

Current Issues Touching Investments

Edward Patchett, CFA

Senior VP & Managing Director

Independent Fiduciary Services

Washington, DC



Agenda

Discuss three topical investment-related issues and what you should know about them

- Fee Transparency (DC and DB Plans)
- Qualified Default Investment Options (QDIAs)
- Voluntary Employees' Beneficiary Associations (VEBAs)

Why is Fee Transparency Important?

- **November 2007: Department of Labor final rule concerning revisions to Form 5500 Schedule C**
 - Must report compensation (money or anything of value over \$5,000) that service provider receives directly or indirectly from the plan for services provided to the plan
 - Must also report service providers who receive more than \$1,000 from a source other than the plan or plan sponsor
 - Compensation includes: gifts, awards, brokerage commissions, Rule 12b-1 fees, soft-dollar payments and “float income”
 - Plan administrator needs information from plan providers in order to make complete and accurate filing

Why is Fee Transparency Important?

- **December 2007: Department of Labor proposed rule regarding fees, compensation and conflicts of interest**
 - ERISA Section 408(b)(2) provides an exemption from a “prohibited transaction” between a plan and a party in interest where the contract or arrangement provides for reasonable compensation
 - Proposed regulation requires written contract / agreement, list of services to be provided and any compensation, method of fee calculation and representation by provider that it has provided complete and accurate required disclosure information to plan

Why is Fee Transparency Important?

- Disclosures must include (among other things)
 - Whether the service provider will provide services as a fiduciary, either under ERISA or the Investment Advisers Act
 - Any financial or other interest in any transaction that the plan will be involved with in connection with the contract
 - Any relationships that may result in a conflict of interest
 - Whether the service provider has processes to manage real or potential conflicts of interest
- Provider must warrant that it will furnish information requested by plan to comply with plan's Form 5500 filing requirements

Why is Fee Transparency Important?

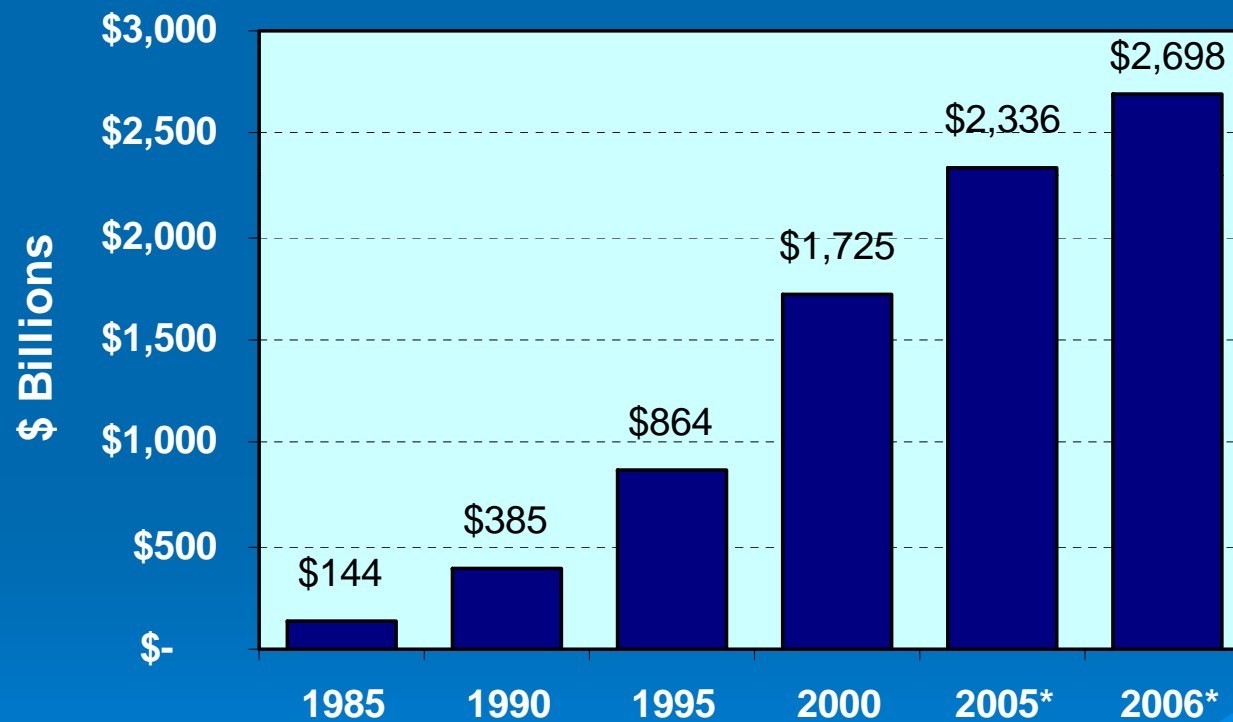
- **New wave of ERISA litigation**
 - Class action suits have been brought by plan participants against service providers for charging excessive fees and failing to disclose such fees
 - Claims against plan sponsors and investment committees for imprudently entering into contracts containing excessive fees, for failing properly to monitor the service providers, and for failing to disclose fees
 - DoL enforcement actions have been instituted against plan sponsors, fiduciaries and service providers

Fee Transparency – DC Plans

- Concerns regarding long-term solvency of DB plans is forcing shift toward defined contribution structures
 - Many employers are reluctant to incur the funding obligations of DB plans
 - Impact Pension Protection Act of 2006
 - Risk of employer withdrawal liability in multiemployer plans
- Impacts participants in collectively bargained multi-employer plans, single employer plans and public funds
- Fee arrangements in many “bundled” DC plan structures are difficult to understand

Fee Transparency – DC Plans

Historical Growth in 401(k) Plan Assets

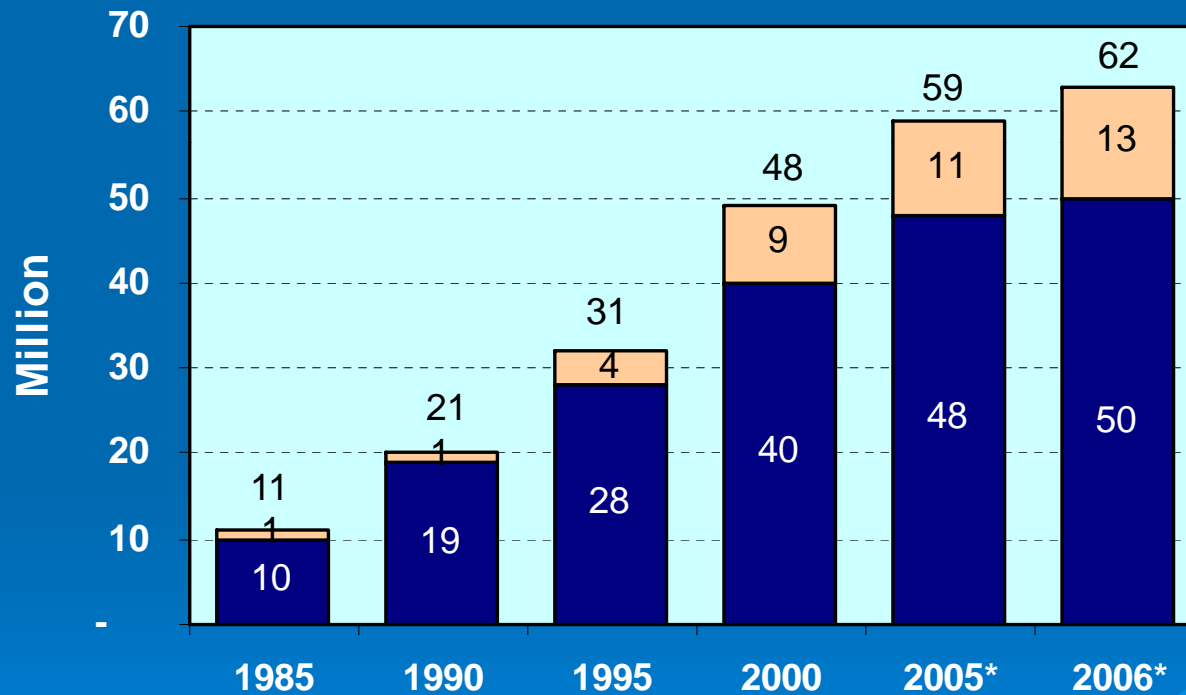


* Reflects estimated assets

Source: Investment Company Institute, Federal Reserve Board, US Department of Labor and Cerulli Associates

Fee Transparency – DC Plans

Number of 401(k) Plan Participants



* Reflects estimated participants. Totals may not add due to rounding.

Source: Investment Company Institute, Federal Reserve Board, US Department of Labor and Cerulli Associates

Fee Transparency – DC Plans

Three Perspectives

- Whether the named fiduciary/investment committee is fulfilling its fiduciary duty to establish a reasonable investment program at a reasonable cost to participants and beneficiaries
- Whether the amounts participants and beneficiaries pay are reasonable in light of what they receive
- Whether the amounts and types of compensation to the service provider are reasonable, including the impact on the quality and objectivity of its services

Fee Transparency – DC Plans

- **Investment Product Expenses*** typically built into costs of mutual funds or other investment vehicles including:
 - **Management fees**
 - **Sales loads**
 - **12b-1 fees**
 - **Sub T/A fees**
 - **Shareholder servicing fees**
 - **Overlay fees**
- **Plan Administration Expenses** for recordkeeping, payroll processing, participant enrollment & education, trustee & custodial services, statements and reporting, compliance testing & auditing
- **Participant Initiated Charges** such as loan processing fees, redemption fees, brokerage account charges and QDROs assessed against individual participants in the plan

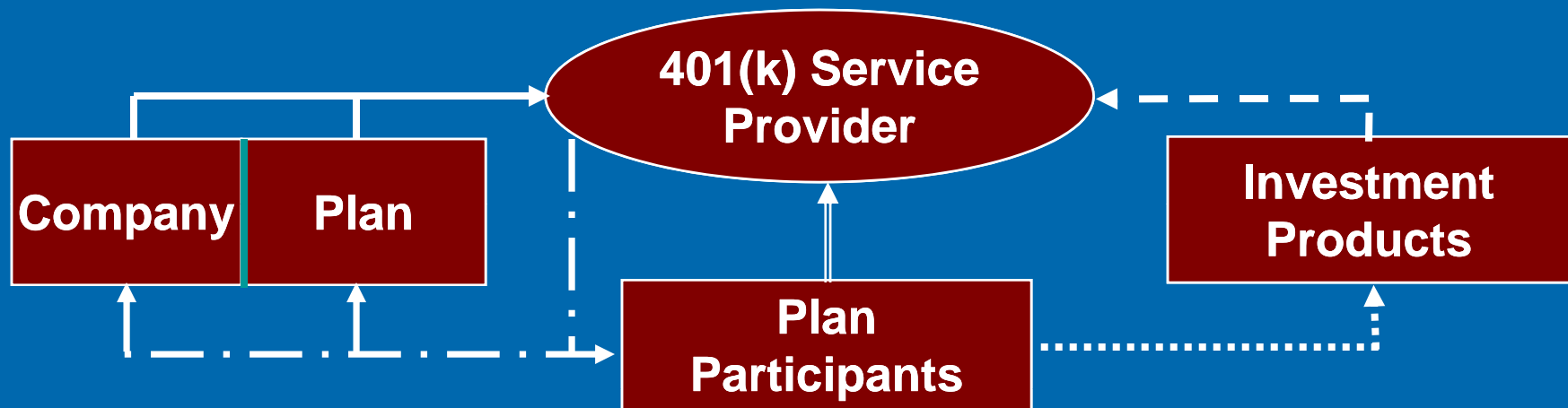
**See Glossary at end of presentation for brief definitions*

Fee Transparency – DC Plans

Defining Fees and Flows

- Revenue Sharing is remuneration from the mutual fund / investment company to the 401(k) service provider
- Rebates or Plan Expense Reimbursement Allocations (PERA) are cash payments from the 401(k) service provider back to the Company or Plan and/or Participants
- Float represents the short-term interest earned on assets in transition
- One Time / Non-Recurring Expenses:
 - *Plan Start up or Conversion costs*
 - *Installation fees*
 - *Plan Document fees / Filing fees*
 - *Plan Amendment fees*
 - *Plan Termination costs*

Fee Transparency – DC Plans



- > Plan administration fees paid directly by the Company/Plan
- . - . - . > Rebates or PERA to Company/Plan and/or Participants
- =====> Plan administration fees paid directly by Participants
-> Investment Product fees paid directly by Participants
- - - - > Revenue sharing from the Investment Products to the Service Provider

Fee Transparency – DC Plans

- Determining “reasonableness” must start with understanding the service requirements of the plan and its participants

	<u>Plan A</u>	<u>Plan B</u>
Total Assets:	\$100 Million	\$100 Million
Plan Service Provider:	ABC Ret, Inc.	ABC Ret, Inc.
Number of Funds:	18	18
Brokerage Window:	Yes	Yes
Matching / Profit Sharing:	Yes	Yes
Immediate Vesting:	Yes	Yes
Loans Available:	Yes	Yes
Daily Valuation:	Yes	Yes
Same Day Exchange Trading:	Yes	Yes
VRU / Internet Access:	Yes	Yes
Advice Program Available:	Yes	Yes

- Should the cost to administer these two plans be similar?

Fee Transparency – DC Plans

- Determining “reasonableness” must start with understanding the service requirements of the plan and its participants

	<u>Plan A</u>	<u>Plan B</u>
Total # of Participants:	500	5000
Avg Balance / Participant:	\$200K	\$20K
Uses only 40-act Mutual Funds:	Yes	No
Uses Non-Affiliated Funds:	No	Yes
Standardized Plan Documents:	Yes	No
Passed Discrimination Testing:	Yes	No
Number of Loans Allowed:	1	3
Education Meetings per Year:	1	4
Number of Sites:	1	10
Custom Materials Required:	No	Yes
Multi-Lingual:	No	Yes

- Should the cost to administer these two plans be similar? -- NOT NECESSARILY!

Fee Transparency – DC Plans

- Recent trend towards more and clearer disclosure from *some* service providers
- Actual example:

“...the funds selected do not reimburse [Provider] for the entire amount required to administer them on our recordkeeping system...we assume you’ll want to pass on these funds’ administration fees to the participants...the alternative is for the Plan or Company to pay them...The fees will be [X basis points for fund A, X bps for fund B, etc...”

Fee Transparency – DC Plans

Investigate...Then Negotiate

Example of Concrete Actions

- “No fee” plans utilizing age-based mapping of all participant assets upon conversion to service providers’ affiliated target-date retirement funds
- Previously undisclosed revenue sharing means possible room for PERA
- Lower cost share classes may be available
- Fee structures with and without a per capita charge on participants

Fee Transparency – DC Plans

Investigate...Then Negotiate

Example of Concrete Actions

- Send provider a well-crafted letter requesting (demanding?) written disclosure of fact and amount of revenue sharing payments
- Rebid your plan's services through a competitive RFP process and compare costs and fees on a direct, side-by-side basis (e.g., a "market based" test)
- Request a multi-year guaranteed cap on fees

Fee Transparency – DB Plans

- “Traditional” investment consulting and investment manager model
 - Independent “Hard-dollar” consultant – paid directly by plan
 - Third-party investment managers
 - Independent custodian
- Plan enters into separate contractual agreements with each party for specific scope of services
 - Complete fee transparency
 - No conflicts of interest
 - Good governance and oversight

Fee Transparency – DB Plans

- “Soft-Dollar” consulting arrangement
 - Consultant paid in whole or part by plan’s trading commissions
 - Commissions generated by investment managers
- Common concerns
 - Possible conflicts of interest
 - Quality of trade execution – who is monitoring?
 - Reporting to plan fiduciaries and amount of total compensation

Fee Transparency – DB Plans

- “Bundled” package of some or all of the following: investment consulting, custody, trading and investment management for an all inclusive fee
 - “Outsourcing” structure appeals to many plans
 - Depending on how arrangement is structured, may be no transparency of individual component costs
 - Possible conflicts of interest (depending on structure)
 - Plan fiduciaries still need to make sure costs are reasonable and prudently monitor the program

Fee Transparency – DB Plans

Examples of Concrete Actions

- Evaluate the level of transparency and reasonableness of fees through formal review
 - Get written disclosures regarding fees and any other possible sources of compensation from providers
 - Compare to understanding of current arrangement and written agreement
- Perform “market test” if concerns exist
 - Use formal written request-for-proposal (RFP)
 - Make sure requested scope of services is complete and responses are comparable

QDIAs

- October 24, 2007: Department of Labor issued final regulations on the use of Qualified Default Investment Alternatives (QDIA)
 - Applies to participant directed DC plans
 - Implements Section 404(c)(5) of ERISA, which was added under the Pension Protection Act of 2006
- “Default” investment option
 - The investment option for participants who are automatically enrolled or do not make an affirmative investment election
 - Historically, many plans have used very “safe,” low-risk investments (like money market or stable value accounts) as their default option
 - Most participants defaulted into an investment option do not change their investment election

QDIAs

- Primary concern
 - Given retirement savings shift from DB to DC plan structures (as discussed previously), these vehicles will increasingly represent the majority of workers' retirement savings
 - Low risk and low return default investment options will not provide participants with enough savings at retirement
- QDIA “safe harbor”
 - Plan fiduciaries are relieved from fiduciary liability from investment losses that may occur in an appropriately selected QDIA
 - Stable value and money market investments alone are not QDIAs

Types of QDIAs

- Target Retirement Date (or “Lifecycle”) Funds
 - Investment alternative designed to provide varying degrees of expected long-term risk and return
 - Asset mix based on participant’s age, target retirement date or life expectancy
 - Examples: “2020 Fund”, “2030 Fund”, “2040 Fund”
 - Initial and on-going asset allocation determined by provider and automatically adjusts over time as participant nears retirement
- “Lifestyle” Funds
 - Series of funds with varying risk and return objectives (e.g., “Conservative”, “Moderate”, “Aggressive”)
 - Asset allocation tends to remain within established range

Types of QDIAs

- **Balanced Fund**
 - Portfolio designed to provide long-term appreciation and capital preservation through a mix of assets
 - Mix based demographics of the Plan as a whole (a “one size fits all” approach)
- **Professionally “Managed Account”**
 - The “Investment Advice” module
 - Investment manager allocates assets of participant’s individual account to achieve long-term risk and return objectives (based on input from participant)
 - Investment options used are those on the existing Plan platform

QDIAs

Examples of Concrete Actions

- Decide whether or not to use default option “safe harbor”
- Many funds qualify as QDIAs, but they can have vastly different long-term risk and return
 - Target Date and Lifestyle funds offered by different providers may have very different approaches to setting initial and ongoing asset allocation
 - Perform a thorough side-by-side comparison of QDIA alternatives

VEBAs

- Voluntary Employees' Beneficiary Association (VEBA)
- Established by Congress in 1928 ¹
 - Generally established as a tax-exempt trust to fund life, health, accident or other benefits to VEBA members
 - Employer contributions are tax deductible and grow tax free
 - About one-third of large companies have VEBAs
- Employers with a collectively-bargained workforce have more flexibility regarding tax deductibility of contributions than non-bargained workforce
- For the 10 year period ended 2006, the number of VEBAs has declined from almost 15,000 to just under 12,500

¹ "What Might GM Trust Fund Mean for Workers Elsewhere?" *The Wall Street Journal*, September 27, 2007.

VEBAs

- If you thought pension benefits are underfunded, wait'll you see this.....
- S&P's 2006 report: 88% funding for pensions vs. **22%** for retiree medical liabilities
- Accounting rules (FAS 106) means balance sheet treatment for these underfunded benefit obligations
- Impact on auto industry (and others) is enormous

Stand-alone VEBAs

- Collectively bargained level of funding and overall structure at the “front end” but **not** jointly sponsored or maintained; may be court-approved through litigation or bankruptcy proceedings
- Gets unfunded liability off corporate balance sheet
- Avoids risk of renegotiated or reduced benefits in case of corporate bankruptcy
- Shifts practical responsibility to the “stand-alone” board of trustees
- Examples: GM, Ford, Goodyear, Delphi, Dana, etc.

Stand-alone VEBA's

- Dana Corporation – “A Model for Offloading Retiree Health Care?” (Financial Week, August 20, 2007)
 - Agreement between company, UAW and USW to fund two VEBA's with approximately \$700 million and \$80 million in post-bankruptcy common stock
- Dana removed approximately \$1.1 billion in unfunded long-term disability and retiree healthcare benefits from its financial statements .. no longer a collectively bargained benefit
- Benefit to company: credit ratings are likely to improve, making future borrowing both easier and cheaper
- Benefit to union(?): benefits are backed by real money which cannot be used for any other purpose (rather than the company's “promise” of benefit which could be eliminated in another bankruptcy or company liquidation)

Stand-alone VEBA

Key VEBA Considerations

- Initial funding: cash, stock (with or without restrictions) or both?
- Level of funding: range has been approximately 70-80¢ on the dollar
- Cash flow demands – asset depletion model
- Ability to keep up with medical cost inflation
- Sustainability over the long-term
- Future benefit cuts?

DISCUSSION

Glossary – DC Plan Fee and Flow Definitions

- **Expense Ratios** – The total cost a participant pays to invest in a particular fund stated as a percentage of assets under management. It is the sum of all underlying fees which are netted from performance rather than being paid distinctly. Underlying fund costs included in typical expense ratios are:
 - **Management fees** – Imposed by the investment advisor / sub-advisor to manage the assets of the fund
 - **Overlay fees** – Charged by some balanced fund-of-fund products such as target-date / target-risk portfolios that invest in other mutual funds. Costs are in addition to the aggregate expenses of the underlying funds
 - **12b-1 fees** – Sales distribution and marketing charges sometimes consisting of two components:
 - **Sales commissions** paid to registered reps for selling the fund
 - **Servicing charges** paid to the entity that services the account after the sale (servicing portion can be no greater than 50bps)

Glossary – Fee and Flow Definitions (cont)

- **Sub T/A fees** – Refers to the sub-contracting of participant accounting to a third party such as a bank or trust company that in turn executes, clears and settles share transactions, and maintains records of ownership
- **Shareholder servicing fees** – Paid to transfer agent or service provider for shareholder communications and other administration or recordkeeping activities. Costs may be subsumed within Sub T/A fee, but sometimes separated
- **M&E fees** – Mortality Risk and Administrative Expenses associated with insurance / annuity products
- **Redemption Fees** – Charges assessed for redeeming shares before a pre-determined minimum holding period has elapsed
- **Revenue Sharing** – The payment of fees from mutual fund/investment companies to the 401(k) service provider. These may be sourced from various underlying fees including 12b-1, shareholder servicing, sub t/a, or management fees
- **Plan Expense Reimbursement Allocations (PERA)** – Commonly referred to as ‘Rebates’, these are payments from the 401(k) service provider to the Company or Plan and/or its participant