Federal Register

Friday,
July 16, 2010

Part III

Department of Labor

Employee Benefits Security Administration

29 CFR Part 2550

Reasonable Contract or Arrangement Under Section 408(b)(2)—Fee Disclosure; Interim Final Rule

2. The Need for Regulatory Action

To the extent that plan fiduciaries are unable to obtain relevant compensation information, or unable to use it to choose among service providers in a manner that upholds their fiduciary duty, a failure exists in the market for services for employee benefit plans. The market for retirement plan services is characterized by acute information asymmetry. The information costs of plan service providers are far lower than their clients'. Vendors are specialists in the design of their products, services, and compensation arrangements, and are continually engaged in marketing to plan sponsors. Plan sponsors often lack this degree of specialization. Even very large, relatively sophisticated plan sponsors shop for services only periodically, generally once every three to five years. Smaller, less sophisticated plan sponsors face still higher information costs. As a result, vendors are able to maintain an information advantage over their plan sponsor clients.

Vendors have a strong incentive to use their information advantage to distort market outcomes in their own favor. Current ERISA rules hold plan sponsors rather than vendors accountable for evaluating the cost and quality of plan services. And vendors can reap excess profit by concealing indirect compensation (and attendant conflicts of interest) from clients, thereby making their prices appear lower and their product quality higher. Consider one typical arrangement: A pension consultant receives a finder's fee from an investment adviser when he recommends that adviser to a plan sponsor. The plan sponsor does not know that the consultant is receiving the finder's fee—an expense the plan bears indirectly. The plan sponsor relies on the consultant to evaluate the quality of the adviser's services, but does not know that the consultant's recommendation and evaluation are subject to a conflict of interest.

The Department has identified evidence that information gaps exist in certain circumstances and that these gaps may distort market results. For example:

- An Advisory Council established under ERISA to advise the Secretary of Labor found that "the lack of transparency in this area has led to an inefficient market where it is extremely difficult for the plan sponsor to determine either the absolute level of fees, or the flow of fees, *i.e.,* who is getting paid what." [18]
- The Securities and Exchange Commission found that pension consultants "typically" do not disclose to clients that they receive compensation from the same money managers that they may recommend, and recommended that pension consultants adopt "policies and procedures to ensure that all disclosures required to fulfill fiduciary obligations are provided to prospective and existing advisory clients, particularly regarding material conflicts of interest [which should] ensure adequate disclosure regarding the consultant's compensation." [19]
- According to GAO, "[s]pecific fees that are 'hidden' may mask the existence of a conflict of interest * * * If the plan sponsors do not know that a third party is receiving these fees, they cannot monitor them, evaluate the worthiness of the compensation in view of services rendered, and take action as needed." [20] GAO found that defined benefit (DB) pension plans using consultants with SEC-identified undisclosed conflicts earned returns 130 basis points lower than the others.[21] GAO recommended that Congress "consider amending ERISA to explicitly require that 401(k) service providers disclose to plan sponsors the compensation that providers receive from other service providers." [22]
- Many DC retirement plan sponsors have "difficulty" obtaining a clear understanding of total administrative fees charged (13 percent), a clear explanation of the normal fund operating expenses of the funds in the plan (9 percent), a clear description of all the revenue sharing arrangements that the recordkeeper has with the mutual funds included in the plan (13 percent), and what it costs the provider to administer the plan (20 percent).[23] Many are "dissatisfied" with the degree to which fees are transparent (18 percent) and the degree to which revenue sharing is disclosed (22 percent); 23 percent feel that their retirement plan provider(s)' current level of fee disclosure does not meet their needs as a plan sponsor.[24] While most fiduciaries may think they have all the information they need, there could be information they are lacking and are not aware of. This disclosure will make sure fiduciaries are receiving the information the Department believes they need to fulfill their fiduciary duty under ERISA.
- One comment [25] received by DOL on the proposed 408(b)(2) regulation notes "the difficulty that plan sponsors encounter in the defined contribution plan marketplace in obtaining comparable information on the charges to be incurred for the same or similar services." Another commented that "Sponsors * * * must expend significant time and effort comparing fees among providers because of varying formats and service models as well as unique fee structures associated with different investment vehicles. By moving toward a more uniform standard of fee disclosure, the Department's initiative * * * will reduce the time and effort spent by plan sponsors assembling and comparing price information, and * * * will help facilitate apples-to-apples comparisons of different service models and investment products." A third commenter stated that "plan expense and fee information is often scattered, difficult to access, or nonexistent * * * Plan fiduciaries should know whether their plan's service providers have potential conflicts of interest."

Under current rules, a large, sophisticated plan sponsor may be able to uncover adequate information to optimize his purchase, if the value he expects to reap is sufficient to offset his information cost. The sophisticated plan sponsor's cost to uncover the information is likely to be far higher than would be the vendor's cost to disclose it. A smaller or less sophisticated plan sponsor cannot economically uncover such information—the value he stands to gain will not offset his information cost. A regulatory action to mandate proactive disclosure will lower information costs for plan sponsors who currently actively seek this information. In addition, to the extent the information provided is

[18] *See e.g.,* ERISA Advisory Council on Employee Welfare and Pension Benefit Plans, *Report of The Working Group on Plan Fees and Reporting on Form 5500* (Nov. 10, 2004), *at http://www.dol.gov/ebsa/publications/AC_111804_report.html.*

[19] *See e.g.,* U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, *Staff Report Concerning Examinations of Select Pension Consultants* (May 2005).

[20] *See e.g.,* GAO, *Increased Reliance on 401(k) Plans Calls for Better Information on Fees,* Private Pensions Report (March 6, 2007), *at http://www.gao.gov/new.items/d07530t.pdf.*

[21] *See e.g.,* GAO, *Conflicts of Interest Involving High Risk of Terminated Plans Pose Enforcement Challenges,* Defined Benefit Pension Report (June 2007), *at http://www.gao.gov/new.items/d07703.pdf.*

[22] *See e.g.,* GAO, *Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees,* Private Pensions Report (Nov. 2006), *at http://www.gao.gov/new.items/d0721.pdf.*

[23] *See e.g.,* Deloitte, *401(k) Benchmarking Survey 2008 Edition.*

[24] *See e.g.,* Chatham Partners, *Looking Beneath the Surface: Plan Sponsor Perspectives on Fee Disclosure* (February 2008).

[25] Public comments on the proposed rule may be found at: *http://www.dol.gov/ebsa/regs/cmt-408(b)(2)-combined.html.*