 13.6 percent.¹ That’s how stocks did, but most
of us don’t own stocks. We own mutual funds, or more commonly, our 401(k)
plans own mutual funds. The bottom line is that if your 401(k) plan invested in the
stock market last year, you were lucky if you made 13 percent, after fees.
According to a recent report by the Investment Company Institute, the average
401(k) plan charged fees equal to 0.76 percent of assets in 2005, but even higher
fees are common.² To be sure, the Vanguard 500 Index Fund—which tracks the
S&P 500—advertises that it charged an investment fee of just 0.18 percent of
assets in 2005 (plus an account management fee of $10 per account).³

In general, the more aggressive your fund manager is (that is, the farther it gets
away from tracking a benchmark like the S&P 500 Index), the higher the fees and
the harder it is to even know what the fees really are.

In fact, there are many fees associated with 401(k) plan stock funds. Companies
charge fees for portfolio management, fund administration, shareholder service,
and other miscellaneous costs. According to a recent report by the U.S. Congress’s
Government Accountability Office (GAO), these investment fees make up
between 80 and 99 percent of all plan fees, depending on the number of

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² Investment Company Institute, The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 15(7) RESEARCH FUNDAMENTALS 8 (November 2006) [hereinafter The Economics of Providing 401(k) Plans].
³ Vanguard, Vanguard 500 Index Fund Investor Shares (VFINX) web page at https://flagship.vanguard.com/VGApp/hnw/FundsSnapshot?FundId=0040&FundIntExt=INT (as of March 8, 2007) (showing a 0.18% expense ratio as of 12/31/2006).
participants in the plan. In addition, there are record-keeping fees associated with maintaining participant accounts, processing fund selections, and mailing account statements. These, too, cut into your bottom line.

There are also other fees associated with setting up a 401(k) plan and explaining it to employees, but these are usually paid by your employer.

All in all, investment fees and record-keeping fees can have a very adverse impact on your retirement savings. For example, imagine a 45-year-old employee who plans to leave $20,000 in a 401(k) account until retirement at age 65. If those assets earn a 6.5 percent net annual return—a 7 percent investment return minus a 0.5 percent charge for fees, that $20,000 will grow to $70,500 at retirement. On the other hand, if fees are instead 1.5 percent annually, that $20,000 investment will grow to just $58,400. That additional 1 percent annual fee will reduce the account balance at retirement by around 17 percent.

Fees, especially investment fees are Wall Street’s dirty little secret. It is extremely difficult for investors to get a complete picture of the fees that fund managers skim off the top. Fund managers rarely advertise how much they make on your money.

Of particular concern, fund managers may receive undisclosed compensation from mutual fund companies in exchange for recommending their funds, and fund managers may receive rewards from stock brokers in exchange for using their brokerage services. The danger is that your money may be steered toward investment products or services that may not get the best returns and may be subjected to higher fees.

There were 47 million participants in 401(k) plans in 2005, up from just 8 million in the 1980s. More than 90 percent of 401(k) plan participants can choose how to invest their accounts, and nearly half invest in stock funds. That’s a lot of money and a lot of investors. At bottom, the investment industry makes a very healthy living off “other people’s money.”

This chapter considers how plan sponsors, plan participants, and government

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5 Id. at 7. See also Jeff Robertson, Making the Most of Scarce Resources: The Opportunity Cost of Retirement Plan Fees, 13 (1) JOURNAL OF PENSION BENEFITS 49 (Autumn 2005).
6 Changes Needed, at 1.
7 Id., at 5.
§ 9.02[1] 

REVIEW OF EMPLOYEE BENEFITS

regulators can get control over fees. At the outset, Section 2 provides an overview of the fees and costs that can arise in connection with a typical 401(k) plan. Next, Section 3 outlines the statutory and regulatory systems that regulate these costs and offers a simple example to highlight some of the major concerns about fees. Section 4 then discusses most recent developments relating to the regulation of 401(k) fees. Finally, Section 5 offers some concluding remarks about how we can get control over 401(k) plan fees and costs.

§ 9.02 AN OVERVIEW OF 401(K) PLAN FEES AND COSTS


Historically, about half of all workers have participated in an employer-sponsored pension plan. When ERISA was enacted, most workers were covered by traditional defined benefit plans that paid workers a life annuity starting at retirement. Employers hired experts to help them manage and invest plan assets so that the firms could meet their benefit obligations.

The overall coverage rate for retirement plans has held relatively steady in recent years, but there has been a shift away from traditional pension plans and toward defined contribution plans, especially 401(k) plans. All in all, traditional pension plans are slowly being supplemented or even supplanted by 401(k) plans.

Pertinent here, in a 401(k) plan, retirement savings are held in individual accounts, and most 401(k) plans are participant-directed, meaning that participants get to choose how to invest their retirement savings. The typical plan lets workers choose from an assortment of mutual funds that include a mix of stocks, bonds, or money market investments. In 2005, for example, 47 million Americans

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8 See, for example, Craig Copeland, Retirement Plan Participation and Asset Allocation, 2004, 28(2) EMPLOYEE BENEFIT RESEARCH INSTITUTE NOTES 2 (2007).

9 Profit-sharing and stock bonus plans may include a feature that allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account according to Internal Revenue Code § 401(k). Consequently, these plans are sometimes called “401(k) plans.” The maximum annual amount of such elective deferrals that can be made by an individual in 2007 is $15,500, although workers over the age of 50 can contribute up to $20,500. IR-2006-12.

10 In 2004, for example, 46.1 percent of working family heads participated in an employment-based retirement plan. Of those, 25.8 percent had a defined benefit plan only, 56 percent had a defined contribution plan only, and the remaining 18 percent had both a defined benefit and defined contribution plan. Copeland, Retirement Plan Participation and Asset Allocation, 2004, at 2.
had 401(k) accounts, and by the end of 2005, 401(k) plans held $2.4 trillion in
assets, about 17 percent of all retirement assets.\footnote{Sarah Holden & Jack VanDerhei, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2005 (Employee Benefit Research Institute Issue Brief No. 296, 2006), at 3} About 87 percent of
plans—covering about 92 percent of participants—are participant-directed.\footnote{Changes Needed, at 5.}

The bottom line is that instead of having a single plan hiring a handful of
experts to manage millions of dollars of assets, we are now in a world in which
most employers have plans in which thousands of workers each make dozens of
decisions about how to invest their much smaller individual accounts. There were
numerous economies of scale associated with traditional pension plans, and those
large plans could negotiate much lower rates for most services.


Fees are charged by a variety of outside companies that the 401(k) plan sponsor
services are needed to maintain a plan. These include record-keeping, transaction
processing, plan creation and modification, and trustee services.

Second, there are participant-focused services. These include participant
communication, participant education and advice, and investment management.
Additional participant-focused services, if offered, can include: 1) a brokerage
window (allowing direct purchase of securities by plan participants), 2) mainte-
nance of an employer stock fund (to facilitate the purchase of employer securities
within the plan), 3) loan processing, and 4) insurance and annuity services.

Third, there are regulatory and compliance services. These include plan
document services, consulting, accounting and audit services, legal advice, plan
testing, and processing of domestic relations orders.

All of these services involve costs which are shared by the plan sponsor and the
plan participants. Most of the fees associated with 401(k) plans are investment

\footnotesize \footnote{Sarah Holden & Jack VanDerhei, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2005 (Employee Benefit Research Institute Issue Brief No. 296, 2006), at 3}  
\footnotesize \footnote{Changes Needed, at 5.}  
\footnotesize \footnote{Christian E. Weller & Shana Jenkins, Building 401(k) Wealth One Percent at a Time: Fees Chip Away at People’s Retirement Nest Eggs 4 (Washington, DC: Center for American Progress 2007) [hereinafter Building 401(k) Wealth].}  
fees. These include sales charges (such as loads or commissions) and management fees (ongoing charges for managing the assets).\textsuperscript{15} Record-keeping fees are the second largest portion of fees. According to a recent study, investment fees accounted for 84.5 percent of total fees in plans with 25 participants and 98.6 percent of total fees in plans with 2,000 participants.\textsuperscript{16} Plan participants usually pay most the investment fees and often pay record-keeping fees.

Most studies find that fees associated with 401(k) plans average just over one percent of assets.\textsuperscript{17} But fees vary for a number of reasons. In particular, because there are economies of scale, larger plans tend to have lower fees per participant than smaller plans. Fees also depend upon the level of services offered by the plan, and plans that provide more services (e.g., loans) cost more than plans that offer more limited services.

Fees also depend on the types of assets held in the plan. For example, stock funds typically have higher fees than bond funds, and international stock funds typically have higher fees than domestic stock funds. Also, funds that are actively managed have higher fees than funds that passively track a stock index.

\section{Related Problems}

Higher fees are by no means the only cost of shifting from traditional pensions to 401(k) plans. First, individuals tend to make worse asset allocation decisions than large pension plan managers, and, second, individual annuities are much more expensive than group annuities.

\subsection{Portfolio Choice}

On average, individual employees tend to be pretty poor investors. They tend to invest too heavily in bonds and guaranteed investment contracts.\textsuperscript{18} Also, when they do invest in stocks, individual employees tend to invest too heavily in the stock of their employers (as the recent Enron scandal showed) and too heavily in U.S. stocks (as opposed to foreign stocks). Also, when employees fail to make an affirmative election about how to invest their 401(k) funds, many plans use low-yield, stable value fund as the default investment. All in all, one recent study

\begin{thebibliography}{9}

\bibitem{18}
Moreover, individuals tend to reduce their equity holdings as they get older, while large pension funds can continue to collect the equity premium in perpetuity. See, for example, Jeremy J. Siegel, \textit{Stocks for the Long Run} (1994).
\end{thebibliography}
found that traditional pension plans managed by investment professionals tend to get annual returns 1.9 percentage points higher than defined contribution plans where individuals tend to choose the investments.\textsuperscript{19} While much of that shortfall is attributable to higher fees, part is, no doubt, attributable to the poorer investment choices made by individual investors.

In recognition of the historically poor investment choices made by individual employees, the Pension Protection Act of 2006 amended ERISA § 404(c) to improve the default investments. In September of 2006, the Department of Labor proposed new regulations that would encourage employers to use higher-yielding default funds that hold a mix of stocks and bonds.\textsuperscript{20} Under the proposed regulations, employees would be encouraged to replace their stable value funds with balanced funds (funds with an unchanging mix of stocks and bonds) and life cycle funds (funds which gradually shift their investments from stocks towards bonds as workers age). At this writing, however, the regulations have not been finalized, perhaps because of intense lobbying by the money market and insurance companies that sponsor those disfavored stable value funds.\textsuperscript{21}

[b] Costs of Annuities

Traditional pension plans also provide monthly benefit checks for life—in effect, low-cost annuities. An individual employee that wants to buy an annuity with the money in her 401(k) plan will face much higher costs.\textsuperscript{22}

\section{THE REGULATION OF FEES AND COSTS}

Fees reduce the rate of return on 401(k) investments, and over the course of a lifetime, fees can reduce retirement savings significantly. As mentioned in the introduction, the Government Accountability Office notes that a one percentage point increase in fees can reduce retirement savings by 17 percent.\textsuperscript{23}

\begin{thebibliography}{9}
\bibitem{19} John C. Goodman, \textit{Statement on America's Private Retirement System: The Need for Reform} (testimony before the U.S. Senate Special Committee on Aging, January 27, 2004), available at http://aging.senate.gov/_files/hr115ig.pdf.
\bibitem{22} See, for example, George A. (Sandy) Mackenzie, \textit{Annuity Markets and Pension Reform} (2006).
\bibitem{23} Changes Needed, at 7. See also \textit{Building 401(k) Wealth}, at 6–7.
\end{thebibliography}
§ 9.03[1]  REVIEW OF EMPLOYEE BENEFITS  9-8

ERISA, the Department of Labor has some authority to regulate fees. In addition, specific investments—such as stocks and annuities—are subject to regulation under the applicable securities, banking, or insurance laws.

[1]  Pension Law

Under ERISA, the Department of Labor generally has oversight authority with respect to pension plans, including 401(k) plans. Pertinent here, the fees charged by service providers must be reasonable, and 401(k) plans must provide participants with investment information, including information about fees.

At the outset, ERISA § 403(c)(1) mandates that plan assets are to 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.”

Similarly, ERISA § 404(a)(1) requires plan’s fiduciaries to discharge their duties “solely in the interest of the participants and beneficiaries and . . . . for the exclusive purpose of . . . . providing benefits to participants and their beneficiaries; and . . . .defraying reasonable expenses of administering the plan.” In short, the fees paid to service providers must be “reasonable.” Moreover, plan sponsors have a duty to get sufficient information to be able to determine that the fees charged by service providers are reasonable.

ERISA requires all 401(k) plans to provide participants with a summary plan description, account statements, and a summary annual report; but these documents are not required to provide much information about fees. However, ERISA does require additional fee disclosures for most plans that allow participants to direct their own investments. These so-called 404(c) plans must

24  ERISA § 406 also specifically prohibits certain transactions between the plan and “parties in interest” including service providers. In general, these rules prevent self-dealing. See especially 2-26 EMPLOYEE BENEFITS GUIDE § 26.09 (Prohibitions Expressly Addressed to Fiduciaries).

25  See, for example, U.S. Department of Labor, Pension and Welfare Benefits Administration, Office of Regulations and Interpretations, Advisory Opinion 97-16A (May 22, 1997).

26  ERISA §§ 101 et seq.

27  ERISA 404(c). More specifically, ERISA § 404(c) provides plans with a “safe harbor” from liability for losses that a participant suffers in their 401(k) accounts to the extent that the participant exercises control over the assets in his or her 401(k) account. To be eligible for the protection of this safe harbor, however, the plan must provide the participant with the opportunity “to exercise control over assets in his individual account” and “to choose, from a broad range of investment alternatives.” 29 C.F.R. § 2550.404c-1(b)(1). The plan must also provide the participant with “the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan,” including information about transaction fees and expenses. 29
provide participants with investment information for each available investment option, including information about the transaction fees associated with buying or selling shares in those options.\textsuperscript{28} Moreover, upon request, these plans must provide additional investment information, including the so-called “expense ratio” for each investment option.\textsuperscript{29} In that regard, plans often provide participants with prospectuses and fund profiles.

Still, most of the evidence suggests that neither participants nor plan sponsors are fully aware of the many different fees that are paid in connection with 401(k) plans. The disclosures that are made to participants are limited, and that makes it hard to understand the fees that are charged or to compare alternative investments.

When it comes to enforcement of these fiduciary and disclosure obligations, participants can sue plan fiduciaries for breach of fiduciary duties under ERISA §§ 502(a)(2) and 502(a)(3) and for failure to make required disclosures under a number of provisions.\textsuperscript{30} The Secretary of Labor has authority over 401(k) plan fees but, so far, has few enforcement projects related to fees.

\section*{2 \ Other Laws}

Also of note, the Securities and Exchange Commission (SEC) regulates registered securities including company stock and mutual funds; a variety of federal and state agencies regulate bank investment products, and state agencies...
generally regulate insurance and annuity products.\textsuperscript{31}

\section*{Putting Fees into Their Proper Context}

\subsection*{A Simple Example}

A simple example can help us put fee issues into the proper context. Assume that WORKER is covered under a simple participant-directed 401(k) PLAN sponsored by EMPLOYER. Under the PLAN, WORKER elects to have $10,000 contributed to the 401(k) PLAN, and, to keep it simple, there are no matching EMPLOYER contributions.

EMPLOYER contracts out virtually all the 401(k) PLAN services. The PLAN uses INVESTMENT ADVISOR to help it select and monitor a variety of appropriate investment funds for its employees. Based on that advice, the PLAN establishes relationships with a number of companies that offer a range of diversified stock and bond funds, including MUTUAL FUND.

The PLAN then allows WORKER to select from among the various mutual funds that it chose, and WORKER chooses to invest all $10,000 in the LARGE CAP PORTFOLIO run by MUTUAL FUND. LARGE CAP PORTFOLIO is an actively managed fund that invests 100 percent of its assets in the stock of Fortune 500 companies. MUTUAL FUND buys its stock through unrelated BROKER.

All stocks are held in trust by TRUSTEE, and all records are kept by RECORDKEEPER. LAWYER set up the plan for EMPLOYER, and ACCOUNTANT and AUDITOR make sure that everything is where it is supposed to be.

Assume further that the underlying stocks purchased by LARGE CAP PORTFOLIO go up in value by 14 percent over a one year time frame. At that point in time, WORKER elects to retire and takes the balance of his account in a lump sum distribution.

The question is who made how much, and why? That’s the $64,000 question.

The only thing we can say for sure is that there is no way that WORKER is going to see a check for $11,400. Why not? Fees! Even reasonable fees would cut into the 14-percent, $1,400 gross return on WORKER’s $10,000 investment.

\textsuperscript{31} Of note, the Securities and Exchange Commission is working with the Department of Labor to determine how fee disclosures should be made to 401(k) plan participants. Andrew J. Donohue, \textit{Speech by SEC Staff: Remarks Before the American Bar Association Section of Business Law Spring Meeting} (March 16, 2007), available at www.sec.gov/news/speech/2007/spch031607ajd.htm.
As you can see there are lots of hands reaching out for that appreciation. At the very least, there will be BROKER fees to buy and sell the underlying stocks and other transaction fees to get the money into and out of the MUTUAL FUND. LARGE CAP PORTFOLIO will also charge a fee to manage the investment, TRUSTEE will charge a fee to hold the underlying stocks, and RECORD-KEEPER, ACCOUNTANT, and AUDITOR will all charge fees to keep track of it all.

Moreover, if instead of taking a lump sum distribution, WORKER wants to use the balance in her account to purchase a life annuity, additional fees and costs will be paid to acquire that annuity. For example, INSURANCE AGENT would collect a commission for selling the policy, and INSURANCE COMPANY would also want to make a profit.

[b] The Problem and Some Pitfalls

The problem is that 401(k) plan costs are much higher than necessary, and those costs are significantly weighted toward plan participants rather than the company. The possibilities for overcharges along the way between investment and return are rampant. Matthew D. Hutcheson puts it this way:

The profitability of the 401(k) industry depends upon the magnitude of the fees it can extract from plan assets and plan sponsor—not on how well it protects and enhances the retirement income security of plan participants.

Here I want to highlight just a few of the pitfalls. For example, the EMPLOYER will usually bear the initial costs to create the plan. There is a temptation, however, for the EMPLOYER to choose the “one-stop-shopping” arrangements offered by large firms that act as third-party service providers. According to Jeffrey C. Troutner:

These firms essentially give away the administration and recordkeeping services, which are typically paid for by the company, in order to gain the business. They aren’t doing this out of the kindness of their capitalistic hearts, of course. They make up those fees on the investment side. And who pays those fees? The participants, of course. In order to get paid enough for these services, the one-stop-shops offer their own mutual funds with sufficiently

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32 See, for example, Jeffrey C. Troutner, Fixing the 401(k)—Before It’s Too Late (TAM Asset Management, Inc., Asset Class newsletter, February 2007).

high management fees to offset the recordkeeping costs and build in a substantial profit.\textsuperscript{34}

Another major pitfall is so-called “revenue-sharing.” These are hidden kickbacks from one service provider to another and are sometimes called “soft dollars.” For example, while WORKER would like to see her stock trades executed as inexpensively as possible, it is MUTUAL FUND that picks the BROKER that executes the trades. One remarkably common practice is for BROKER to provide a variety of services in exchange for the MUTUAL FUND business. For example, the BROKER might provide computers, access to its research and databases, and invitations to special investment conferences. BROKER recoups these costs by charging larger fees to execute the trades and may even encourage the MUTUAL FUND to engage in more trades than would be prudent.\textsuperscript{35} Similarly, MUTUAL FUND, itself, may provide research services, finder fees, and other hidden kickbacks to INVESTMENT ADVISOR.\textsuperscript{36}

Trading costs can, themselves be hidden fees. It costs money to buy and sell stocks, but these trading costs are not incorporated into a mutual fund’s “total expense ratio” but instead come out of shareholder assets. In that regard, actively traded funds have higher trading costs than passive funds that track a major stock index like the Standard & Poor’s 500. Indeed, the average turnover ratio for actively managed domestic stock funds is well over 100 percent each year.\textsuperscript{37} That means that one percent of WORKER’s assets in LARGE CAP PORTFOLIO can disappear even before the other expenses, fees, and costs are taken into account. And there are other hidden fees, as well.\textsuperscript{38}

The critical question is whether “these fees exist to pay for reasonable, legitimate and valuable services that benefit participants” or “to support the

\textsuperscript{34} Id., at 2.

\textsuperscript{35} There is also the possibility that MUTUAL FUND or BROKER may play with the timing of its trades in a way that favors some clients over others. See, for example, Nell Hennessy, \textit{Follow the Money: ERISA Plan Investments in Mutual Funds and Insurance}, 38 \textit{John Marshall Law Review} 867 (Spring 2005); Thomas R. Hurst, \textit{The Unfinished Business of Mutual Fund Reform}, 26 \textit{Pace Law Review} 133 (Fall 2005) (discussing the recent market timing and late trading scandals).

\textsuperscript{36} Hutcheson argues that using “soft dollars” for any purpose other than for providing benefits to participants and beneficiaries and paying reasonable expenses is a breach of fiduciary duty. Hutcheson, \textit{Uncovering and Understanding Hidden Fees in Qualified Retirement Plans}, at 24.

\textsuperscript{37} Id., at 23.

\textsuperscript{38} Id., at 27–35 (discussing sub-transfer agent fees, account distribution (sales) based 12(b)-1 fees, and variable annuity wrap fees).
financial services industry at the expense of participants.” 39 There are nearly 7,000 mutual funds today, but there are not even that many individual U.S. stocks. 40 It is no wonder that “in any given year only about three in 10 managers are deft—or lucky—enough to outwit the market.” 41

If the 401(k) industry can’t beat the market, then, perhaps, the typical 401(k) plan should offer just a handful of low-fee funds that passively track the markets. Indeed, one can imagine that an EMPLOYER that cared about its fiduciary responsibilities to its WORKERS might want to offer a 401(k) PLAN with a single passive fund with aggregate fees running well under 0.5 percent (50 basis points). For example, EMPLOYER might have PLAN invest 60 percent of its assets in a fund that tracks the S&P 500 Index and the other 40 percent in a fund that tracks the Lehman Aggregate Bond Index.

If more funds are needed, for example, in order to provide a range of choices under ERISA § 404(c), perhaps a few life-cycle funds could be added. These are funds that gradually shift their investments from stocks to bonds as workers age.

§ 9.04 RECENT DEVELOPMENTS

Under ERISA, plan fiduciaries are supposed to look out for their participants and beneficiaries, and it is not at all clear that current 401(k) plan fiduciaries have been doing that. What is clear, however, is that giving workers more active management choices has meant more fees (including hidden fees), and those fees have often meant lower after-fee rates of return for workers. Whether through regulation, legislation, or litigation, it is all about to change.

[1] Regulation

The U.S. Department of Labor already has some authority to oversee 401(k) plan fees, but it lacks the information that it needs to regulate hidden fees. 42 Of note, in 2004, after an in-depth review of fee issues, the Working Group of the ERISA Advisory Council called for additional disclosure of fees in defined

39 Id., at 19.
40 Troutner, Fixing the 401(k)—Before It’s Too Late, at 2.
42 Changes Needed, at 3.
contribution plans that seek the protections of ERISA § 404(c). The group provided a number of sample disclosure reports that would help participants in self-directed accounts better understand and evaluate the fees that they pay.

Partly as a result of those ERISA Advisory Council suggestions, the Department of Labor now has a number of initiatives underway to increase disclosures about fee information. The Department of Labor is developing new rules regarding fee information that must be disclosed to participants under ERISA § 404(c), the Department is considering changes to improve fee disclosures on the Form 5500s that plan sponsors need to file, and the Department is developing new rules under ERISA § 408(b)(2) to help ensure that plan sponsors have the information they need to decide whether to select or retain a service provider. The Department of Labor also has a model fee disclosure worksheet on its Web site and numerous resources to help workers evaluate qualified plan investments.

Also, as already mentioned, the Pension Protection Act of 2006 recently amended ERISA § 404(c) to improve the default investments, and the Department of Labor

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44 Also in 2004, another Working Group of the ERISA Advisory Council recommended that:
   A. Plan sponsors should avoid entering transactions with vendors who refuse to disclose the amount and sources of all fees and compensation received in connection with plan.
   B. Plan sponsors should require plan providers to provide a detailed written analysis of all fees and compensation (whether directly or indirectly) to be received for its services to the plan prior to retention.
   C. Plan sponsors should obtain all information on fees and expenses as well as revenue sharing arrangements with each investment option. Plan sponsors should also determine the availability of other mutual funds or share classes within a mutual fund with lower revenue sharing arrangements prior to selecting an investment option.
   D. Plan sponsors should require vendors to provide annual written statements with respect to all compensation, both direct and indirect, received by the provider in connection its services to the plan.
   E. Plan sponsors need to be aware that with asset-based fees, fees can grow just as the size of the asset pool grows, regardless of whether any additional services are provided by the vendor, and as a result, asset-based fees should be monitored periodically.
   F. Plan sponsors should calculate the total plan costs annually.


45 See, for example, U.S. Department of Labor, 401(k) Plan Fees Disclosure Form, available at www.dol.gov.
recently proposed new regulations that will have an impact on 401(k) plan investments and fees.

[2] Legislation

Congress is also becoming increasingly interested in the issue of 401(k) plan fees. In that regard, to give the Department of Labor the information it needs to provide more effective oversight, the Government Accountability Office recently recommended amending ERISA and updating regulations to improve disclosure of fees and business arrangements among service providers. The General Accountability Office also suggests that the Department of Labor should require plan sponsors to provide 401(k) plan participants with a summary of all fees that are paid out of plan assets or by participants.

Of note, Representative George Miller (D-CA), the new chair of the House Committee on Education and Labor, has recently expressed a great deal of interest in the 401(k) fee issue, and his committee recently held a spirited hearing on the subject. Almost everyone at the hearing agreed that 401(k) fees are sometimes excessive, that there are problems with the current disclosure rules, and that our capital markets will work better if investors have complete information about all investment and record-keeping fees. Many also expressed concern that any new disclosure requirements should not unduly burden plan sponsors nor overload participants with too much information. There was less consensus about the kind of legislation, if any, that might be needed to better protect 401(k) plan participants.

In principle, even the securities industry supports expanded disclosure requirements. For example, the Investment Company Institute recently issued a policy statement that encourages the Department of Labor to require: 1) that investment companies provide clear disclosures to plan sponsors that highlight the most pertinent information, including total plan costs, and 2) that plan administrators provide participants in self-directed plans with a simple straightforward explanation of each investment option available to them that includes information on fees.

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46 Changes Needed, at 28.
47 Id., at 29.
and expenses. 49

Another legislative approach would be to expand the availability of low-cost, limited-option plans like the federal government’s Thrift Savings Plan. 50 This could be as simple as permitting private sector employees to join the Thrift Savings Plan or permitting them to join a state or local government retirement plan. Alternatively, federal, state, or local governments could be permitted to run new low-cost plans for private sector employees. For that matter, we could let industry or community groups set up low-cost multi-employer 401(k) plans. 51 We might even go so far as to develop a system of mandatory individual retirement savings accounts on top of the current Social Security system. 52

[3] Litigation

Recently a number of class action lawsuits have been filed against employers and service providers alleging that plan fiduciaries have breached their fiduciary liabilities by paying excessive and improper fees and by failing to disclose those fees to participants. For example, a recent class action brought against Lockheed Martin Corporation alleges that Lockheed breached its fiduciary duties to its 401(k) plan participants by failing to adequately disclose and keep a lid on fees. 53 Count I alleges that Lockheed is liable under ERISA § 502(a)(2) and Count II alleges that Lockheed is liable under ERISA § 502(a)(3).

These cases highlight the problems with high and hidden fees, and, no doubt, these cases will result in plan sponsors becoming more knowledgeable and cautious about fees. 54 On the other hand, proving a breach of fiduciary

50 See, for example, Building 401(k) Wealth and sources cited therein.
51 Along the similar lines, President George Bush has called for the creation of so-called “association health plans” to permit community groups and nonprofit organizations to extend health care coverage to more Americans. See, for example, COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 2006, at 100 (Washington, DC: U.S. Government Printing Office, 2006).
52 See, for example, Adam Carasso & Jonathan Barry Forman, A Mandatory Universal Pension System, in NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND COMPENSATION, Chapter 1, pp. 5–1 to 5–34 (Alvin D. Lurie ed., 2006); Jeff Sessions, A Bipartisan Fix for Retirees, WASHINGTON POST, December 26, 2005, at A25.
54 See, for example, Follow the Money: DOL Initiatives and New Litigation on Service Provider
Responsibility is going to be an uphill battle. To date, the courts have permitted fiduciaries a great deal of discretion in their investment policies. For example, one recent case held that a plan sponsor’s “investing in a money market fund can hardly be characterized as irresponsible.”

Primarily what matters in a breach of fiduciary responsibility case under ERISA is the after-fee rate of return that the fiduciary achieves, not the specific fees along the way, and I expect that the courts will be quite tolerant of employer efforts to secure reasonable after-fee rates of return on the various investment funds that they offer. The recent class action suits, however, focus on fees, virtually to the exclusion of the after-fee rate of return. For example, in the Lockheed Martin case, the plaintiffs allege that:

5. The most certain means of increasing the return on employees’ 401(k) savings is to reduce the fees and expenses employees pay from their 401(k) accounts.

That kind of assertion will be hard to prove, at best, as will assertions that fees are unreasonable. Pertinent here, although the Department of Labor has investigated a few allegations of excessive fees, it “does not find many fee violations because it is difficult to identify unreasonable fees.”

§ 9.05 CONCLUSION

There are not very many investors that can beat the market, and it would appear that there are not very many 401(k) plans that can beat the market either, especially after fees are taken into account. Plan sponsors have a fiduciary responsibility to look out for their workers, and if they don’t start soon, they will face the prospect of more litigation, more regulation, and more legislation. I expect that the Department of Labor will soon issue more stringent guidance on fees and fee disclosure, and I expect that the courts will slowly begin to impose slightly greater duties on fiduciaries to understand and monitor fees. Ultimately, I expect that Congress will enact legislation that mandates greater fee disclosures.

Revenue Sharing (a March 29, 2007 conference cosponsored by the American Bar Association Joint Committee on Employee Benefits and the American College of Employee Benefits Counsel).

55 King v. National Human Resource Committee, Inc., 218 F.3d 719, 724 (C.A. 7, 2000). That court also noted that a plan sponsor’s money market “investment was not a risky choice which could give rise to liability even in the absence of damages.” Id.

56 Changes Needed, at 21.

57 See generally Report of the Working Group on Plan Fees and Reporting on Form 5500, supra note 44.
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and clarifies the fiduciary duty to understand and monitor fees imposed on participants.