



INDEPENDENT FIDUCIARY SERVICES, INC.

**Presentation to the
United States Department of Labor
2007 ERISA Advisory Council
Working Group on Fiduciary Responsibilities
Update and Revenue Sharing**

September 20, 2007

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Chairman and CEO
Independent Fiduciary Services**

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I. Introduction

- A. Thank you for inviting me to present to your working group today. My name is Francis X. Lilly and I am Chairman and CEO of IFS, a Washington, D.C.-based investment consulting firm. IFS and its predecessor firm have provided “hard dollar” investment consulting advice to institutional investors for 20 years.

Prior to forming IFS’ predecessor, Bear Stearns Fiduciary Services, I had the distinct honor and privilege to serve as the Solicitor (General Counsel) of the United States Department of Labor from mid-1983 until December 1985.

During that time, I had the opportunity to work extensively with EBSA’s predecessor, the Pension and Welfare Benefits Administration, on many complex issues. One that sticks out in my mind is the Plan Asset regulations. If the Department and EBSA were able to navigate their way through that particular thicket, I am confident they will do it again here in the very complex and confusing area of defined contribution plan fees and fee disclosure. In that regard, I would like to congratulate Alan Lebowitz, the Deputy Assistant Secretary of EBSA. I had the pleasure of working with Alan when I served as Solicitor on the Plan Asset regulations, as well as many other ERISA matters. Mr. Lebowitz joined the Department of Labor in 1979 and has been a leader in the field of ERISA and related matters since that time. That is a long and dedicated career and employee benefit funds in this country are in better condition because of the work of Alan and his colleagues.

With me today are two of my colleagues from IFS who assisted me in preparing today’s presentation. They work with many of IFS’ retainer clients, including our defined contribution (“DC”) plan clients, and wrestle with the issues you are trying to better understand today. They are Leslie Billet, a Senior Vice President, who has been with us for 10 years and Natalie Kossak, our Assistant General Counsel and Chief Compliance Officer. Not coincidentally, Natalie is no stranger

to the DOL. She worked for the Department from 1997 through 1999, both in the New York City and Washington, D.C. offices.

B. Presentation Today

We have been asked to provide both comments and practical insights with regard to what the Working Group has referred to as “revenue sharing”, in connection with defined contribution plan investment management expenses.

The Working Group, in the statement of “Working Group Objectives,” which you distributed posed four issues it is seeking to evaluate. The wording of these four issues and the related questions on page 4 of the “Working Group Objectives” provides a good example of one of the difficulties in this area: that is, not even relatively sophisticated investors – and regulators – have a clear understanding and agreement on basic terminology and definitions, much less a precise understanding of, and methodology for, reporting and disclosing all fees paid by plans, directly and indirectly, as well as the fees earned by and between service providers to these DC plans.

For example, on page 4 of the Working Group Objectives, Question Number 7 states: “What, if any, guidance should the DOL issue with regard to the obligations of plan sponsors, trustees and other fiduciaries regarding the allocation of revenue sharing payments received by the plan from a service provider?” Unfortunately, but not surprisingly, this use of the phrase “revenue sharing” is not consistent with the generally accepted definition and understanding of the term “revenue sharing”. One commentator framed the definition as follows: “Revenue sharing is the primary method exploited in order to pay distribution fees. With revenue sharing, a portion of the internal fees associated with the investment product [i.e., paid to the investment manager] is paid to an entity who either provides services to the plan or distributes the product.”¹

Thus, payments made directly to the plan by a bundled service provider (vs. the investment manager for the mutual fund option) would not, normally, be considered “revenue sharing” but rather “rebates”. I will discuss these and other definitions later.

- C. Before attempting to define the myriad of terms that different parties use to describe different fees and costs, it might make sense to take a quick look at where the Courts and the regulators are with regard to some of these issues and questions.

II. Current Legal Developments

There have been several legal actions filed against plan sponsors and service providers over the past few years relating to 401(k) plan fees. The cases fall into two basic categories: (a)

¹ The 401(k) Market and Revenue Sharing, Darwin Abrahamson, 2006

cases filed by plan participants alleging that plan sponsors failed to disclose all appropriate information to participants and failed to identify, negotiate and monitor fees and expenses that were excessive and unreasonable and (b) cases against plan service providers alleging that the service providers did not disclose the revenue sharing arrangements and that those payments should have been used for the benefit of plan participants to offset fees that otherwise would be paid by the plan or its participants and beneficiaries. The most notable recent development is in the case of Dennis Hecker, et al. v. Deere & Company, et al., Memorandum and Order, 06-C-719-S, June 20, 2007. In the Hecker case, the plaintiffs alleged that (i) the plan sponsor violated ERISA's disclosure and fiduciary requirements by failing to disclose the revenue sharing arrangements between Fidelity Trust, the Trustee and recordkeeper for the Plan, and Fidelity Research, the investment manager for some of the mutual funds offered in the Plan and (ii) that the plan sponsor violated ERISA by selecting investment options with unreasonably high fees. Very recently, the U.S. District Court dismissed plaintiffs' complaint concluding that neither ERISA, nor the DOL's regulations thereunder, currently require disclosure of revenue sharing payments. Numerous other cases are still pending² and in many cases, the courts have given plaintiffs more latitude than the Hecker court, permitting plaintiffs to amend their complaints and/or denying defendants' motions to dismiss the complaint. In one case, the court went as far as certifying the class.³ To say the least, the state of litigation and "the law" in this arena remains uncertain at this time. Failure by the DOL to issue regulations or provide clear guidance may well result in conflicting court decisions and inconsistent requirements for plan sponsors and service providers.

III. Current Regulatory Framework

The DOL is taking several steps to address the fee disclosure issue and by implication, the legality of fees associated with defined contribution plan administration and investment. The initiatives are likely to result in the issuance of "guidance" with the goal of requiring increased disclosure. The guidance will probably be at two levels: (a) the plan sponsor level and (b) the plan participant level. With respect to the plan sponsor level disclosure, the DOL guidance will include the amendment to Form 5500, Schedule C, and perhaps amendments to the regulations under 408(b)(2), requiring better disclosure as a condition of that statutory exemption. The proposed changes to Schedule C would clarify the requirements regarding reporting of direct and indirect compensation paid in connection with services rendered to any plan. The current Schedule C provides for little reporting of indirect compensation. The revised Schedule C would provide for reporting all compensation (direct or indirect) received by or paid to a service provider during the plan year in connection with the services rendered to the plan. In addition, a new section of the Form will be added requiring the source and nature of compensation in excess of \$1,000 received from parties other than the plan or the plan sponsor be disclosed for certain key service providers, including investment managers, consultants, brokers, and trustees, as well as other fiduciaries. The current regulations under 408(b)(2) require that services be necessary and appropriate, the arrangement be reasonable and no more than reasonable compensation is paid. The revised regulation will likely require disclosure of sufficient information in order to

² *Haddock v. Nationwide Fin. Svcs., Inc.*, 419 F.Supp.2d 156 (D. Conn. 2006); *Taylor v. United Technologies Corp.*, No. 3:06-cv-01494 (D. Conn. Aug. 9, 2007); *Abbott v. Lockheed Martin Corp.*, (S.D. Ill. No. 06-CV-0701-MJR, Aug. 13, 2007); *Ruppert v. Principal Life Ins. Co.*, 02:06-cv-00967-EAS-MRA (S.D. Ohio); *Phones Plus, Inc. v. Hartford Financial Services, Inc.*, 3:06-cv-01835-AVC (D.Conn.).

³ See *Loomis v. Exelon Corp.*, No.06-C-4900, 2007 U.S. Dist. Lexis 46893

permit a plan fiduciary to consider whether the fees the plan is paying are reasonable for the services received, that the service provider's total compensation is reasonable and whether there are any conflicts of interest that impair the objectivity of the service provider's advice.

With respect to the participant level disclosure, the DOL has issued a request for information from plan participants, plan sponsors and service providers to gather information about what fee and expense information participants should "consider"; how the information should be provided or made available to participants; and who should be responsible for providing the information. The goal of the request for information is to help the DOL determine to what extent regulations should be adopted or modified, or whether other action should be taken to ensure that participants and beneficiaries have the information needed to make informed decisions about their retirement accounts. As I understand it, the DOL is still in the process of working through all the information it has obtained through the RFI and hopes to issue guidance shortly. The guidance will likely be amendments to the regulations under 404(c) and will apply to all 401(k) plans, not just those that are participant directed under 404(c) and may include both automatic and on-request disclosure requirements.⁴

IV. Real World Environment in which Plans and Fiduciaries Operate

A. Introduction

IFS has a number of DC plan clients. Some of these are benefit plans related to a plan sponsor's DB plan; others are stand-alone 401(k) plan relationships. The 401(k) plans we serve are generally medium- to larger-sized DC plans, both corporate and multi-employer. In this context, the 2004 ERISA Advisory Council's "Report of the Working Group on Plan Fees and Reporting on Form 5500" contained a number of worthwhile observations by various witnesses. One that struck me, and I think is instructive in this area, was the comment by Mr. Mark Davis. Mr. Davis apparently discussed with that Working Group the fact that the larger and more sophisticated the DC plan, the greater the amount and quality of fee and "revenue-sharing" disclosure to the plan. I would suggest that this same principle applies to other DC plan fee-related disclosures as well. While this may result from the relative negotiating leverage of the larger plans vis-à-vis the service providers, as well as the quality of the plans' legal and investment consulting providers, it is not the ideal situation. Since many of the fees in question here are based on the size of the asset base, it's not surprising that the proverbial "800 lb. gorillas" get most of the attention.

The fact remains that the fiduciary responsibility and duties owed to the "P's & B's" of the smaller plans are no different than in the larger plans. The Department of Labor and specifically EBSA should do all in its authority to provide an efficient and effective framework within which DC plan fees are clearly and adequately defined and disclosed. Moreover, it is not apparent that in all cases that large plans necessarily know more about fee structures, nor are they necessarily paying the lowest possible costs simply because they have the negotiating leverage that comes with size. Additionally, we believe that any agreements between bundled service providers to the plans and the investment managers or investment companies that provide

⁴ Representative Miller on July 26, 2007, introduced into Congress a bill that would amend ERISA and impose new requirements with respect to the identification and disclosure of fees that plans pay for services; however, we believe that the Department of Labor should take the lead on issuing regulations and other guidance in this area.

the investment options in those plans should also be sufficiently transparent and disclosed. The last point is much more difficult to understand, define and disclose in the real world of small to medium sized DC plans.

B. Definitions

For the purposes of this discussion, it probably makes sense to begin the conversation of real world practices by trying to define some of the most frequently used terminology, since, as I have mentioned, it is not consistently applied in the world of DC plans.

Before doing so, it may be worth suggesting to this Working Group and your Sponsor that the DOL take the lead in formally defining 401(k) terms. It would be an important first step in reducing the confusion about flows of revenues, fees and costs, and would help mitigate some of the perceived “bait and switch” environment of certain 401(k) fee structures. As noted above, if the Department does not do so as a regulatory matter, it is possible that conflicting Court decisions could create a mine-field for plan sponsors, fiduciaries and fair and honest service providers.

Below we have listed fairly widely accepted definitions of many of the more important elements of fees, costs and revenues that are paid, and/or earned, by DC plans, their service providers and mutual fund/investment companies for the DC plans.

Expense Ratio: typically stated as a percentage of the assets under management, this term is universally agreed upon. At the mutual fund level, it is the stated, total cost that a participant must pay to invest in a particular mutual fund. It is the sum of all the underlying fees that result from the structure of the plan with its service provider(s), of which participants, plan sponsors – and even their advisors – may or may not be fully aware. The amount of the total Expense Ratio is netted from mutual fund performance rather than being paid directly by the Plan. Participants may pay additional hard dollar fees levied by the plan, typically administrative fees that are entirely separate from the mutual fund Expense Ratio.

Management Fee: the management fee is the charge imposed by the investment manager of each mutual fund option in the plan to manage the assets and to earn the returns of that mutual fund. Not separately disclosed to the plan sponsor, but included in the management fee, are all the normal and legitimate costs of investment management, including, but not limited to research and data, brokerage and trading costs, and custody fees.

12b1 Fees: this fee is generally understood to be a sales distribution and marketing charge, paid by the mutual fund/investment company to a 401(k) provider or mutual fund distributor (e.g., broker) in order to be included in that particular distributor’s program. It is frequently listed as a single charge. However, there may be two components: (1) sales commissions; and (2) servicing charges.

- Sales commissions: are paid to a registered representative for selling the mutual fund to an investor or for getting it included in a plan.
- Servicing charges: are paid to the person or entity who services an account after the sale.

Sub TA Fees (Sub Transfer Agent Fees): The name of this fee refers to the subcontracting of participant accounting to third parties, called Sub Transfer Agents. The transfer agent is the bank or trust company that executes, clears and settles buy or sell orders for mutual fund shares, and maintains shareholder records of ownership.⁵ When these functions are subcontracted to another recordkeeper, the fee paid to the sub-contractor is called the Sub-TA fee.

Shareholder Servicing Fee: fees paid to the mutual fund's transfer agent, or to service providers performing such activities as communications, administration, or recordkeeping, to name a few. These costs may be subsumed within the Sub TA fee, but occasionally, a 401(k) service provider may have line item fees for both Shareholder Servicing Fees and Sub TA fees.

Revenue Sharing: the payment of fees from mutual fund/investment companies to the 401(k) service provider

Rebates (or Plan Expense Reimbursement Allocation (PERA)): the payment of cash as a "reimbursement" to the plan (or directly to participants) from the 401(k) bundled service provider out of the total fees paid to the bundled service provider by the plan the plan participants or the mutual fund companies managing the plan's investment options. Some service providers will disclose the revenue they earn, mutual fund by mutual fund, that being the source of some portion of the rebates they pay to plans.

C. Primary Question Regarding 401(k) Fees

As the Department, in its capacity as the primary regulator of private retirement plans and plan fiduciaries, becomes increasingly concerned with the responsibility to understand fully the cost structure of the 401(k) programs offered to participants, the key question the industry is struggling with is: what are the real costs of plan administration and mutual fund investment management in a 401(k) environment and what is the most efficient and effective way to disclose those costs? (We make the distinction here between investment management fees compared to participant-generated charges for explicit services provided by the DC plan, such as charges for administering participant loan programs. The latter are typically a stated, hard dollar charge, and are not the subject of this discussion.) There are a number of subsidiary questions that inevitably arise from this primary question. Some of these are set forth below.

Question #1: If 401(k) service providers can afford to rebate back to the plan some or even most of the plan costs/payments for services received, what are the real costs of providing these services, and moreover, is the plan getting back all that may or should be available?

Question #2: Mutual fund expenses are more complicated than they appear. While the fund prospectus may identify a management fee, 12b1 fee, and Sub TA fee, each of these fees may be composed of several sub-parts, such as sales or distribution; administration or recordkeeping. Moreover, service providers sometimes shift fees

⁵ Matthew D. Hutcheson, "Uncovering and Understanding Hidden Fees in Qualified Retirement Plans, 2nd Edition, February 1, 2007

into different categories, making it harder to know exactly what services the plan is actually paying for. Thus the question arises whether fees should be broken out and identified so that plans and fiduciaries may determine what is fair and reasonable?

Question #3: In reality, are any of the stated fees fixed and non-negotiable? That seems unlikely for a variety of reasons. 401(k) service providers share fees with investment managers in a variety of ways.

- The stated 12b1 Fee may be distributed/paid to the 401(k) service provider by the mutual fund/investment company, but not necessarily. If it is not being paid to the 401(k) service provider, it still remains a cost of business that figures some way in the total expense ratio being paid by participants, driving up the cost of the mutual fund.
- The investment manager may have a share class with lower fees, particularly, no 12b1 fee, but the 401(k) service provider offers only the more expensive share class to a plan sponsor in order to earn higher revenues. Is this appropriate taking into account the actual cost of administering the plan? Smaller plans are particularly vulnerable to this practice; larger plans may have some negotiating room in this regard, demanding share classes with no 12b1 fees. The bundled service provider will then have to find other ways to earn fees (e.g., raising Sub TA fees) or accept lower revenues.
- If a 12b1 fee is insufficient to cover the distribution and administrative costs of the 401(k) service provider, that may put more pressure on mutual fund/investment company to share a portion of its management fee with the service provider.
- The 401(k) service provider may impose a Sub TA fee, regardless of the size of the 12b1 Fee or its share of the management fee. The significance is that there are a number of ways a bundled provider can raise revenue. How can the plan fiduciaries best determine and evaluate that all the fees imposed are for the costs of real and necessary services to the plan?
- Some 401(k) service providers impose a Shareholder Servicing Fee and/or a Recordkeeping Fee, in addition to a Sub TA fee, creating the appearance of different fees for different services without any clear description of exactly what services, if any, those fees pay for.

D. Where Do We Go From Here?

The Market Economy

I think we all agree that in a market economy, a vendor is allowed to earn as much as the market will bear. Supply and demand dictate pricing. Also, technology improves the flow of information and, at some point, reduces the cost of doing business. We recognize that:

- Technology, and continuing improvements to it, is a cost in the delivery of financial services, and prices reflect the need to amortize development costs;
- Distribution channels also impose a real cost on the provider;
- Service providers are not required to, nor should they be asked to, disclose their profit margin in their pricing models.

However, there are fiduciary and regulatory issues that impact market driven behavior:

- Buyers of financial services have a right to understand the actual costs of specific services
- Fiduciaries have a responsibility to understand fully plan administration and investment costs
- Competition, and supply and demand, may not always be sufficient to cause service providers to change how they define and disclose the 401(k) service provider pricing process

The ERISA Environment: In an effort to strike a balance between market dynamics and fiduciary needs, is there something that can make ERISA more effective in this arena?

With regard to defined benefit plan assets, ERISA is very clear, and the DOL has reinforced through its rulemaking and enforcement actions that DB plan assets must be used solely in the interest of participants and beneficiaries. Some examples:

- ERISA states that plan assets shall be held for the exclusive benefit of plan participants and beneficiaries, not for the benefit of the employer;
- ERISA fiduciaries must act prudently and solely in the interest of plan participants and beneficiaries;
- ERISA 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.

401(k) investment programs are increasingly an important retirement benefit offered by employers, frequently in lieu of traditional defined benefit plans, which have the full protection of ERISA. In the 401(k) marketplace, there appears to be a meaningful role for ERISA to become more effective in requiring uniform disclosure and controlling excessive costs. 401(k) plan fiduciaries also must meet the ERISA fiduciary standards of care, but may lack sufficient information regarding defined contribution plan fees to do their jobs adequately. As a result, lawsuits initiated by participants regarding fees, are on the rise, indicating some awareness or belief by a “lay” population that expenses are unclear, and may be unfair (whether in fact they are).

Recommended Fixes

Standardize Definitions: Ambiguous terms and the use of different terms obfuscate what is being paid by participants in 401(k) plans, and prevents plan fiduciaries from understanding and being able to negotiate reasonable fees for identifiable services. We recommend that the DOL standardize the definition of terms used in the defined contribution plan field so that everyone is using the same language and meaning for fees, expenses and revenue categories. IFS works with a number of different 401(k) bundled service providers. We push them hard to provide clear and complete information to our mutual DC plan clients, but we, too, run into barriers or limits on the degree to which we can get clear answers to the very questions we pose here today. One of the largest bundled service providers has told us on a number of occasions that it would welcome DOL direction and guidance on both the clear definition of terms used and an industry wide standard for disclosure of fee information. The service provider estimated that such definitions, disclosure standards and clarity would reduce by hundreds, if not thousands, of hours the time the provider spends discussing these matters with DC plan clients and advisors. Only the DOL can level this playing field.

Move toward the clarification of costs and services: IFS believes the industry, with the DOL's "assistance," should move toward an environment where 401(k) service providers must state the cost for certain services. More broadly, the industry discussion is about bundled vs. unbundled service and fee programs. While bundled programs may seem like a good deal, sometimes plans and fiduciaries do not understand exactly what they are paying for the different services they are receiving as part of the "bundle." It becomes difficult to know the cost of providing recordkeeping vs. participant education vs. web development? IFS understands that the size of the plan, the number of participants, the types of services, to name a few, drive pricing for different plans. However, a clear understanding and definition of the relationship between costs and services would help make it possible to compare vendors more readily.

V. Possible Approaches to Make the World of Defined Contribution Plan Fee Disclosures More Effective

Presently, fiduciaries of 401(k) plans clearly operate within the ERISA regulatory framework, but not all aspects of service provider activities are directly regulated by ERISA. As a result, plan fiduciaries are required to understand fees, but service providers are not required to disclose fees in a way that makes it possible for fiduciaries to do their jobs.

Mutual funds/investment companies and bundled service providers provide necessary and valuable services for DC plans. As these plans continue to increase in size and importance, however, it is critical that they provide transparent fees and fee structures for at least two reasons.

First, the ability for fiduciaries to make informed decisions about the fees and services will only be accomplished when it is possible to compare providers on the same level playing field. Until then, it is difficult to know how well providers compete with each other.

Second, fiduciaries plans and participants and beneficiaries need useful, clear information to carry out their responsibilities. Absent clearly defined terms which are accepted on an

industry-wide basis, coupled with a uniform disclosure framework for all plan service providers, this will remain a difficult task.

VI. Conclusion

IFS appreciates the opportunity to share with the Working Group our experiences and observations on working with DC plans in the area of “revenue-sharing,” DC plan fees and expenses and disclosure.

We applaud the Advisory Council’s decision to tackle this issue. We also offer our continued assistance in the Department’s efforts.

Thank you.