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RETIREMENT SECURITY

Challenges and Prospects for Employees of Small Businesses

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GAO-13-748T

GAO Highlights

Highlights of GAO-13-748T, a testimony before the Committee on Health, Education, Labor, and Pensions, U.S. Senate

Why GAO Did This Study

About 42 million workers, or about one-third of all private-sector employees, work for employers with fewer than 100 employees, and recent federal data suggest many of these workers lack access to work-based retirement benefits. Despite efforts by the federal government to develop new plan designs and to increase tax incentives, plan sponsorship remains low among small employers. MEPs, a type of arrangement involving more than one employer, have been suggested as a potential way to increase coverage.

This testimony describes (1) the challenges small employers face in helping ensure that their workers secure retirement income, and (2) types of MEPs and their potential to address these challenges. GAO drew from its previous reports related to small employer challenges in establishing and maintaining a retirement plan and recent work on MEPs issued from March 2012 through September 2012.

What GAO Recommends

GAO is not making any new recommendations. GAO made several recommendations in prior reports to Labor and the Internal Revenue Service (IRS) to address challenges facing small employers and to improve oversight and coordination for MEPs. The agencies generally agreed with GAO's recommendations. However, Labor disagreed with a recommendation to create a single webportal for federal guidance. GAO believes consolidating information could benefit small employers, mainly because resources are scattered.

View GAO-13-748T. For more information, contact Charles A. Jeszeck at (202) 512-7215 or jeszeckc@gao.gov.

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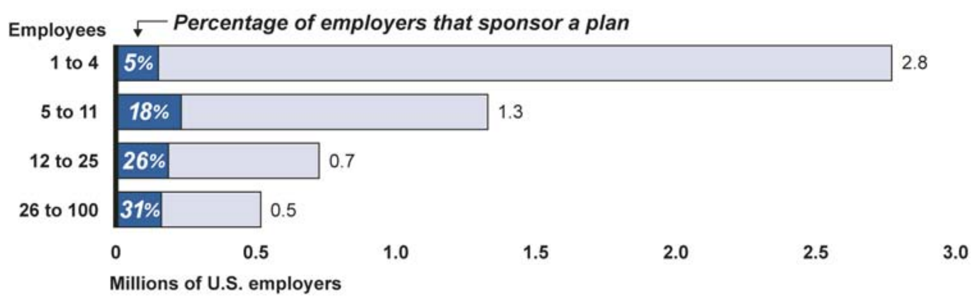
Challenges and Prospects for Employees of Small Businesses

What GAO Found

About 14 percent of small employers sponsor some type of plan for their employees to save for retirement and these employers in general can face numerous challenges establishing and maintaining a plan. GAO's March 2012 report found that many of the small employers who were contacted said they felt overwhelmed by the number of plan options, plan administration requirements, and fiduciary responsibilities. For example, some small employers found it challenging to select investment funds for their plans. Small employers also cited other challenges in sponsoring a plan, including a lack of financial resources, time, and personnel. GAO's April 2012 review of select 401(k) plans—the most common type of plan sponsored by small employers—found that some smaller plan sponsors did not know about or fully understand fees they and their participants were charged, such as fees associated with group annuity contracts. In addition to these fees, participants in small plans often pay higher recordkeeping and investment management fees than participants in larger plans. GAO's work demonstrates the need for plan sponsors, particularly small sponsors, to understand fees in order to help participants secure adequate retirement savings. Any fees paid by participants, even a seemingly small amount, can significantly reduce retirement savings over time.

Small Employer Plan Sponsorship by Number of Employees in 2009



Source: GAO analysis of Labor and IRS data.

Little is known about the types of employers that participate in multiple employer plans (MEP), particularly because, since 2004, no publically available information has been collected on such employers. MEP representatives have suggested MEPs as a viable way for small employers to reduce the administrative and fiduciary responsibilities that come with sponsoring a pension plan, and for reducing costs, in part through asset pooling. However, GAO found that these advantages are not always unique to MEPs. There was also no consensus on the potential for MEPs to increase plan coverage. During GAO's September 2012 study the Department of Labor (Labor) ruled that some MEPs made up of otherwise unrelated employers did not constitute a single pension plan but an arrangement under which each employer sponsored a separate plan for its own employees. Because this raises significant policy and compliance questions and data are limited, it is important that Labor gather information on participating employers to inform policy and oversight activities on retirement security for employees of small businesses.

Chairman Harkin, Ranking Member Alexander, and Members of the Committee:

I am pleased to be here today to discuss retirement security for employees of small businesses. One-third of all private-sector employees, about 42 million, work for small businesses with fewer than 100 employees and many of these employees lack access to a work-based plan to save for retirement. In fact, an estimated 51 to 71 percent of employees of small businesses lack access to such plans.[1] Over the years, the federal government has taken steps to encourage small employers to sponsor some type of plan, and legislation has been enacted that has established incentives such as plan types with fewer federal reporting requirements, higher plan contribution limits, and a tax credit for plan startup costs. Despite such efforts, plan sponsorship remains low among small employers. One proposed option to address this challenge is the use of pooled arrangements, such as a multiple employer plan (MEP), a type of arrangement comprised of more than one employer. GAO recently examined the characteristics of MEPs and the ongoing challenges that small employers face in establishing and maintaining a plan for their employees. My statement today describes: (1) the challenges small employers face in helping ensure that their workers secure retirement income; and (2) the types of MEPs and their potential to address small employers' challenges. This statement is drawn from prior reports we issued from March 2012 through September 2012 regarding small employer plans and MEPs.[2] Those reports contain detailed explanations of the methods used to conduct our work. We conducted all of our work in accordance with generally accepted government auditing standards.

[1] The lower percentages in these ranges are Bureau of Labor Statistics' estimates based on 2011 data from the National Compensation Survey. The higher percentages are the Employee Benefit Research Institute's estimates based on 2011 data from the Census Bureau's Current Population Survey.

[2] GAO, *Private Sector Pensions: Federal Agencies Should Collect Data and Coordinate Oversight of Multiple Employer Plans*, GAO-12-665 (Washington, D.C.: Sept. 13, 2012); *401(k) Plans: Increased Educational Outreach and Broader Oversight May Help Reduce Plan Fees*, GAO-12-325 (Washington, D.C.: April 24, 2012); and *Private Pensions: Better Agency Coordination Could Help Small Employers Address Challenges to Plan Sponsorship*, GAO-12-326 (Washington, D.C.: Mar. 5, 2012).

Background

To encourage employers to provide retirement benefits for their employees, the federal government provides preferential tax treatment under the Internal Revenue Code (IRC) for pension plans that meet certain requirements. In addition, the Employee Retirement Income Security Act of 1974 (ERISA)[3] sets forth certain protections for participants in private-sector pension plans[4] and establishes standards of conduct for those who manage such plans and their assets, generally called fiduciaries.[5] To the extent they qualify as fiduciaries under the law, plan sponsors assume certain responsibilities and potential liability under ERISA. For example, a fiduciary must act prudently and in the sole interest of the plan's participants and their beneficiaries.[6] Responsibilities of plan sponsors and other fiduciaries may include reporting plan information to the federal government and to participants, selecting and monitoring investment options the plan will offer, and ensuring that the services provided to their plans are necessary and that the cost of those services is reasonable.

Employers may choose to sponsor a plan for their employees from one of three categories: employer-sponsored individual retirement arrangement (IRA) plans; defined contribution (DC) plans; and defined benefit (DB) plans.[7] Small employers may also choose to sponsor a Savings Incentive Match Plans for Employees (SIMPLE) IRA. Employer-sponsored IRAs and DC plans generally allow employers, employees, or both to make contributions to individual employee accounts within the plan. DC plans

[3] Pub. L. No. 93-406, 88 Stat. 829 (codified in part at 29 U.S.C. §§ 1002 -1461).

[4] In this statement, consistent with ERISA, we use the term "pension" to refer generally to all types of private retirement plans, not just defined benefit plans.

[5] Under ERISA, a fiduciary is anyone who exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets or renders investment advice for a fee or compensation, direct or indirect, with respect to any moneys or other property of such plan, or has authority to do so, or has any discretionary authority or discretionary responsibility in the administration of the plan. 29 U.S.C. § 1002(21)(A).

[6] 29 U.S.C. § 1104.

[7] Defined benefit plans are plans in which employers generally maintain a fund to provide a fixed level of monthly retirement income based on a formula specified in the plan. Defined contribution plans are plans in which retirement income is based on employer and employee contributions and the performance of investments in individual employee accounts.

tend to have higher contribution limits for employees than employer-sponsored IRA plans. However, DC plans are also subject to more reporting and other requirements.[8]

A MEP is a type of arrangement involving more than one employer, and can be structured as either a DB or a DC plan. A MEP is distinct from a single employer plan that is established and maintained by one employer for its employees.[9] MEPs are also distinct from multiemployer plans that are also maintained by more than one employer, in that MEPs need not be established by one or more employee organizations pursuant to a collective bargaining agreement.[10] When employers decide to participate in a MEP, they legally adopt the plan as their own as participating employers. A participating employer may sign an agreement that serves to identify the plan terms that will apply to its employees.

Some MEPs were formed long before the enactment of ERISA in 1974. Our September 2012 report identified four types of MEPs: association, corporate, professional employer organization (PEO), and open MEPs.[11] MEPs maintained by most associations we interviewed included over 100 participating employers and were often organized around a common trade or industry that served smaller employers. However, the majority of the largest 25 MEPs are corporate. These sponsors tend to be large Fortune 500 or Global 500 corporations with few participating

[8] For additional information about the rules and reporting requirements plans are subject to, see GAO-12-326.

[9] 29 U.S.C. § 1002(41) and (42).

[10] For more information on multiemployer plans, see GAO, *Private Pensions: Timely Action Needed to Address Impending Multiemployer Plan Insolvencies*, GAO-13-240 (Washington, D.C.: Mar 28, 2013). Another plan-type that can involve multiple employers are master or prototype plans, which are largely based on a uniform plan document sponsored by an organization for adoption by employers who are either its customers or members.

[11] GAO-12-665.

employers.[12] Of the association and corporate MEPs we interviewed, all sponsored a traditional DB plan, while the other types generally sponsored DC plans only.

Other types of MEPs appear to have become popular more recently and are often structured as DC plans. These include MEPs sponsored by PEOs, which are firms that provide payroll and other human resources services to clients, and so called “open” MEPs sponsored by firms that do not purport to employ plan participants. Employers in these “open” MEPs are related solely by their participation in the plan.[13]

To operate an employer sponsored plan, employers may hire companies to provide services, such as legal, accounting, trustee/custodial, record keeping, investment management, investment education, or advice. These companies, typically referred to as plan service providers, can assist with administrative functions associated with establishing and maintaining a plan, including, for example, any required testing, plan

[12] Those we interviewed maintained MEPs to cover subsidiaries not under common control. For most purposes, all employees of employers in the same controlled group are treated as employed by a single employer. 26 U.S.C. § 414(b). The status of these large, corporate plans as MEPs may be temporary if the transactions that resulted in them becoming MEPs are undone. For example, one plan sponsor representative we interviewed said that the sponsor’s DB and DC plans became MEPs in the early-to-mid 2000s as a result of a merger within a business segment. Not long after, however, that particular segment was spun-off from the company and, by sometime in 2012, both the DB and DC plans will no longer be MEPs, but may be single-employer plans. The extent to which two or more corporations are considered in the same controlled group has to do chiefly with the percentage of ownership one has in the other. 26 U.S.C. § 1563.

[13] On May 25, 2012, the Department of Labor (Labor) issued an advisory opinion on an open MEP arrangement and found that it was not a single employee benefit plan under Title I of ERISA. The Internal Revenue Service (IRS) has found at least one open MEP qualified for preferential tax treatment. IRS does not take into consideration a MEP’s status under Title I of ERISA when considering whether it qualifies for preferential tax treatment. IRS focuses solely on compliance with IRC provisions. Labor’s advisory opinion means, in effect, that an open MEP may be simultaneously considered both a single plan by IRS, for purposes of certain tax laws, and a series of plans by Labor. Dept. of Labor Advisory Op. 2012-04A.

audits, or filing of government reports, chiefly the Form 5500.[14] Service providers are compensated for their services generally in the form of fees charged to the plan, which may be passed on to plan participants.[15] Plan fees, even seemingly small ones, can significantly reduce a participant's retirement savings over the course of a career. Service providers charge an array of fees depending on the type of product and arrangement the provider may have with other entities that provide plan services. Some investment fees may be paid by third parties in connection with investment-related services, also known as revenue sharing,[16] which are ultimately indirectly paid for by the plan or its participants.

To respond to concerns about the lack of access to employer-sponsored plans for employees of small businesses, legislation has been enacted to lower costs, simplify requirements, and ease administrative burdens. For example, the Revenue Act of 1978[17] and the Small Business Job Protection Act of 1996[18] established the SEP (Simplified Employee Pension) IRA plan and the SIMPLE IRA plan, respectively, featuring fewer compliance requirements than other plan types. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[19] also

[14] Most tax-qualified plans are required to annually file a Form 5500, developed jointly by Labor, the IRS, and the Pension Benefit Guaranty Corporation (PBGC) to satisfy certain annual reporting requirements under ERISA and the Internal Revenue Code. ERISA established a reporting and disclosure framework, in part, to protect the interests of participants and beneficiaries by requiring that certain financial and other information be provided to participants and beneficiaries, as well as to the federal government. Some small plans may be eligible to use a simplified version of Form 5500. SIMPLE IRA and Simplified Employee Pension (SEP) IRA plans that comply with certain alternative methods of compliance are not required to file Form 5500.

[15] For details about how service providers charge plan fees and the types of fees that can be charged, see GAO-12-325.

[16] Revenue sharing, in the 401(k) plan industry, generally refers to indirect payments made from one service provider, such as the investment fund provider, to another service provider in connection with services provided to the plan, rather than payments made directly by the plan sponsor for plan services. For example, a plan's record keeper and investment fund manager may have an arrangement where the investment fund company collects sub-TA fees from plan assets invested in a particular fund that may then be used as a credit to offset the record keeper's fees.

[17] Pub. L. No. 95-600, § 152, 92 Stat. 2763, 2791.

[18] Pub. L. No. 104-188, § 1421, 110 Stat. 1755, 1792.

[19] Pub. L. No. 107-16, 115 Stat. 38.

included a number of provisions that affected small businesses. For example, EGTRRA eliminated top-heavy testing requirements[20] for safe harbor 401(k) plans,[21] increased contribution limits for employer-sponsored IRA plans and 401(k) plans, and created a tax credit for small employers to offset startup costs, including the cost of educating employees about a new plan.[22] EGTRRA also created a tax credit for individuals within certain income limits who make eligible contributions to retirement plans. The Pension Protection Act of 2006,[23] among other changes, made these EGTRRA provisions permanent and established additional provisions that support plan participation by rank-and-file employees, such as automatic enrollment. Despite these incentives and legislative efforts, the percentage of the U.S. workforce that participates in a pension plan remains around 50 percent.[24]

To help encourage plan sponsorship, federal agencies conduct education and outreach activities, and provide information about retirement plans for small employers. The Department of Labor (Labor), the Internal Revenue Service (IRS), and the Small Business Administration (SBA)—which maintains an extensive network of field offices—have collaborated with each other and with national and local organizations to develop information on small employer retirement plans and conduct outreach

[20] Some plans may be subject to top-heavy requirements and be required to conduct further testing to ensure a minimum level of benefits are provided to rank-and-file workers in plans that are sponsored by owner-dominated firms, where the majority of benefits accrue to “key” employees, such as owners and top executives.

[21] 26 U,S,C, § 401(k)(12). Safe harbor 401(k) plans require employers to either make a specified matching contribution to each participating employee’s account or contribute at least 3 percent of compensation to all nonhighly compensated eligible employees.

[22] The credit for small employer pension plan startup costs applies to certain startup costs in connection with the establishment of a new qualified DB plan, DC plan (including 401(k) plans), SIMPLE IRA plan, or SEP IRA plan. To be eligible, an employer must have no more than 100 employees who received at least $5,000 of compensation in the preceding year. The credit equals 50 percent of qualified startup costs, which include administration costs and employee education, up to a maximum of $500 per year (for the first 3 years of the plan). 26 U.S.C. § 45E.

[23] Pub. L. No. 109-280, 120 Stat. 780. EGTRRA was set to expire on December 31, 2010, but the Pension Protection Act of 2006 made permanent EGTRRA’s provisions relating to pensions and IRAs.

[24] John J. Topoleski, *U.S. Household Savings for Retirement in 2010* (Washington, D.C.: Congressional Research Service, April. 30, 2013).

with small employers. For example, Labor, IRS, SBA and the U.S. Chamber of Commerce partnered to create the Choosing a Retirement Solution Campaign, which targets small employers and their employees.

Labor’s Employee Benefits Security Administration (EBSA) is the primary agency responsible for protecting private-sector pension plan participants from the misuse or theft of their pension assets, among other things, and carries out its responsibilities through such activities as issuing regulations and conducting investigations of plan fiduciaries and service providers. EBSA also issues advisory opinions in which it facilitates compliance with ERISA through interpretative guidance.

Small Employers Face Challenges Helping Their Workers Save for Retirement

Complex Rules, Resource Constraints, and Financial Instability Contribute to Low Rates of Plan Sponsorship by Small Employers

As we reported in March 2012,[25] retirement plan sponsorship is low among small employers, which may reflect the challenges employers face in establishing and maintaining a plan.[26] Our analysis of available Labor and IRS data found that about 14 percent of small employers sponsored some type of plan in 2009.[27] As shown in figure 1, the smallest employers—those with 1 to 4 employees—had the lowest sponsorship rate at 5 percent but even employers with 26 to 100 employees had a sponsorship rate of 31 percent.[28] To put this in context, about 50 percent of the private sector workforce at any one time participates in an employer-sponsored pension plan. Also, small employers paying average annual wages of $50,000 to $99,999 had the highest rate of plan sponsorship at 34 percent while small employers paying average wages of under $10,000 had the lowest sponsorship rate at 3 percent.

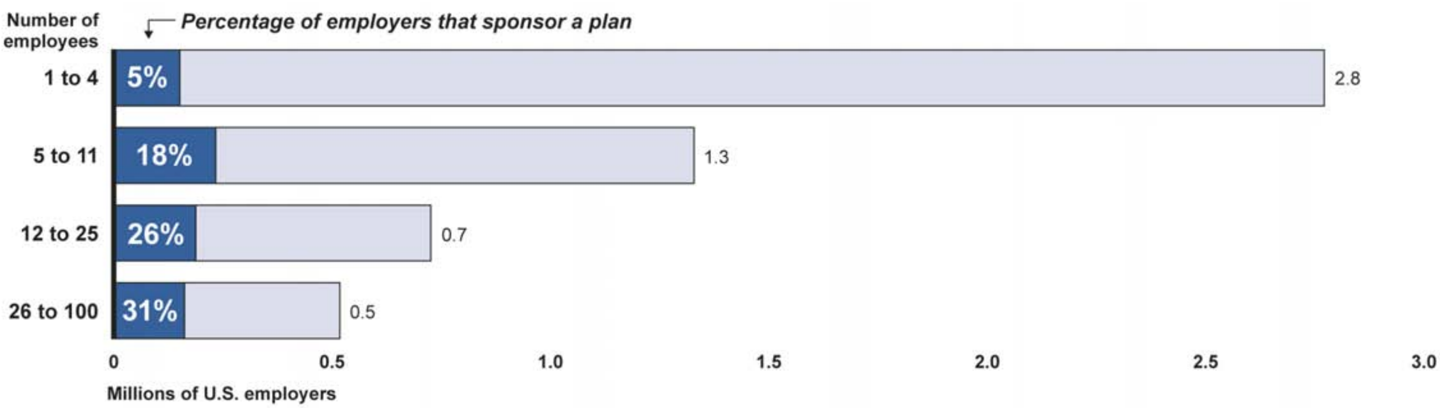
[25] GAO-12-326.

[26] For the purposes of this statement, we defined a small employer as a for-profit firm with at least 1 employee and no more than 100 employees. Because not all employees may participate or be eligible to participate in the plan, we define a "small plan" as those with fewer than 50 participants.

[27] This sponsorship rate does not include small employers that sponsor SEP IRAs because the IRS currently does not have a means to collect data on employers that sponsor this plan type. The sponsorship rate also does not include small employers that participated only in MEPs or multiemployer retirement plans. In addition, for the purposes of this study, we chose to use a "firm" as our unit of analysis, which may differ from other studies. For example, the BLS's 2010 National Compensation Survey used "establishment" as a unit of analysis. An establishment differs from a firm in that an establishment can be a business at a single physical location or a branch of a larger companying operating multiple branches, where we defined a firm as a complete, for-profit, independent business. For additional information on the scope and methodology of this analysis, see GAO-12-326.

[28] Given the traditional dynamism of business formation in the U.S., one would expect the "churn" rate of new business formations and dissolutions to result in a low sponsorship rate for the smallest employers.

Figure 1: Small Employer Plan Sponsorship by Number of Employees in 2009



Source: GAO analysis of Labor and IRS data.

When we met with small employers and other stakeholders, they identified a variety of factors as challenges to sponsoring retirement plans or as reasons for terminating existing plans.[29] One commonly cited concern focused on the multiplicity of plan types and the burden of paperwork and administration. For example, some small employers and retirement experts said that the broad range of plan types and features made it difficult for small employers to compare and choose plans. Another small employer who previously sponsored a 401(k) plan with a company match said the amount of required plan paperwork, including generating annual reports, was a key reason he terminated it.

Other areas of concern for small employers centered on a sponsor's fiduciary responsibilities with respect to managing or controlling plan assets. Specifically, some small employer sponsors found the fiduciary responsibility of selecting investment fund choices for their plans particularly challenging. A small employer with a 401(k) plan described the difficulties of selecting investment options with an appropriate balance

[29] For our March 2012 report, we conducted structured interviews with groups of small employers that did and did not sponsor plans. Our interview protocols also sought to identify and interview small employers of varying sizes and from various industries. While the findings from these interviews are not generalizable to the overall population of small employers, these discussions were extensive and included separate interviews with both sponsors and nonsponsors of pension plans to discuss the overall challenges of pension plan sponsorship. For additional details about our small group interviews, see GAO-12-326.

of risk for a workforce that includes both younger and older workers. Moreover, a number of stakeholders said some small employers may not have an adequate understanding of their fiduciary duties and are not always aware of all their legal responsibilities. One service provider explained that some small employers mistakenly believe that all fiduciary responsibilities and liabilities are transferred to a service provider when they are hired. Another expert noted that some small employers have an exaggerated sense of the possible liabilities that being a fiduciary carries, and may avoid sponsoring a plan out of fear of being sued by their employees.

In addition to these challenges, smaller or newer firms may be unwilling or unable to sponsor plans because they lack sufficient financial resources, time, and personnel. For instance, smaller employers noted that startup and ongoing costs involved with maintaining a plan, costs associated with reporting and testing requirements, administrative fees paid to an outside party, and any employer requirements to match employee contributions were barriers to plan sponsorship. Small employers also expressed the need to reach a certain level of profitability before they would consider sponsoring a plan and that general economic uncertainty makes them reluctant to commit to such long-term expenses.

Low employee demand for an employer-sponsored plan may also be a challenge for small employers. For example, a number of small employers stated that employees prioritized health care benefits over retirement benefits. One small employer thought that, given the limited funds available to contribute towards benefits, his employees would prefer those resources be applied toward lowering the employees' share of health insurance premiums. Small employers emphasized that offering health care benefits was necessary to attract quality employees. Additionally, some small employers, such as those who described having a younger workforce, stated that their employees were less concerned about saving for retirement and, as a result, were not demanding retirement benefits. Other small employers told us that employees, particularly those with low pay, do not have any interest in retirement benefits because they live paycheck to paycheck and are less likely to have funds left over to contribute to a plan. For example, one small employer discontinued his plan when too few of his employees—most of whom he described as low-wage—participated in the plan. Another small employer noted that even senior-level managers in his business did not participate in the plan. However, a retirement expert stated that while some employees might not be interested in participating in a retirement plan, he believed the perceived lack of demand to be exaggerated. He added that he believed some businesses may use lack of employee demand as an excuse when the small employer was not interested in sponsoring a plan.

In March 2012, we made a recommendation to Labor to convene an interagency task force with the Department of the Treasury, IRS, SBA, and other appropriate agencies to review, analyze, and address the challenges small employers face in helping ensure retirement security.[30] The agencies generally agreed with this recommendation, however, Labor disagreed with one aspect of our recommendation, which was for the task force to create a single webportal for federal guidance. We believe consolidating plan information onto one webportal could benefit small employers, mainly because federal resources are scattered across different sites. We also made a recommendation to the Department of the Treasury to collect additional information on IRA plans.

Participants of Small Employer 401(k) Plans are Likely to Pay Higher Fees

Small employers are more likely to sponsor 401(k) plans and participants of these plans tend to pay higher fees than larger plans. According to our analysis of Labor and IRS data, out of slightly more than 712,000 small employers that sponsored a single type of plan in 2009, about 46 percent sponsored a 401(k) plan, 40 percent a SIMPLE IRA, and the remaining employers sponsored other types of plans, including DB and non-401(k) profit sharing plans.[31] Experts have identified low contribution rates as a key problem facing workers seeking to secure an adequate retirement income. In 2011, the average account balance of 401(k) plans with 100 or fewer participants was about $59,000. This may reflect the challenges facing participants in small plans of not only contributing faithfully, but also investing prudently and avoiding high fees.

Regarding fees, plans with fewer than 100 participants account for the majority of 401(k) plans, and these plans usually pay higher fees. According to industry experts and research, plans with fewer participants generally have lower plan assets, and therefore pay higher fees as a percentage of assets than plans with more assets or older plans that have

[30] GAO-12-326.

[31] For additional information about the number and types of other plans sponsored, see GAO-12-326.

grown their assets over time. Service providers and an industry expert we met with noted that administrative fees to start a 401(k) plan can be significant for small plans. Additionally, representatives of a retirement industry organization said that it may be difficult for sponsors of small plans to negotiate for lower fees because assets in these plans are modest.

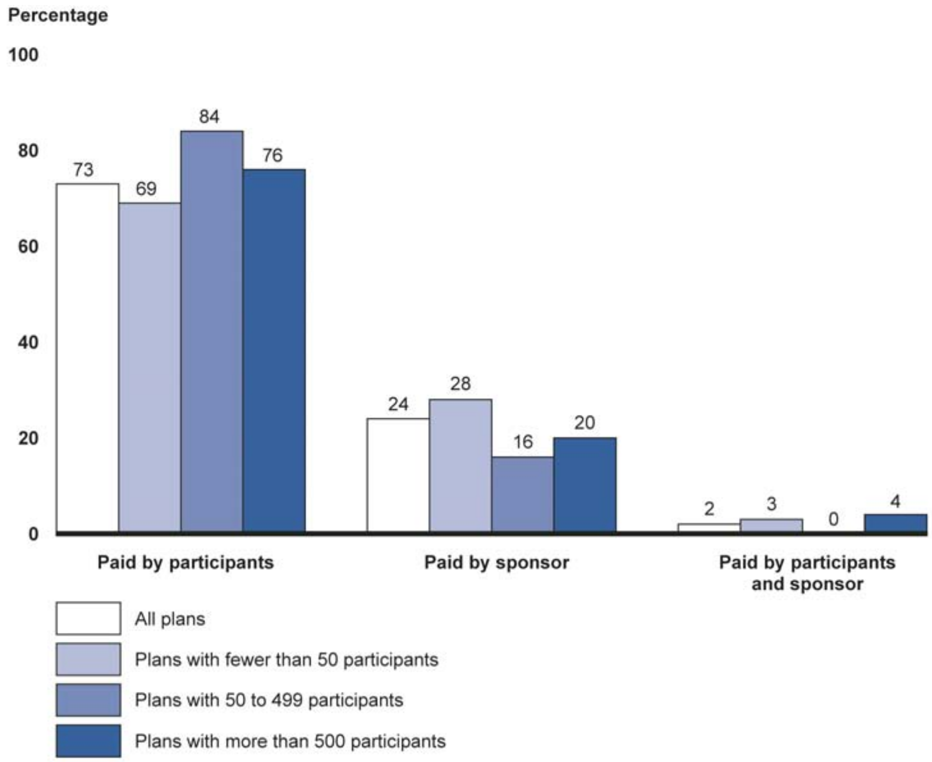
In April 2012, we reported that participants in smaller plans typically pay higher fees than participants in larger plans.[32] Specifically, our nationally representative survey of plan sponsors found that participants in plans with fewer than 50 participants paid an average of 0.43 percent of their plan assets annually, while participants in larger plans—those with more than 500 participants—paid 0.22 percent for record keeping and administrative services.[33] On top of these fees, participants likely paid other plan fees. For example, according to survey results, in about 69 percent of small plans, participants paid all of the investment fees (see fig. 2 for additional details), which ranged from less than 0.01 percent to 3.24 percent of assets.[34]

32 GAO-12-325. This work was conducted before Labor finalized regulations regarding disclosure of service providers' direct and indirect compensation; and before regulations to disclose certain plan and investment-related information, such as fees, to participants and their beneficiaries in participant-directed individual accounts were in effect. 29 C.F.R. §§ 2550.408b-2 and 2550.404a-5 (2012).

33 For further details on the design of our 401(k) plan sponsor survey on fees, see GAO-12-325.

34 Our estimates of investment management fees are not generalizable to the population of 401(k) plans.

Figure 2: Among Survey Respondents Who Provided Amounts, the Percentage of Investment Management Fees Paid by Participants, Sponsors, or Both, 2010



Source: GAO analysis of Survey of 401(k) Plan Sponsors.

Note: Percentages may not total to 100 because of rounding. Estimates in this figure have margins of error that are less than plus or minus 24 percentage points.

Investment management fees account for the majority of 410(k) plan fees, but sponsors of about 50 percent of plans we surveyed did not know if they or their participants paid investment management fees or believed these fees were waived. This was especially prevalent among smaller plans. For example, respondents of 57 percent of small plans either did not know about fees or claimed fees were waived, compared with 31 percent of large plans. Some of these sponsors may not know about investment management fees, because these fees are usually borne by participants and are typically charged against participants' assets, as opposed to being invoiced to the plan sponsor.

Some Common Investment-Related Fees

- **Management fees:** These fees are typically paid out of fund assets to the fund's investment adviser for investment portfolio management, other management fees payable to the fund's investment adviser or its affiliates, and administrative fees payable to the investment adviser that may not be included in some of the fees identified below.
- **Marketing and distribution fees, also known as 12b-1 fees:** These fees may be used to pay commissions to brokers and other salespersons, to pay for advertising and other costs of promoting the fund to investors, and to pay various service providers of a 401(k) plan pursuant to a bundled services arrangement. They are usually between 0.25 percent and 1.00 percent of assets annually.
- **Sub-transfer agent (sub-TA) fees**: These fees are typically used to reimburse a plan's record keeper for shareholder services that the fund would have otherwise provided, such as maintaining participant-level accounts and distributing the fund's prospectus.
- **Trading or transaction costs**: These fees are associated with an investment manager's buying and selling of securities within a particular investment vehicle, such as a mutual fund, which can include commissions. These also include costs associated with portfolio turnover.
- **Wrap fees**: These fees are usually associated with insurance products, such as group variable annuities. They are aggregate fees that encompass multiple components, such as investment management fees, mortality risk and administrative expense charges, and surrender and transfer charges.

We also found instances in which participants paid for consulting and advisory services to help the employer with their plan responsibilities, such as monitoring investments and selecting plan vendors. These fees were also higher for participants in smaller plans. For example, while participants in small plans paid approximately 0.29 percent annually, the median amount participants in large plans (500 or more participants) paid was 0.07 percent of assets.

A lack of understanding on the part of plan sponsors about how fees are charged can also have adverse effects on participants' retirement savings by unknowingly passing those fees along to participants. As noted earlier, understanding these fee arrangements may be even more challenging for small employers, who lack the time and resources to fully identify and understand them. Our review of selected plans indicates that some smaller plan sponsors did not know about or fully understand revenue sharing arrangements, in which fees for plan services are indirectly charged to the plan through an outside entity. For example, in comparing survey responses to annual plan investment reports, we found that a plan with about $6 million in assets unknowingly paid about $5,000 in 12b-1 fees and other revenue sharing fees—a type of revenue sharing fee used to pay commissions to brokers, advertising and other costs of promoting a fund to investors, and various other marketing and distribution services. Moreover, plan sponsors that were aware of revenue sharing arrangements may not have fully understood the impact of these arrangements on plan services and plan fees, and therefore likely paid higher fees than they reported on our survey. For example, a plan with 65 participants and about $5.8 million in plan assets reported that the company did not pay anything for record keeping and administrative fees, though the fee report the sponsor provided indicated that these fees in total were about $10,700—about $5,900 was invoiced to the company and roughly $4,800 was paid to the provider from revenue sharing fees collected from participants' asset accounts. Failing to understand these arrangements can have adverse effects on the plan sponsor and participants.[35]

Small plan sponsors may also not be aware of other fees that participants are paying, such as wrap fees associated with group annuity contracts. These contracts are products that place a "wrapper" of benefits, namely a guaranteed lifetime annuity income or a minimum death benefit, around a bundle of investments that are similar to mutual funds—called separate accounts or subaccounts. Some service providers we met with said that plan sponsors often do not know that they are invested in group variable annuities and are unaware of the associated fees. These wrap fees include administrative fees and a mortality and expense risk charge, which is typically in the range of 1.25 percent of assets per year.[36]

[35] A short video illustrating a hypothetical example of how revenue sharing arrangements can work and how the fees for services change over time under such an arrangement is available at http://www.gao.gov/products/GAO-12-325.

[36] These fees can be significant, and plan sponsors are likely contracting with providers that charge higher fee rates without knowing the benefits for which they and their participants are paying. Moreover, without knowing if their plan is a group annuity contract, plan sponsors cannot adequately assess whether the benefits tied to that product are worth the associated fees.

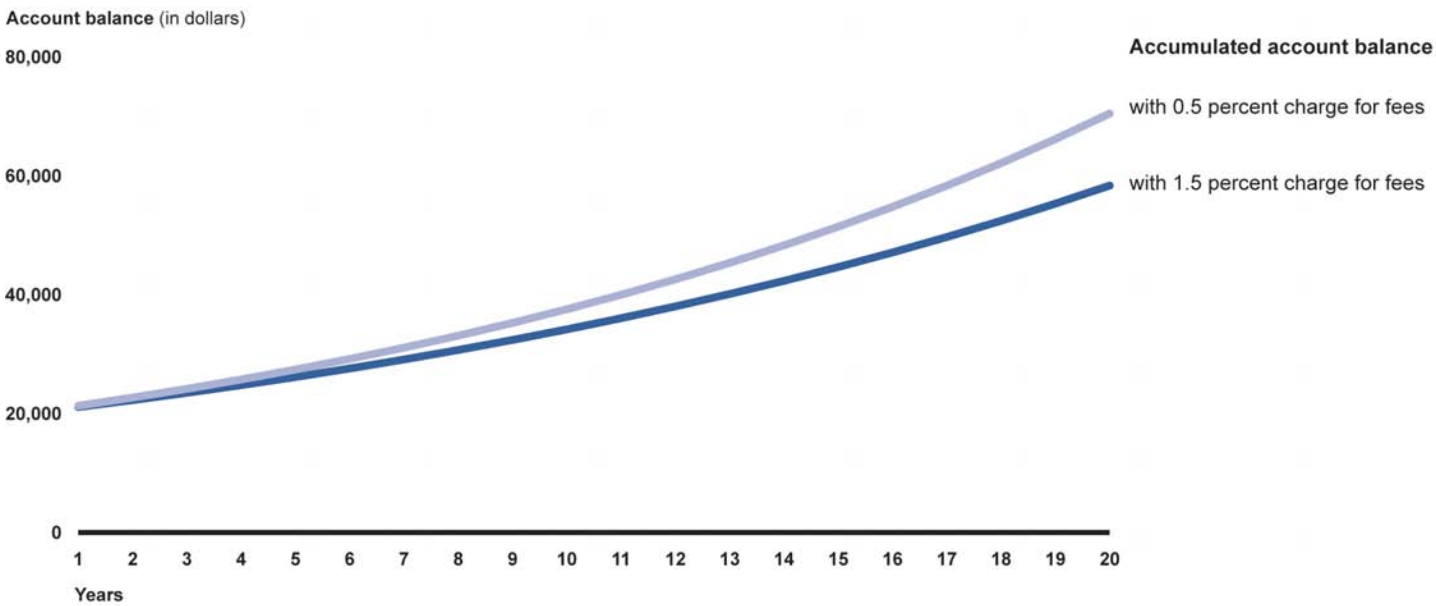
Finally, small plan sponsors may not be aware that their participants are paying potentially significant transaction costs (also known as trading costs). These costs are commonly paid for indirectly by plan participants and typically include commissions incurred when an investment manager buys and sells securities within a particular investment vehicle.[37] While transaction costs are common among mutual funds, and more than 80 percent of 401(k) plans in our survey offer mutual funds, sponsors of an estimated 48 percent of plans did not know if their plans incurred transaction costs through the deduction from participants' returns on investments. We previously reported that the transaction cost for an investment option was as high as 2.72 percent.[38]

Our work demonstrates the need for plan sponsors, particularly small sponsors, to understand plan fees in order to help participants secure adequate retirement savings. Any fees paid by participants, even a seemingly small amount, such as a 1 percent annual fee, can significantly reduce retirement savings over time, as shown in figure 3.

[37] There are also "transaction costs" associated with plan participant actions, such as withdrawals and taking a loan from their 401(k) plan accounts; however, this definition of transaction costs differs from the types of transactions referred to in this testimony.

[38] Our analysis of transaction costs was limited to 83 plans; see GAO-12-325 for additional details about this analysis.

Figure 3: Effect of 1-Percentage Point in Higher Annual Fees on a $20,000 DC Plan Balance Invested over 20 Years



Source: GAO analysis.

In our April 2012 report, we made a number of recommendations to help small and large plan sponsors better understand and monitor fees.[39] Specifically, we recommended that Labor develop and implement outreach and education initiatives that actively engage sponsors and we recommended enhancing online access to available plan fee information. Labor generally agreed with these recommendations. We will continue to monitor Labor's actions to address these recommendations.

[39] GAO-12-325.

Little Information Available About Current MEPs and Their Potential to Increase Small Business Sponsorship

As we reported in September 2012, little is known about the employers that participate in MEPs, or even the number of MEPs by type, in part because the federal government no longer collects these data.[40] As of 2009, the most recent data available for our September 2012 report, MEPs represented only a small portion of the pension universe.[41] Specifically, DB MEPs represented 0.7 percent of all DB plans, about 6.0 percent of all DB assets and 5.0 percent of all DB participants. DC MEPs represented about the same percentage of all DC plans, assets and participants. In our September 2012 report, we found smaller employers in MEPs were mainly participating in association-sponsored MEPs.[42] Two associations told us their participating employers averaged between 20 and 60 employees. However, one MEP sponsored by a PEO[43] reported that the typical participating employer in its plan was small as well. In particular, little data exist on the current number of PEO or open MEP plan types,[44] their asset size, the number of participants, or the participating employers. Relative to other MEP types, PEO and open MEPs are the newest, and may be the only types actively marketing their MEPs to participating employers.[45]

MEPs have been suggested by PEO and open MEP representatives as a viable way for small employers to reduce their administrative responsibility for their pension plans. Several MEP representatives said

[40] GAO-12-665.

[41] While the federal government stopped collecting data on MEP participating employers in 2005, the most recent Form 5500 plan-level data on MEPs was from 2009.

[42] GAO-12-665.

[43] A PEO is a firm that provides payroll and other human resources services to clients.

[44] The key differences between PEO MEPs and open MEPs appear to be that open MEPs do not (1) offer payroll management or other administrative services PEOs typically offer, or (2) purport to be an employer of plan participants. Employers in open MEPs are related solely by their participation in the MEP.

[45] Key public data on participating employers have not been collected since 2004. Additionally, participating employer information alone does not identify sponsor types or specific employer relationships that could indicate whether the MEP is sponsored by, for example, a large corporation, PEO, or association. According to officials we interviewed, the information that was collected in 2004 and prior was also not particularly useful because it was not required on an annual schedule for all employers—and the information that was collected was not particularly direct or timely. For our September 2012 report, GAO-12-665, we were able to obtain such information by interviewing plan representatives.

MEP administrators can complete the record keeping and the annual testing, and can submit required filings such as a single Form 5500 for the MEP on behalf of all the participating employers. Furthermore, employees can more easily move among employers in the plan. For example, in a DB MEP sponsored by an association, as long as a participant remains an employee of an employer within the association, participants can change employers and continue earning vesting service credit in the same plan. A small employer sponsoring a single employer plan can also contract with a service provider to perform administrative functions, but a couple of interviewees said employers not already offering plans might find it easier and faster to join a MEP than to create their own single employer plan. MEPs have also been suggested by some as a possible means to lower the costs of plan sponsorship, since participating employers can pool assets to obtain lower pricing available to larger plans. One expert we spoke with said that certain association plans have been very effective at offering efficient, cost-effective retirement options for their members. Furthermore, a couple of interviewees said MEPs may also reduce costs for employers since they will not need to spend money to create an initial plan document, as they would in establishing a new single-employer plan.

As we found in September 2012, another possible benefit of MEPs, according to some MEP marketing material, is reducing participating employers' fiduciary liability since the MEP administrator takes on some fiduciary duties.[46] However, it is not clear how much relief from fiduciary liability a MEP can provide to participating employers, and it is not clear that such relief is unique to MEPs. For example, small employers may also be able to receive a similar degree of reduced fiduciary liability by using a service provider to administer the employer's own plan. Because small employers may not be familiar with how to manage a plan, reduced fiduciary liability may be an attractive feature for them, and, in our March 2012 small employer report,[47] small employers identified possible fiduciary responsibility as a barrier to sponsoring a pension plan. However, while MEP representatives and MEP marketing materials sometimes stated otherwise, participating employers retain some fiduciary responsibility, according to Labor officials. At a minimum,

[46] GAO-12-665.

[47] GAO-12-326.

participating employers must still select a MEP to join and monitor a plan's investments and fees, which Labor considers a fiduciary function.

Overall, no consensus existed among MEP representatives and pension experts on the potential for MEPs to substantially expand coverage. Large associations can provide the option of joining a MEP to their members. That option is unavailable to small employers not part of a membership organization looking out for their interests. The extent to which small employers can join a MEP may depend on whether a MEP is actively marketed and sold, since one pension expert observed that small employers do not extensively research pension plans or actively seek them out. Additionally, employers who choose to become part of a MEP for the first time may already have been providing a plan for their employees. While a couple of the MEP representatives we spoke with specifically targeted employers without plans, several targeted businesses with existing plans.

From Labor's perspective, their primary regulatory concern centers on one type of MEP, the open MEP. During our review for our September 2012 report, Labor issued an advisory opinion stating that one particular open MEP did not constitute a pension plan under ERISA because it was not established or maintained by an employer or an employee organization.[48] Labor determined that, in the case of this MEP, participating employers did not constitute a bona fide employer group or association, sufficient to be considered an employer sponsoring the arrangement, because, among other things, they did not exercise sufficient control over the plan.[49] As a consequence of this guidance, the

[48] An advisory opinion, which is limited to the facts in the opinion, can be relied upon, as a legal matter, only by the parties in the opinion. However, these opinions serve as guidance to others on what arrangements are considered employee benefit plans under ERISA.

[49] Dept. of Labor Advisory. Op 2012-04A. On both MEWAs (Multiple Employer Welfare Arrangements), arrangements providing welfare benefits such as health coverage and MEPs, Labor has held that multiple employers may maintain a single plan through a bona fide employer group or association of employers. However, Labor has been careful to define the nature of such an association in advisory opinions. Labor's advisory opinions on MEWAs may have been prompted by abuses by their promoters. When state insurance regulators found such practices violated their insurance laws, MEWAs claimed to be ERISA-covered plans preempted from state regulation. According to a Labor official, the MEWAs that failed to maintain adequate funds to pay promised benefits were often comprised of otherwise unrelated employers. Labor is still confronting challenges stemming from abuses of participants. For additional details, see GAO-12-665.

participating employers in that open MEP were instead determined to each be the sponsors of their own, individual plans. Association MEP representatives told us Labor's guidance had no affect on their plans.[50]

As a practical matter, Labor's ruling is being treated by many as meaning that individual participating employers in an open MEP have to comply with any reporting, auditing, and bonding requirements on an individual rather than aggregate basis. In our September 2012 report, we noted that a number of compliance-related questions were left unanswered for open MEPs.[51] Additionally, we noted that, for purposes of preferential tax treatment, IRS might still consider an open MEP to be one plan rather than a series of individual plans. In an effort to remove confusion for plan sponsors, we recommended Labor and IRS coordinate their interpretations and develop compliance-related guidance. Labor and IRS generally agreed with our recommendations on coordination.[52]

Labor's expectation is that the recently issued opinions on open MEPs will serve as guidance to the pension industry at large. However, despite the ruling on open MEPs from Labor, pension experts and MEP representatives told us that broader policy questions remain. The opinion did not provide Labor's view on the potential of open MEPs to lower plan costs or expand coverage, but we were told by MEP representatives and pension experts that open MEPs will continue to receive the attention of policymakers for that reason. At this time no one knows for certain how many open MEPs there are, who is in them, or how they may affect future pension coverage. Pension experts cautioned that any legislative change allowing certain open MEPs should ensure that there are appropriate safeguards to protect plan participants.

[50] The PEO representatives we interviewed said their PEOs operated under what they referred to as a "coemployer" contract. We did not find coemployer defined in federal statute. Because the term PEO is not well-defined either, and the actual services are contractually determined, some refer to certain PEO practices as "employee leasing" or "payrolling," which involves providing administrative or financial services to employers, rather than serving as an employer in the sense of hiring or supervising workers. According to Labor officials, a PEO does not represent a bona fide association but establishes an employer relationship with the employees of its clients through the services it offers them.

[51] GAO-12-665.

[52] Specifically, Labor and IRS officials said they will amend their coordination agreement if compliance issues become more apparent.

Labor officials said the potential for inadequate employer oversight of a MEP is greater than for other pension arrangements because employers pass along so much responsibility to the entity controlling the MEP. Labor officials noted that potential abuses might include layering fees, misusing assets, or falsifying benefit statements.[53] One pension expert agreed that there is potential for MEPs to charge excess fees without the enrolled employer being aware. While Labor officials acknowledged that single employer plans could be subject to similar abuses, they cautioned that the way a MEP is structured and operated could make it particularly susceptible to abuses.[54] For this reason, the structure of a particular MEP can be important. Representatives of MEPs maintained by associations we interviewed said they had an appointed board made up of association members who served as the named fiduciaries of the plan. Most of these associations required board members to also participate in the MEP. However, the extent to which open MEPs have or would have such structures in place is unclear. Given the limited knowledge some plan sponsors have of the fees they pay and their fiduciary responsibilities, it would appear that some such governance structure or related safeguards is warranted to protect employer and participant interests.

Labor's lack of data to identify different MEP sponsor types or any employers participating in MEPs limits the agency's ability to protect MEP employers and participants. To ensure Labor has information needed to oversee MEPs, in September 2012, we recommended that Labor gather

[53] Under ERISA, an employee pension benefit plan can only be sponsored by an employer, an employee organization, or both. A group or association can be considered an employer under ERISA if Labor determines the association is bona fide. Under its advisory opinions, Labor has long looked at certain factors, such as pre-existing relationships among employers, to determine if a group of employers constitutes a bona fide association of employers that may, therefore, sponsor a single employer plan under Title I of ERISA. Pension and Welfare Benefits Admin., U.S. Dept. of Labor, Advisory Opinion 83-15A, 1983 ERISA Lexis 43. Because by definition an open MEP is open for any employer to join, without pre-existing relationships or other factors necessary to establish a bona fide association, it is not considered an employer under ERISA and cannot maintain an employee pension benefit plan.

[54] On April 15, 2013, a former trustee and fiduciary of a number of MEPs was convicted of 17 counts of wire fraud by a federal jury in Boise, Idaho. The jury heard evidence that the individual misappropriated plan assets for his personal use. According to Labor officials, sentencing is scheduled for July 31, 2013. Labor officials told us that last year, they obtained the appointment of an independent fiduciary who is currently managing the remaining plan assets and making distributions. They stated further that the department is monitoring the progress of the criminal case, as well as the efforts of the independent fiduciary, who they report is actively attempting to recover additional assets.

additional information about the employers participating in MEPs, potentially through the Form 5500, which is the primary source of pension plan information for government oversight activities.[55] Labor officials said the number of participating employers or the names of participating employers could be useful oversight information. The agencies generally agreed with our recommendation on gathering additional MEP-related information and said they will consider MEP-related changes to the Form 5500 as part of their regular evaluations. We consider this an important first step, and await any proposed or scheduled changes to data collection.

Concluding Observations

For workers at small employers, building an adequate level of income for retirement is becoming increasingly challenging. Particularly for small employers, the low level of plan sponsorship means that many of their workers may enter retirement with little or no income outside of Social Security. Small employers also face some greater challenges to sponsorship than larger employers and they often have less time, fewer resources and personnel to handle them. The potential advantages of multiple employer plan design are appealing in this context, however, current data and information, as well as other safeguards, will be necessary to ensure that small employer interests are protected and promises to participants are not broken.

Chairman Harkin, Ranking Member Alexander, and Members of the Committee, this completes my prepared statement. I would be pleased to respond to any questions that you may have at this time.

[55] GAO-12-665

GAO Contact and Staff Acknowledgments

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For further information about this testimony, please contact Charles A. Jeszeck at (202) 512-7215 or jeszeckc@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Tamara Cross, Assistant Director; James Bennett, Edward Bodine, Sarah Cornetto, Patrick diBattista, Chuck Ford, Gene Kuehneman, David Lehrer, Ted Leslie, Sheila McCoy, Thomas A. Moscovitch, MaryLynn Sergent, Roger Thomas, Frank Todisco, Kathleen van Gelder, Lacy Vong,and Craig Winslow were key contributors to this testimony.

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