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Education and Labor
House of Representatives

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PRIVATE PENSIONS

Increased Reliance on 401(k) Plans Calls for Better Information on Fees

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Education, Workforce, and Income Security Issues





Highlights of GAO-07-530T, a testimony before the Committee on Education and Labor, House of Representatives

PRIVATE PENSIONS

Increased Reliance on 401(k) Plans Calls for Better Information on Fees

Why GAO Did This Study

Over the past two decades there has been a noticeable shift in the types of plans employers are offering employees. Employers are increasingly moving away from traditional defined benefit plans to what has become the most dominant and fastest growing type of defined contribution plan, the 401(k).

As more workers participate in 401(k) plans, they bear more of the responsibility for funding their retirement. Given the choices facing participants, specific information about the plan and plan options becomes more relevant than under defined benefit plans because participants are responsible for ensuring that they have adequate income at retirement. While information on historical performance and investment risk for each plan option are important for participants to understand, so too is information on fees because fees can significantly decrease participants' retirement savings over the course of a career. As a result of employees bearing more responsibility for funding their retirement under 401(k) plans, you asked us to talk about the prevalence of 401(k) plans today and to summarize our recent work on providing better information to 401(k) participants and the Department of Labor (Labor) on fees. My remarks today will focus on (1) trends in the use of 401(k) plans, and (2) the types of fees associated with these plans.

www.gao.gov/cgi-bin/getrpt?GAO-07-530T.

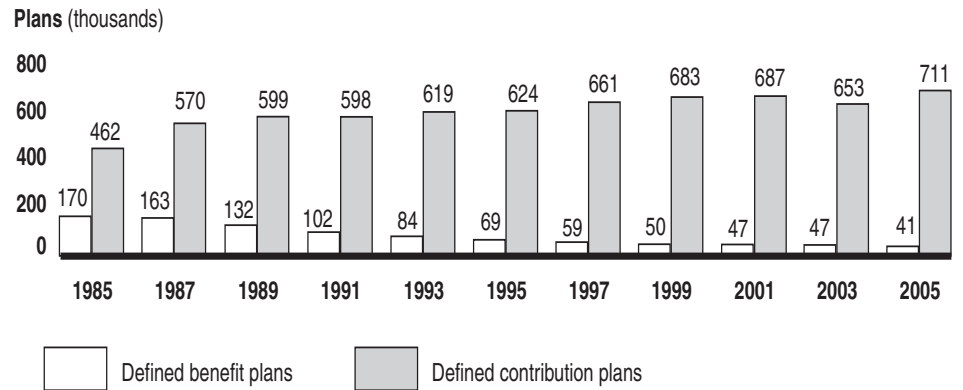
To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara D. Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

There are an increasing number of active participants in 401(k) plans than in other types of employer-sponsored pension plans, a trend that has accelerated since the 1980s. Now, 401(k) plans represent the majority of all private pension plans; they also service the most participants and hold the most assets. These plans offer a range of investment options, but equity funds—those that invest primarily in stocks—accounted for nearly half of 401(k) assets at the close of 2005. Most 401(k) plans are participant-directed, meaning that a participant is responsible for making the investment decisions about his or her own retirement plan contributions.

Inadequate disclosure and reporting requirements may leave participants without a simple way to compare fees among plan investment options, and Labor without the information it needs to oversee fees and identify questionable 401(k) business practices. The Employee Retirement Income Security Act (ERISA) of 1974 requires 401(k) plan sponsors to disclose only limited information on fees. Participants must collect various documents over time and may be required to seek out some documents in order to get a clear picture of the total fees that they pay. Furthermore, the documents that participants receive do not provide a simple way to compare fees—along with risk and historical performance—among the investment options in their 401(k) plan. The information reported to Labor does not identify all fees charged to 401(k) plans and therefore has limited use for effectively overseeing fees and identifying undisclosed business arrangements among consultants or service providers. As a result, participants may have more limited investment options and pay higher fees for these options than they otherwise would.

Comparison of Defined Benefit Plans with Defined Contribution Plans, 1985 and 2005.



Source: U.S. Department of Labor (1985 - 2003 data); Investment Company Institute (2005 estimates).

Mr. Chairman and Members of the Committee:

I am pleased to be here to discuss American workers' increased participation in 401(k) plans and the potential effects of the fees associated with these plans on their retirement income. Over the past two decades there has been a noticeable shift in the types of plans employers are offering employees. Employers are increasingly moving away from traditional defined benefit plans to what has become the most dominant and fastest growing type of defined contribution plan, the 401(k).¹

As more workers participate in 401(k) plans, they bear more of the responsibility for funding their retirement than they do when covered by traditional defined benefit plans. Under 401(k) plans, participants are responsible for choosing how much of their pretax income to contribute, how to invest their contributions in the choices offered by the plan sponsor, and how to manage their 401(k) investments upon retirement. Given the choices facing participants, specific information about the plan and plan options becomes more relevant than under defined benefit plans because participants are responsible for ensuring that they have adequate income at retirement. Although information on historical performance and investment risk for each plan option are important for participants to understand, so too is information on fees because fees can significantly decrease participants' retirement savings over the course of a career. As a result of employees bearing more responsibility for funding their retirement under 401(k) plans, you asked us to talk about the prevalence of 401(k) plans in the private pension system today and to summarize our recent work on providing better information to 401(k) participants and the Department of Labor (Labor) on fees. My remarks today will focus on (1) trends in the use of 401(k) plans, and (2) the types of fees associated with these plans and the information available to participants and Labor.

To describe the current trend toward the increased use of 401(k) plans, we relied on our previous work on the nature of the private pension system and information from Labor and industry research. Regarding plan fees, we also relied on our previous work that looked at the types of fees associated with 401(k) plans, who pays these fees, how information is

¹ Traditional defined benefit plans generally provide a fixed level of monthly retirement income that is based on salary, years of service, and age at retirement regardless of how the plan's investments perform. In contrast, benefits from defined contribution plans are based on the contributions to and the performance of the investments in individual accounts, which may fluctuate in value.

disclosed to participants, and Labor's oversight of fees and certain related business arrangements.² We conducted our review from February 2007 through March 2007 in accordance with generally accepted government auditing standards.

In summary, there are more active participants now in 401(k) plans than other types of employer-sponsored pension plans, a trend that has accelerated since the 1980s.³ Now, 401(k) plans represent the majority of all private pension plans; they also service the most participants and hold the most assets. These plans offer a range of investment options, but equity funds—those that invest primarily in stocks—accounted for nearly half of 401(k) assets at the close of 2005. Most 401(k) plans are participant-directed, meaning that a participant is responsible for making the investment decisions about his or her own retirement plan contributions.

Inadequate disclosure and reporting requirements may leave participants without a simple way to compare fees among plan investment options, and Labor without the information it needs to oversee fees and identify questionable 401(k) business practices. The Employee Retirement Income Security Act of 1974 (ERISA)⁴ requires 401(k) plan sponsors to disclose only limited information on fees. Participants must collect various documents over time and may be required to seek out some documents in order to get a clear picture of the total fees that they pay. Furthermore, the documents that participants receive do not provide a simple way to compare fees—along with risk and historical performance—among the investment options in their 401(k) plan. The information reported to Labor does not identify all fees charged to 401(k) plans and therefore has limited use for effectively overseeing fees and identifying undisclosed business arrangements among consultants or service providers. As a result, participants may have more limited investment options and pay higher fees for these options than they otherwise would.

² GAO, *PRIVATE PENSIONS: Changes Needed To Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, GAO-07-21 (Washington, D.C.: Nov. 2006).

³ Active participants include any worker currently in employment covered by a plan and workers who are earning or retaining credited service under a plan. It does not include retired participants and vested participants not yet in pay status.

⁴ 29 U.S.C. §§ 1001-1461.

Background

Roughly half of all workers participate in an employer-sponsored retirement, or pension plan. Private sector pension plans are classified as either defined benefit or defined contribution plans. Defined benefit plans promise to provide, generally, a fixed level of monthly retirement income that is based on salary, years of service, and age at retirement regardless of how the plan's investments perform. In contrast, benefits from defined contribution plans are based on the contributions to and the performance of the investments in individual accounts, which may fluctuate in value. Examples of defined contribution plans include 401(k) profit-sharing and thrift-savings plans, stock bonus plans, and annuity plans.

Labor's Employee Benefits Security Administration (EBSA) oversees 401(k) plans—including the fees associated with running the plans—because they are considered employee benefit plans under ERISA. Enacted before 401(k) plans came into wide use, ERISA establishes the responsibilities of employee benefit plan decision makers and the requirements for disclosing and reporting plan fees. Typically, the plan sponsor is a fiduciary.⁵ A plan fiduciary includes a person who has discretionary control or authority over the management or administration of the plan, including the plan's assets. ERISA requires that plan sponsors responsible for managing employee benefit plans carry out their responsibilities prudently and do so solely in the interest of the plans' participants and beneficiaries.

The law also provides Labor with oversight authority over pension plans.⁶ However, the specific investment products commonly contained in pension plans—such as company stock, mutual funds, collective investment funds, and group annuity contracts—fall under the authority of the applicable securities, banking, or insurance regulators:

⁵ A plan fiduciary is anyone who exercises discretionary authority or control over plan management (or any authority or control over the management or distribution of plan assets), renders or is responsible for rendering investment advice for a fee, or has discretionary authority or responsibility in plan administration. 29 U.S.C. § 1002(21)(A).

⁶ The Internal Revenue Service also oversees various aspects of 401(k) contributions under the authority of the Internal Revenue Code. Roth contributions to 401(k) plans were created under the Economic Growth and Tax Relief Reconciliation Act of 2001 effective for plan years beginning on or after January 1, 2006. This new account type was subsequently made permanent under the Pension Protection Act of 2006. Designated Roth contributions are a new type of contribution that can be accepted by new or existing 401(k) plans. If a plan adopts this feature, employees can designate some or all of their elective contributions as Roth contributions (which are included in gross income) rather than pre-tax elective contributions.

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- The Securities and Exchange Commission (SEC), among other responsibilities, regulates registered securities including company stock and mutual funds under securities law.⁷
 - The federal agencies charged with oversight of banks—primarily the Federal Reserve Board, the Treasury Department’s Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation—regulate bank investment products, such as collective investment funds.
 - State agencies generally regulate insurance products, such as variable annuity contracts. Such investment products may also include one or more insurance elements, which are not present in other investment options. Generally, these elements include an annuity feature, interest and expense guarantees, and any death benefit provided during the term of the contract.⁸

An Increasing Number of Employees Participate in Defined Contribution Plans, and This Trend Has Been Increasing Since the 1980s

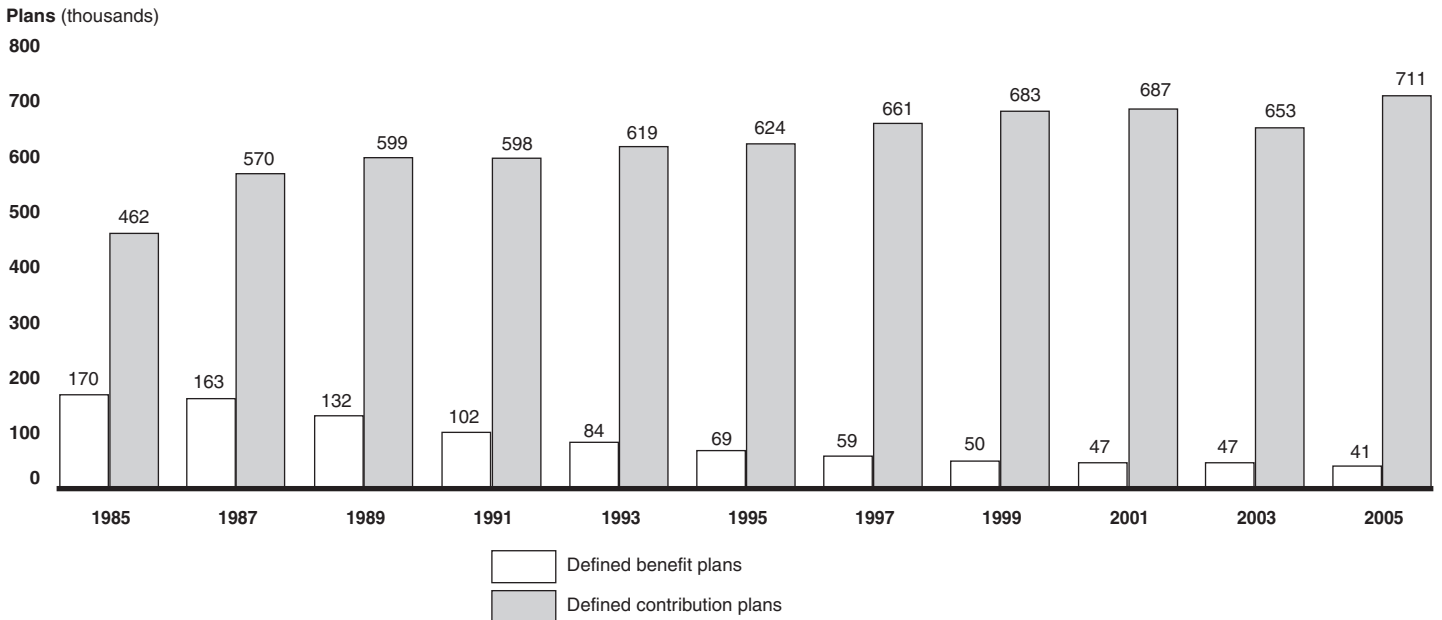
The number of defined contribution plans has increased since 1985, while the number of defined benefit plans has declined dramatically.⁹ Figure 1 shows the growth of defined contribution plans relative to that of defined benefit plans from 1985 to 2005.

⁷ 15 U.S.C. § 78a. Generally, public offerings and the sale of securities must be registered with the SEC.

⁸ The variable annuity contract “wraps” around investment options, often a number of mutual funds. Participants select from among the investment options offered, and the return to their individual accounts varies with their choice of investments. If registered securities make up the underlying investments, they are regulated by the SEC.

⁹ For 1985 data, see “Private Pension Plan Bulletin Abstract of 1999 Form 5500 Annual Reports,” U.S. Department of Labor (1985 data); for 2005 estimates, see Sarah Holden, Peter Brady, Michael Hadley, “401(k) Plans: A 25-Year Retrospective,” Investment Company Institute, *Research Perspective*, vol. 12, no. 2, (2006).

Figure 1: Changes in the Number of Defined Benefit Plans and Defined Contribution Plans, 1985-2005

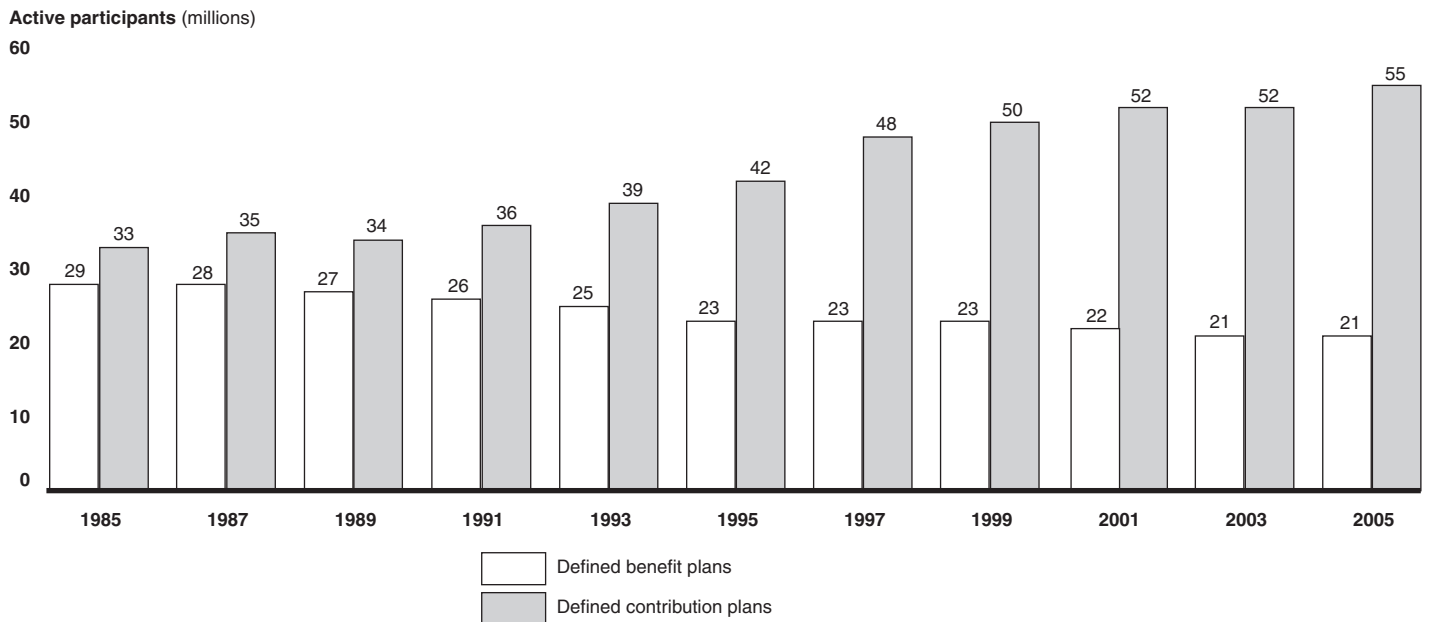


Source: U.S. Department of Labor (1985 - 2003 data); Investment Company Institute (2005 estimates).

Note: The Investment Company Institute's estimates for 2005 are based on the Department of Labor, Form 5500 Annual Reports, and other information.

In 2005, more workers were covered by defined contribution plans than by defined benefit plans. In 1985, defined benefit plans covered approximately 29 million active participants, compared to 33 million active participants in defined contribution plans. By 2005, the difference in the numbers had become more pronounced, with roughly 21 million active participants covered by defined benefit plans and approximately 55 million active participants in defined contribution plans. Figure 2 shows the shift in active participants from defined benefit to defined contribution plans since 1985.

Figure 2: Changes in the Number of Active Participants in Defined Benefit Plans and Defined Contribution Plans, 1985-2005



Source: U.S. Department of Labor (1985 - 2003 data); Investment Company Institute (2005 estimates).

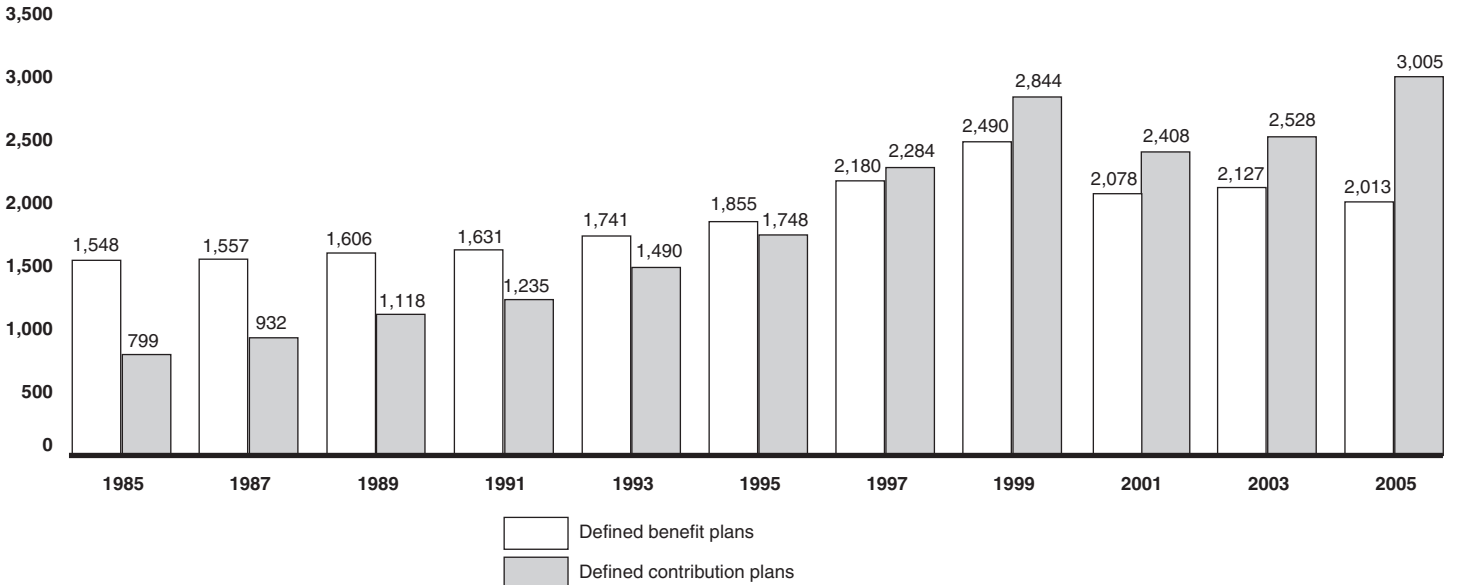
Note: The Investment Company Institute's estimates for 2005 are based on the Department of Labor, Form 5500 Annual Reports, and other information.

With the growth in plans and participants, the majority of private pension plan assets are now held in defined contribution plans. As shown in figure 3, defined benefit plan assets decreased from \$2.0 trillion in constant 2006 dollars, or about 66 percent of total private pension assets, in 1985 to \$1.5 trillion, or just over 40 percent of the total, in 2005.¹⁰

¹⁰ To calculate 2006 constant dollars, we used consumer price index information for the most current year available from the 2007 Economic Report of the President, p.302.

Figure 3: Changes in Defined Benefit and Defined Contribution Plan Assets, 1985-2005

Assets (2006 constant dollars in billions)



Source: U.S. Department of Labor (1985 - 2003 data); Investment Company Institute (2005 estimates).

Note: The Investment Company Institute's estimates for 2005 are based on the Department of Labor, Form 5500 Annual Reports, and other information.

Similarly, the number of 401(k) plans grew from less than 30,000 in 1985, or less than 7 percent of all defined contribution plans, to an estimated 417,000 plans, or about 95 percent of all defined contribution plans in 2005. During this same time period, the number of active participants in 401(k) plans increased from 10 million to 47 million, and plan assets increased from \$270 billion to about \$2.5 trillion in constant 2006 dollars.

Based on industry estimates, equity funds accounted for nearly half of the 401(k) plan assets at the close of 2005.¹¹ Equity funds are investment

¹¹ The 2005 data gathered by the Employee Benefit Research Institute (EBRI)/Investment Company Institute (ICI) joint project represents about 42 percent of estimated 401(k) plan assets, 37 percent of the estimated plan participant universe and about 11 percent of the estimated total number of 401(k) plans. See Sarah Holden and Jack VanDerhei, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2005," Research Perspective, vol. 12, no. 1, (2006) and "Appendix: Additional Figures for the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project for Year-End 2005," Research Perspective, vol. 12, no. 1A, (2006).

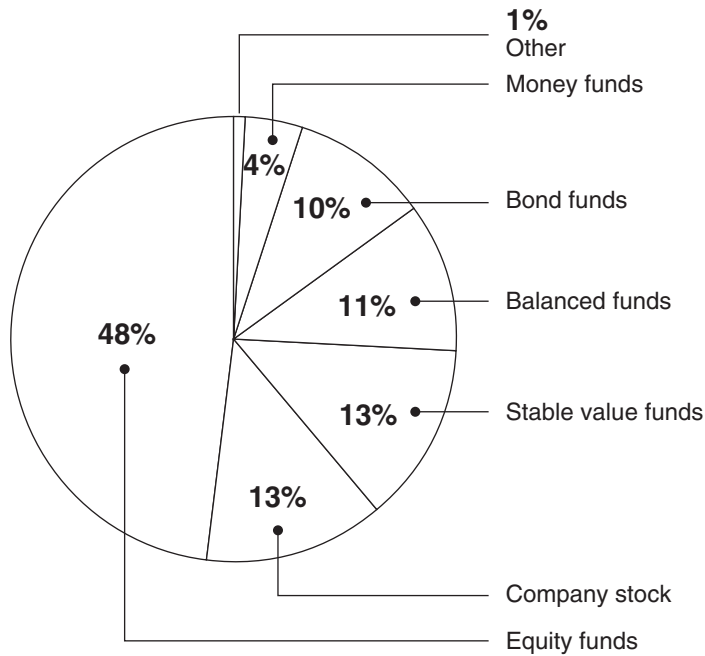
options that invest primarily in stocks, such as mutual funds, bank collective funds,¹² life insurance separate accounts, and certain pooled investment products (see fig. 4). Other plan assets were invested in company stock; stable value funds,¹³ including guaranteed investment contracts; balanced funds;¹⁴ bond funds; and money funds. Several of these options can be held in mutual funds, which in total represent about 51 percent of 401(k) plan assets. Common plan features, like the type and number of investment options provided to participants in their 401(k) plans, is a topic being studied under other GAO work on plan sponsor practices requested by this committee.

¹² A collective investment fund is a trust managed by a bank or trust company that pools investments of retirement plans or other large institutional investors.

¹³ The stable value funds typically offered as 401(k) investment options by insurance companies and banks generally provide a guaranteed rate of return over a specific period of time, such as 3 to 5 years.

¹⁴ Balanced funds are pooled accounts invested in both stocks and bonds.

Figure 4: 401(k) Plan Average Asset Allocation in 2005



Source: Investment Company Institute.

Note: The Investment Company Institute's estimates for 2005 are based on the Department of Labor, Form 5500 Annual Reports; and other information

With the growth in 401(k) plans, more workers now bear greater responsibility for funding their retirement income. According to the most recent data from Labor, the majority of 401(k) plans are participant-directed, meaning that a participant makes investment decisions about his or her own retirement plan contributions. In 2003, about 88 percent of all 401(k) plans—covering 93 percent of all active 401(k) plan participants and 92 percent of all 401(k) plan assets—generally allowed participants to choose how much to invest, within federal limits, and to select from a menu of diversified investment options selected by the employer sponsoring the plan.¹⁵

While some participants have account balances of greater than \$100,000, most have much smaller balances. Based on industry estimates for 2005, 37 percent of participants had balances of less than \$10,000, while 16

¹⁵ "Private Pension Plan Bulletin Abstract of 2003 Form 5500 Annual Reports," U.S. Department of Labor (Washington, D.C.: Oct. 2006).

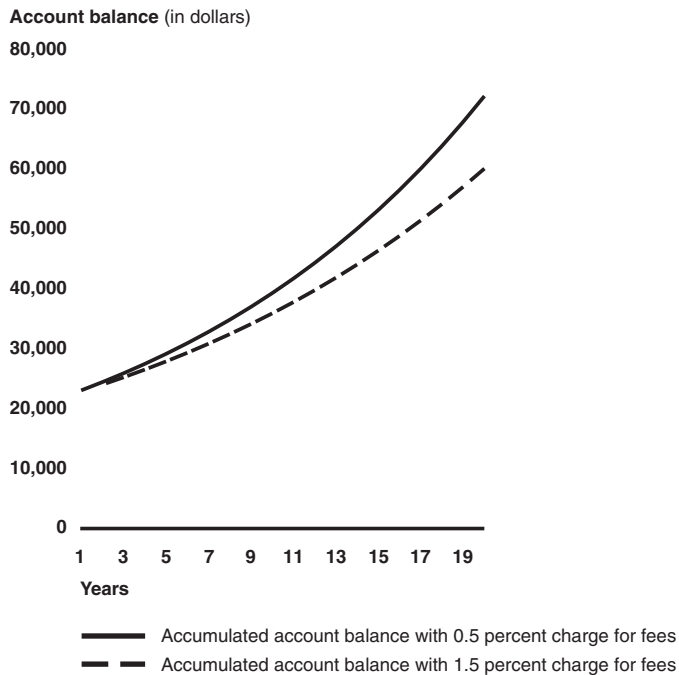
percent had balances greater than \$100,000.¹⁶ The median account balance was \$19,328, while the average account balance was \$58,328. Participants' account balances also include any contributions employers make on their behalf.

Fees are charged by the various outside companies that the plan sponsor—often the employer offering the 401(k) plan—hires to provide a number of services necessary to operate the plan. Services can include investment management (i.e., selecting and managing the securities included in a mutual fund); consulting and providing financial advice (i.e., selecting vendors for investment options or other services); record keeping (i.e., tracking individual account contributions); custodial or trustee services for plan assets (i.e., holding the plan assets in a bank); and telephone or Web-based customer services for participants. Generally there are two ways to provide services: “bundled” (the sponsor hires one company that provides the full range of services directly or through subcontracts) and “unbundled” (the sponsor uses a combination of service providers).

Fees are one of many factors—such as the historical performance and investment risk for each plan option—participants should consider when investing in a 401(k) plan because fees can significantly decrease retirement savings over the course of a career. As participants accrue earnings on their investments, they pay a number of fees, including expenses, commissions, or other charges associated with operating a 401(k) plan. Over the course of the employee's career, for example, a 1 percentage point difference in fees can significantly reduce the amount of money saved for retirement. Figure 5 assumes an employee who is 45 years of age with 20 years until retirement changes employers and leaves \$20,000 in a 401(k) account until retirement. If the average annual net return is 6.5 percent—a 7 percent investment return minus a 0.5 percent charge for fees—the \$20,000 will grow to about \$70,500 at retirement. However, if fees are instead 1.5 percent annually, the average net return is reduced to 5.5 percent, and the \$20,000 will grow to only about \$58,400. The additional 1 percent annual charge for fees would reduce the account balance at retirement by about 17 percent.

¹⁶ Sarah Holden and Jack VanDerhei, “Appendix: Additional Figures for the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project for Year-End 2005,” 10.

Figure 5: Effect of 1 Percentage Point in Higher Annual Fees on a \$20,000 401(k) Balance Invested over 20 Years



Source: GAO analysis.

Investment and Record-Keeping Fees Account for Most 401(K) Plan Fees, but Information on These Fees May Be Limited or Unavailable to Participants and Labor

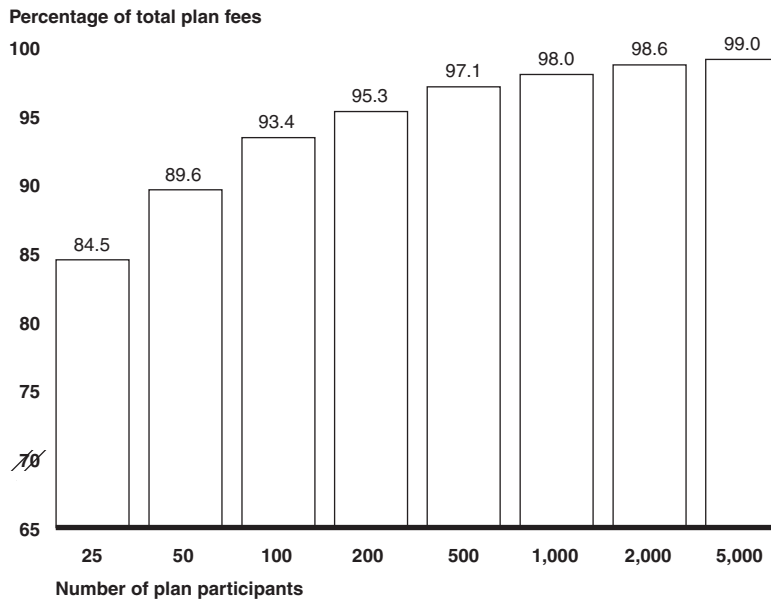
Various fees are associated with 401(k) plans, but investment and record-keeping fees account for most 401(k) plan fees. However, inadequate disclosure and reporting requirements may leave participants and Labor without important information on these fees. The information on fees that plan sponsors are required to disclose to participants does not allow participants to easily compare the fees for the investment options in their 401(k) plan. In addition, Labor does not have the information it needs to oversee fees and identify questionable 401(k) business practices. Labor has several initiatives under way to improve the information it has on fees and the various business arrangements among service providers.

Investment Fees Account for Most 401(k) Plan Fees and Are Usually Borne by Plan Participants

Investment fees account for the largest portion of total fees regardless of plan size, as figure 6 illustrates. Investment fees are, for example, fees charged by companies that manage a mutual fund for all services related to operating the fund. These fees pay for selecting a mutual fund's portfolio of securities and managing the fund; marketing the fund and

compensating brokers who sell the fund; and providing other shareholder services, such as distributing the fund prospectus.

Figure 6: Investment Fees as a Percentage of Total Plan Fees, 2005

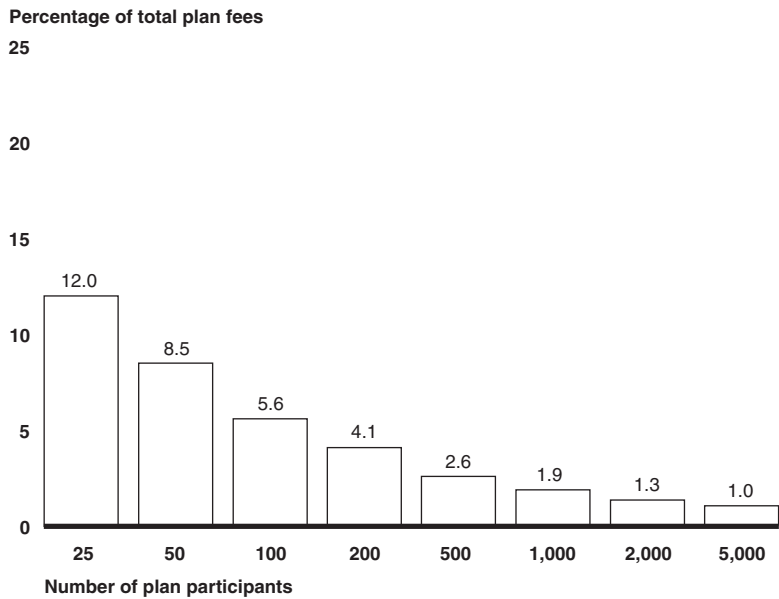


Source: HR Investment Consultants.

Note: The results of HR Investment Consultants' survey are based on responses from 125 vendors that service 401(k) plans. This response represents about 85 percent of the assets invested in 401(k) plans but may not be representative of the universe of 401(k) plans.

Plan record-keeping fees generally constitute the second-largest portion of plan fees. Plan record-keeping fees are usually charged by the service provider to set up and maintain the 401(k) plan. These fees cover activities such as enrolling plan participants, processing participant fund selections, preparing and mailing account statements, and other related administrative activities. Unlike investment fees, plan record-keeping fees apply to the entire 401(k) plan rather than the individual investment options. As shown in figure 7, these fees make up a smaller proportion of total plan fees in larger plans, indicating economies of scale.

Figure 7: Plan Record-Keeping Fees as a Percentage of Total Plan Fees, 2005



Source: HR Investment Consultants.

Note: The results of HR Investment Consultants' survey are based on responses from 125 vendors that service 401(k) plans. This response represents about 85 percent of the assets invested in 401(k) plans but may not be representative of the universe of 401(k) plans. While these data include primarily record keeping, they include a negligible amount of other administrative fees, according to the survey author.

There are a number of other fees associated with establishing and maintaining a plan, such as fees to communicate basic information about the plan to participants. However, these fees generally constitute a much smaller percentage of total plan fees than investment and plan record-keeping fees.

Whether and how participants or plan sponsors pay these fees varies by the type of fee and the size of the 401(k) plan. Investment fees, which are usually charged as a fixed percentage of assets and deducted from investment returns, are typically borne by participants. Plan record-keeping fees are charged as a percentage of a participant's assets, a flat fee, or a combination of both. Although plan sponsors pay these fees in a considerable number of plans, they are increasingly being paid by participants.

**Required Disclosures
Provide Limited Fee
Information to Assist
Participants in Comparing
Investment Options**

ERISA requires that plan sponsors provide all participants with a summary plan description, account statements, and the summary annual report, but these documents are not required to disclose information on fees borne by individual participants. Table 1 provides an overview of each of these disclosure documents, and the type of fee information they may contain.

Table 1: Required Disclosure Documents to All Participants

Disclosure document	Document purpose	Information on fees
Summary plan description	To explain to participants how the plan operates	May contain information on how various fees such as investment, record-keeping, and loan fees are charged to participants, but not required by ERISA to do so.
Account statement	To show the account balance due to a participant	Typically identifies fees, such as for loans, which are directly attributable to an account during a specific period. Also, may show investment and record-keeping fees, but not required by ERISA to do so.
Summary annual report	To disclose the financial condition of the plan to participants	Contains total plan costs incurred by plan participants during the year.

Source: GAO analysis.

ERISA also requires 401(k) plan sponsors that have elected liability protection from participants' investment decisions to provide additional fee information.¹⁷ Most 401(k) plan sponsors elect this protection and therefore must provide, among other information, a description of the investment risk and historical performance of each investment option available in the plan and any associated transaction fees for buying or selling shares in these options. Upon request, these plans must also provide participants with the expense ratio—a fund's operating fees as a percentage of its assets—for each investment option.

Plan sponsors may voluntarily provide participants with more information on fees than ERISA requires. For example, plans may distribute

¹⁷ Section 404(c) of ERISA generally relieves the fiduciaries of participant-directed plans from liability for any loss or breach that results from a participant's investment decisions about his or her plan assets. 29 U.S.C. § 1104(c) (2000). To be entitled to this relief, the plan must meet the standards promulgated by Labor. 29 C.F.R. § 2550.404c-1 (2006).

prospectuses or fund profiles for individual investment options in the plan. Although not required, plan sponsors may provide record-keeping or other information on fees in participants' account statements.

Although participants are responsible for directing their investments in the plan, they may not be aware of the different fees that they pay. In a nationwide survey, more than 80 percent of 401(k) participants report not knowing how much they pay in fees.¹⁸ Some industry professionals said that making participants who direct their investments more aware of fees would help them make more informed investment decisions.

Participants may not have a clear picture of the total fees they pay because plan sponsors provide this information in a piecemeal fashion. Some documents that contain fee information are provided to participants automatically, such as annually or within 90 days of joining the plan, while others, such as prospectuses, may require that participants seek them out.

Furthermore, the documents that participants receive do not provide a simple way for participants to compare fees among the investment options in their 401(k) plan. Industry professionals suggested that comparing the expense ratio across investment options is the most effective way to compare fees within a 401(k) plan.¹⁹ The expense ratio is useful because it includes investment fees, which account for most of the fees participants pay, and is generally the only fee measure that varies by option. However, as noted above, not all plan sponsors are required to provide expense ratios to participants.

Labor Has Authority Over 401(k) Plan Fees and Certain Types of Business Arrangements, but Lacks Information for Effective Oversight

Labor has authority under ERISA to oversee 401(k) plan fees and certain types of business arrangements involving service providers, but lacks the information it needs to provide effective oversight. Under ERISA, Labor is responsible for enforcing the requirements that plan sponsors (1) ensure that fees paid with plan assets are reasonable and for necessary services; (2) be prudent and diversify the plan's investments or, if plan sponsors elect liability protection, provide a broad range of investment choices for

¹⁸ AARP Policy Institute, "Pension Participant Knowledge About Plan Fees," *Data Digest* (November 2004).

¹⁹ Mutual funds include their expense ratios in their prospectuses. Other investment options may not provide prospectuses but have expense ratio equivalents that investment industry professionals can identify.

participants; and (3) report information known on certain business arrangements involving service providers. Labor does this in a number of ways, including collecting some information on fees from plan sponsors, investigating participants' complaints or referrals from other agencies on questionable 401(k) plan practices, and conducting outreach to educate plan sponsors about their responsibilities.

However, the information plan sponsors are required to report to Labor is limited, and the lack of information hinders the agency's ability to effectively oversee fees. Many of the fees are associated with the individual investment options in the 401(k) plan, such as a mutual fund; they are deducted from investment returns and not included on the annual reporting form plan sponsors submit to Labor, Form 5500. As a result, the Form 5500 does not include the largest type of fee, even though plan sponsors receive this information from the mutual fund companies in the form of a prospectus. In 2004, the ERISA Advisory Council concluded that Form 5500s are of little use to policy makers, government enforcement personnel, and participants in terms of understanding the cost of a plan and recommended that Labor modify the form and its accompanying schedules so that all fees incurred directly or indirectly can be reported or estimated. Without information on all fees, Labor's oversight is limited because it is unable to identify fees that may be questionable.

Labor and plan sponsors also may not have information on arrangements among service providers that could steer plan sponsors toward offering investment options that benefit service providers but may not be in the best interest of participants. For example, the SEC released a report in May 2005 that raised questions about whether some pension consultants are fully disclosing potential conflicts of interest that may affect the objectivity of the advice.²⁰ Plan sponsors pay pension consultants to give them advice on matters such as selecting investment options for the plan and monitoring their performance and selecting other service providers, such as custodians, administrators, and broker-dealers. The report highlighted concerns that these arrangements may provide incentives for pension consultants to recommend certain mutual funds to a 401(k) plan sponsor and create conflicts of interest that are not adequately disclosed to plan sponsors. Plan sponsors may not be aware of these arrangements

²⁰ Office of Compliance Inspections and Examinations, *Staff Report Concerning Examinations of Select Pension Consultants*, U.S. Securities and Exchange Commission (Washington, D.C.: May 16, 2005).

and thus could select mutual funds recommended by the pension consultant over lower-cost alternatives. As a result, participants may have more limited investment options and may pay higher fees for these options than they otherwise would.

In addition, specific fees that are considered to be “hidden” may mask the existence of a conflict of interest. Hidden fees are usually related to business arrangements where one service provider to a 401(k) plan pays a third-party provider for services, such as record keeping, but does not disclose this compensation to the plan sponsor. For example, a mutual fund normally provides record-keeping services for its retail investors, i.e., those who invest outside of a 401(k) plan. The same mutual fund, when associated with a plan, might compensate the plan’s record keeper for performing the services that it would otherwise perform, such as maintaining individual participants’ account records and consolidating their requests to buy or sell shares.²¹

The problem with hidden fees is not how much is being paid to the service provider, but with knowing what entity is receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered. Labor’s position is that plan sponsors must know about these fees in order to fulfill their fiduciary responsibilities. However, 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.

Labor Has Several Initiatives Under Way to Improve Information It Has on Fees and the Various Business Arrangements Among Service Providers

Labor officials told us about three initiatives currently under way to improve the disclosure of fee information by plan sponsors to participants and to avoid conflicts of interest:

- Labor is considering promulgating a rule regarding the fee information required to be furnished to participants in plans where sponsors have elected liability protection. According to Labor officials, they are attempting to define the critical information on fees that plan sponsors should provide to participants and what format would enable participants to easily compare the fees across the plan’s various investment options.

²¹ *Final Report of the 2004 ERISA Advisory Council Working Group, Health and Welfare Form 5500 Requirements* (Washington, D.C.: Nov. 10, 2004).

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- Labor has proposed changes to the Form 5500 Schedule A and Schedule C to improve reporting of fees.²²
 - Labor proposed to add a check box on Schedule A to improve the disclosure of insurance fees and commissions and identify insurers who fail to supply information to plan sponsors. According to a 2004 ERISA Advisory Council report,²³ many employers have difficulty obtaining timely Schedule A information from insurers.
 - Consistent with recommendations made by the ERISA Advisory Council Working Groups and GAO, Labor proposed changes to the Schedule C to clarify that the plan sponsor must report any direct and indirect compensation (i.e., money or anything else of value) it pays to a service provider during the plan year. Plan sponsors also would be required to disclose the source and nature of compensation in excess of \$1,000 that certain key service providers, including, among others, investment managers, consultants, brokers, and trustees as well as all other fiduciaries, receive from parties other than the plan or the plan sponsor, such as record keepers. Labor officials told us that the revision aims to improve the information plan sponsors receive from service providers. The officials acknowledge, however, that this requirement may be difficult for plan sponsors to fulfill without an explicit requirement in ERISA for service providers to give plan sponsors information on the fees they pay to other providers.
 - The third initiative involves amending Labor's regulations under section 408(b)(2) of ERISA to define the information plan sponsors need in deciding whether to select or retain a service provider. According to Labor, plan sponsors need information to assess the reasonableness of the fees being paid by the plan for services rendered and to assess potential conflicts of interest that might affect the objectivity with which the service provider provides its services to the plan. This change to the regulation would be intended to make clear what plan sponsors need to know and, accordingly, what service providers need to provide to plan sponsors.

²² 71. Fed. Reg. 41,392 (July 21, 2006).

²³ *Final Report of the 2004 ERISA Advisory Council Working Group, Health and Welfare Form 5500 Requirements* (Washington, D.C.: Nov. 10, 2004).

To ensure that participants have a tool to make informed comparisons and decisions among plan investment options, we recommended in our previous report that Congress consider amending ERISA to require all sponsors of participant-directed plans to disclose fee information of 401(k) investment options to participants in a way that facilitates comparison among the options. To better enable the agency to effectively oversee 401(k) plan fees, we recommended that the Secretary of Labor should require plan sponsors to report a summary of all fees that are paid out of plan assets or by participants. To allow plan sponsors, and ultimately Labor, to provide better oversight of fees and certain business arrangements among service providers, we also recommended that Congress should consider amending ERISA to explicitly require that 401(k) service providers disclose to plan sponsors the compensation that providers receive from other service providers. In response to our draft report, Labor generally agreed with our findings and conclusions. Specifically, Labor stated that it will give careful consideration to GAO's recommendation that plans be required to provide a summary of all fees that are paid out of plan assets or by participants. Labor and SEC also provided technical comments on the draft, which we incorporated as appropriate.

Conclusions

The pension plan universe has changed: 401(k) plans have emerged to cover most plan participants and the majority of plan assets. With this shift, participants now bear more responsibility for ensuring they have adequate income in retirement, emphasizing the importance of having sufficient information to make informed 401(k) investment decisions. Information about investment options' historical performance is useful, but alone is not enough. Thus, giving participants key information on fees for each of the plan's investment options in a simple format—including fees, historical performance, and risk—will help participants make informed investment decisions within their 401(k) plan. In choosing between investment options with similar performance and risk profiles but different fee structures, the additional provision of expense ratio data may help participants build their retirement savings over time by avoiding investments with relatively high fees.

Regulators, too, will need to have better information to provide more effective oversight, especially of the fees associated with 401(k) plans. Amending ERISA and updating regulations to better reflect the impact of fees and undisclosed business arrangements among service providers will help put Labor in a better position to oversee 401(k) plan fees. Furthermore, requiring plan sponsors to report more complete

information to Labor on fees—those paid out of plan assets or by participants—would put the agency in a better position to effectively oversee 401(k) plans.

Contacts and Acknowledgements

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