

GAO

Report to the Ranking Member,  
Committee on Education and the  
Workforce, House of Representatives

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January 2011

## 401(K) PLANS

# Improved Regulation Could Better Protect Participants from Conflicts of Interest



G A O

Accountability \* Integrity \* Reliability

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## Why GAO Did This Study

Recent volatility in financial markets highlights the need for prudent investment decisions if 401(k) plans are to provide an adequate source of retirement income. While plan sponsors and participants may receive help in assessing their investment choices, concerns have been raised about the impartiality of the advice provided. GAO was asked to describe circumstances where service providers may have conflicts of interest in providing assistance related to the selection of investment options for (1) plan sponsors and (2) plan participants, and (3) steps the Department of Labor (Labor) has taken to address conflicts of interest related to the selection of investment options.

## What GAO Recommends

GAO recommends that Labor amend pending regulations to require that service providers disclose compensation and fiduciary status in a consistent, summary format and revise current standards, which permit a service provider to highlight investment options in which it has a financial interest. GAO also recommends that the Department of the Treasury amend proposed regulations to require disclosure that investment products outside a plan typically have higher fees than products available within a plan. Overall, Labor and Treasury generally agreed to consider our recommendations as they evaluate comments received on pending regulations.

View [GAO-11-119](#) or key components. For more information, contact Charlie Jeszeck at (202) 512-7215 or [jeszeck@gao.gov](mailto:jeszeck@gao.gov).

## 401(K) PLANS

### Improved Regulation Could Better Protect Participants from Conflicts of Interest

## What GAO Found

The sponsors of 401(k) plans face conflicts of interest from service providers assisting in the selection of investment options because of third-party payments and other business arrangements. For example, providers who help sponsors to establish and maintain their plans may receive third-party payments from investment fund companies. The payments, sometimes called revenue sharing, create a conflict of interest because the provider may receive greater compensation from certain funds. Moreover, providers are reported to commonly structure their relationships with sponsors in a manner that avoids being subject to fiduciary standards under the Employee Retirement Income Security Act (ERISA). According to several industry experts, many sponsors, particularly of smaller plans, do not understand whether or not providers to the plan are fiduciaries, nor are they aware that the provider's compensation may vary based on the investment options selected. Such conflicts could lead to higher costs for the plan, which are typically borne by participants.

In certain situations, participants face conflicts of interest from providers that have a financial interest when providing investment assistance. For example, although investment education is defined as generalized investment information, providers may highlight their own funds as examples of investments available within asset classes even though they may have a financial interest in the funds. According to industry experts, participants perceive education as investment advice. Thus, participants may not understand that the provider is not a fiduciary adviser required to act solely in participants' best interests. Also, several industry experts expressed concerns that providers stand to gain higher profits from marketing investment products outside of plans to participants, a practice known as cross-selling. For example, if participants use their plan provider for Individual Retirement Account rollovers, they may not understand, because of insufficient disclosures, that fees are often higher for products offered outside the plan and that the provider may not be serving as a fiduciary adviser. Consequently, participants may choose funds that do not meet their needs and pay higher fees, which reduce their retirement savings.

While Labor has taken steps to address the potential for conflicted investment advice provided to sponsors and participants, more can be done to ensure they receive impartial advice. In fiscal year 2007, the Employee Benefits Security Administration (EBSA) began a national enforcement project that focuses on the receipt of improper or undisclosed compensation by certain providers, but its enforcement efforts are constrained to fiduciary providers and limited by EBSA's approach for generating cases. In addition, EBSA issued regulations to revise the definition of an ERISA fiduciary and require enhanced disclosure of providers' compensation and fiduciary status. These regulations, as currently specified, would help EBSA and sponsors detect and deter conflicted investment advice. However, the regulations do not require that certain disclosures be made in consistent or summary formats, which may leave sponsors with information that is not sufficient or comparable.

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## Abbreviations

bps	basis points
CAP	Consultant/Adviser Project
DB	defined benefit
DC	defined contribution
EBSA	Employee Benefits Security Administration
ELAA	eligible investment advice arrangement
ERISA	Employee Retirement Income Security Act
FINRA	Financial Industry Regulatory Authority, Inc.
ICI	Investment Company Institute
IRA	individual retirement account
IRS	Internal Revenue Service
NASD	National Association of Securities Dealers
OIG	Office of Inspector General
PPA	Pension Protection Act
PSCA	Profit Sharing/401(k) Council of America
QDIA	qualified default investment alternative
RIA	registered investment advisor
SEC	Securities and Exchange Commission
SHRM	Society for Human Resource Management
SIPP	Survey of Income and Program Participation
SPARK	Society of Professional Asset-Managers and Record Keepers
SRO	self-regulatory organization

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United States Government Accountability Office  
Washington, DC 20548

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January 28, 2011

The Honorable George Miller  
Ranking Member  
House Education and the Workforce Committee  
United States House of Representatives

Dear Mr. Miller:

In recent high-profile court cases, 401(k) plan participants allege they have lost millions of dollars because of investment options that benefited the plan's service provider at the expense of participants.<sup>1</sup> Plan sponsors and participants may rely on investment education or advice from their service provider to help them assess their investment choices at two key points: first, when the plan sponsor decides which investment options to include in the plan, and second, when each plan participant decides where to invest his or her assets given the available options in the plan. However, questions have been raised about the impartiality of the assistance provided when the service provider has a conflict of interest. A conflict of interest occurs when someone in a position of trust, like a pension plan adviser, has competing professional or personal financial interests. For example, the structure of advisers' compensation and their other business arrangements could create competing interests that may bias their investment recommendations to plan sponsors or participants. If left unchecked, conflicts of interest could lead plan sponsors or participants to select investment options with higher fees or mediocre performance, which, while beneficial to the service provider, could amount to a significant reduction in retirement savings over a worker's career.

The potential for financial harm to participants from conflicted investment advice has raised questions about its nature and extent in 401(k) plans. To better understand how conflicts of interest may arise in investment assistance provided to plan sponsors or participants and to evaluate how

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<sup>1</sup>A plan sponsor, often the employer offering a 401(k) plan, hires companies to provide a number of services necessary to operate a plan. Services can include fund management (i.e., selecting and managing the securities included in a mutual fund), consulting and investment advice (i.e., selecting vendors for investment options or other services, such as record keeping), record keeping (i.e., tracking individual account contributions), custodial or trustee services for plan assets (i.e., hold the plan assets in a bank), and telephone or Web-based customer services for participants.

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such conflicts are addressed by current and proposed regulations, you asked us to address the following questions:

1. What are circumstances where service providers may have conflicts of interest in providing assistance related to the selection of investment options by plan sponsors?
2. What are circumstances where service providers may have conflicts of interest in providing assistance related to the selection of investment options by plan participants?
3. What steps has the Department of Labor (Labor) taken to address conflicts of interest related to the selection of investment options?

To answer these questions, we reviewed relevant research and federal laws and regulations on investment advice arrangements for plan sponsors and participants. We conducted interviews with 401(k) plan service providers, government officials, and other industry experts to identify different practices that may create conflicts of interest in the provision of investment advice to plan sponsors and participants. In addition, we reviewed relevant Securities and Exchange Commission (SEC) and Labor enforcement cases and spoke with field investigators to examine revenue-sharing arrangements and other business practices where conflicts of interest were identified. To identify current practices in participant-level investment advice, we conducted a poll of plan sponsors and service providers in partnership with the Society for Human Resource Management (SHRM) and the Society of Professional Asset-Managers and Record Keepers (SPARK). In addition, we obtained and analyzed data from service providers, the Investment Company Institute (ICI), and the Survey of Income and Program Participation (SIPP) to ascertain the percentage of plan participants who have transferred or rolled 401(k) plan assets into individual retirement accounts (IRA). We assessed the reliability of the data we present and found the data to be sufficiently reliable as used in this report. To determine the extent to which Labor's actions address the potential for conflicted investment advice, we reviewed relevant federal laws and regulations and interviewed Labor's Employee Benefits Security Administration (EBSA) officials, including Consultant/Adviser Project and field investigators, and industry experts. In addition, we reviewed reports and interviewed officials from Labor's Office of Inspector General (OIG) who evaluated EBSA's efforts to protect pension plan assets from conflicts of interest in pension plan service providers. We also interviewed service providers and industry experts on the likely impact of recent regulations issued by Labor pertaining to

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investment advice to participants and disclosure of compensation received by service providers. For additional information on the methodology used in this review, see appendix I.

We conducted this performance audit from January 2010 through January 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

In contrast to workers in a traditional defined benefit (DB) plan, workers in a 401(k) plan, the predominant type of defined contribution (DC) plan in the United States, have more control over their retirement assets, but also bear greater responsibility and risk in the investment of assets. In a typical 401(k) plan, workers decide whether or not to make contributions into an individual account. Contributions may also be made by their employer. Participants direct these contributions to mutual funds and other financial market investments to accumulate pension benefits, dependent on investment returns net of fees. As we reported in 2006, investment fees are usually paid by participants and administrative fees are often paid by employers, but participants bear them in a growing number of plans.<sup>2</sup> Depending on contributions and net investment returns, participants accumulate an account balance that will then be withdrawn at or after retirement. Over the last decade, participation in DC plans among all private industry employees has increased from 36 percent in 1999 to 43 percent in 2008.<sup>3</sup> In 2008, about 49.8 million workers actively participated in a 401(k) plan.<sup>4</sup>

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<sup>2</sup>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. 16, 2006).

<sup>3</sup>U.S. Bureau of Labor Statistics. *National Compensation Survey of Employee Benefits in the United States, March 2009*. Percentages can be attributed to the overall private industry workforce, not just those of private industry employees with access to defined contribution plans.

<sup>4</sup>See Investment Company Institute, FAQs & Resource Centers: "Frequently Asked Questions about 401(k) Plans," at [http://www.ici.org/faqs/faqs\\_401k](http://www.ici.org/faqs/faqs_401k). A worker that actively participated in a 401(k) plan may participate in more than one DC plan and also might participate in a DB plan in addition to his or her 401(k) plan.

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The degree of responsibility and risk borne by workers in 401(k) plans underscores the need for prudent investment decisions if these plans are to provide an adequate source of income in retirement. Poor investment decisions—either by the plan sponsors when they decide which investment options to offer in the plans, or by participants when, given these options, they decide where to invest their assets—can result in lower returns and correspondingly less retirement savings. Several studies have found that, from 1988 to 2006, DC plans underperformed DB plans by 1 percentage point or more, which may be explained by higher fees in 401(k) plans and a lack of diversification in participants’ investment allocations.<sup>5</sup> Numerous studies on financial literacy have also pointed to the need to educate participants to improve their investment decision-making and savings outcomes.<sup>6</sup> For example, one study found that a large percentage of American workers have not conducted meaningful retirement planning, even when retirement is in the near future.<sup>7</sup> Another study found that most workers acknowledge they do not know as much as they should about retirement planning and that many workers actually guessed at their retirement savings needs.<sup>8</sup>

To address the challenges of investment risk in 401(k) plans, both plan sponsors and participants may seek assistance from service providers in selecting investment options. At the plan sponsor level, many plans rely

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<sup>5</sup>See Alicia H. Munnell et al., *Investment Returns: Defined Benefit vs. 401(k) Plans*. (Chestnut Hill, Mass. 2006); Watson Wyatt, “Defined Benefit vs. 401(k) Plans: Investment Returns for 2003-2006,” at <http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=19148>; and Waring and Siegal, “Wake Up and Smell the Coffee! DC Plans Aren’t Working: Here’s How to Fix Them,” *Journal of Investing* (Winter 2007).

<sup>6</sup>See, e.g., Annamaria Lusardi and O. S. Mitchell, Working Paper: “Financial Literacy and Planning: Implications for Retirement Wellbeing,” University of Pennsylvania, Wharton School of Business, Pension Research Council (October 2006); Annamaria Lusardi and O. S. Mitchell, “Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth,” 54 *J. Monetary Economics* 205, 205-24 (2007); Annamaria Lusardi, “Household Savings Behavior: The Role of Financial Literacy, Information, and Financial Education Programs,” *Policymaking Insights from Behavioral Economics* (Dartmouth College and NBER 2008); A. Hung, et al., Working Paper: “Building Up, Spending Down: Financial Literacy, Retirement Savings Management, and Decumulation,” RAND Corporation (2009); “Bridging the Gap Between Employers’ and Workers’ Understanding of 401(k) Fees,” TransAmerica Center for Retirement Studies (July 2010).

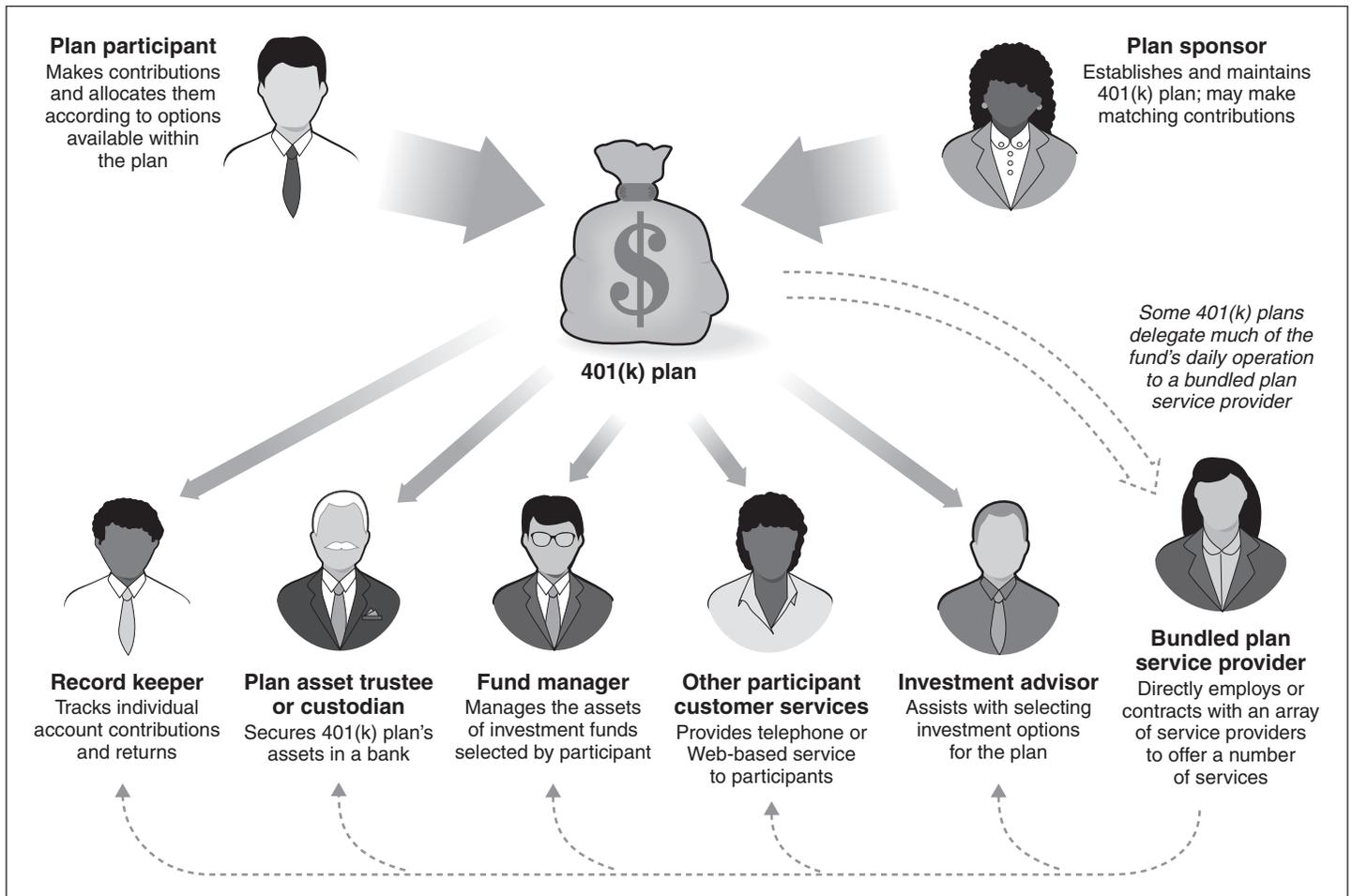
<sup>7</sup>Lusardi, “Household Savings Behavior: The Role of Financial Literacy, Information, and Financial Education Programs,” 2.

<sup>8</sup>TransAmerica Center for Retirement Studies, “Bridging the Gap Between Employers’ and Workers’ Understanding of 401(k) Fees,” 10.

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heavily on the expertise and guidance of their advisers when making investment decisions. The service providers that offer these advisory services to plan sponsors can vary considerably in their business arrangements. While some service providers operate as independent, “fee-only” advisers, who are compensated solely by their clients and do not receive additional compensation contingent on the purchase or sale of a financial product, other service providers offer affiliated services, including brokerage and money management, in addition to advisory services. As shown in figure 1, service providers can be used to provide a number of services necessary to operate a 401(k) plan, which can be bundled or unbundled with investment management services or advisory services. Under a bundled service arrangement, the plan sponsor hires a company that provides multiple services directly or through subcontracts.

**Figure 1: Structure of Service Provider Arrangements in 401(k) Plans**



Source: GAO analysis of information from industry practitioners.

At the participant level, advisory services can also be provided through a variety of methods, including call centers or help desks, group seminars, one-on-one sessions, computer models (e.g., software that estimates future retirement income needs or asset allocation models), or brochures and other printed materials provided by plan service providers. When providing this assistance to participants, a service provider may furnish either investment education or investment advice. As specified by EBSA, investment education consists of general investment information, including general information about the plan and asset allocation models that is not tailored to the needs or interests of an individual plan

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participant (see table 1).<sup>9</sup> Investment advice, on the other hand, consists of one or more individualized investment recommendations tailored to a participant's particular investment needs.

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**Table 1: EBSA's Definition of Investment Education**

In June 1996, EBSA issued an interpretive bulletin defining participant investment education (codified at 29 C.F.R. § 2509.96-1(d)). The bulletin identified specific categories of investment-related information that, when furnished to plan participants or beneficiaries, would not constitute the rendering of investment advice under the Employee Retirement Income Security Act of 1974 (ERISA). The categories of information include the following:

- **Plan information**—information and materials that inform a participant or beneficiary about the benefits of plan participation, the impact of preretirement withdrawals on retirement income, the terms and operation of the plan, and other general plan information. Such information cannot reference the appropriateness of any investment option for a particular participant or beneficiary.
- **General financial and investment information**—information and materials that inform a participant or beneficiary about, among other things, general financial and investment concepts, historic differences in rates of return between different asset classes, effects of inflation, and estimating future retirement income needs. Such general information cannot directly relate to any investment alternatives available to participants and beneficiaries.
- **Asset allocation models**—information and materials that provide a participant or beneficiary with models of asset allocation portfolios of hypothetical individuals with different time horizons and risk profiles. If an asset allocation model identifies specific investment alternatives available under a plan, the model must be accompanied by a statement that other investment alternatives having similar risk and return characteristics may be available under the plan.
- **Interactive investment materials**—includes questionnaires, worksheets, software, and similar materials that provide a participant or beneficiary the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income.

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Source: GAO review of EBSA's interpretive bulletin relating to participant investment education (codified at 29 C.F.R. § 2509.96-1(d)).

While plan sponsors and participants may rely on service providers for assistance in making investment decisions, concerns have been raised about the independence of the advice provided in some cases. A 2005 SEC report noted that its examination of investment advisers providing pension consultant services found that many such consultants provide services to both plans and money managers, a situation that has the potential to compromise the objectivity of the consultant's recommendations to the

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<sup>9</sup>29 C.F.R. § 2509.96-1(d).

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plan.<sup>10</sup> Namely, the report states that concerns exist that consultants may steer plans to hire certain money managers or other vendors based on the consultant's (or an affiliate's) other business relationships and receipt of fees from these firms, rather than because the money manager is best suited to the plan's needs. As we reported in 2007, no complete information exists about the presence of conflicts of interest at pension plan service providers.<sup>11</sup> However, the 2005 SEC examination of the activities of 24 pension consultants from 2002 through 2003 revealed that 13 out of 24 of the service providers examined failed to disclose significant ongoing conflicts of interest, such as affiliated businesses or compensation received from money managers.<sup>12</sup>

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## Regulation of Investment Advice

### ERISA

Investment advice provided to plan sponsors and participants and any related conflicts of interest are regulated under ERISA. ERISA states that a person who renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or property of a plan or has any authority or responsibility to do so is a fiduciary and thus is subject to fiduciary standards outlined in the law and regulations.<sup>13</sup> This statutory

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<sup>10</sup>SEC Office of Compliance Inspections and Examinations, *Staff Report Concerning Examinations of Select Pension Consultants* (Washington, D.C.: May 16, 2005).

<sup>11</sup>GAO, *Defined Benefit Pensions: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges*, [GAO-07-703](#) (Washington, D.C.: June 28, 2007).

<sup>12</sup>According to the SEC report, the pension consultants examined represented a cross section of the pension consultant community and varied in size (measured in terms of the number and size of their pension plan clients) and the type of products and services they offered. About half of the pension consultants examined were among the largest pension consulting service providers, measured in terms of the assets of the plans they advise. The remainder of the sample consisted of medium and smaller consultants. Since the consultants were not selected randomly, this sample cannot be generalized to the population of pension consultants. See, also [GAO-07-703](#). GAO worked with SEC to obtain data to conduct a statistical analysis of rates of return associated with the consultants examined in SEC's study, including the 13 consultants identified by the SEC as having undisclosed conflicts of interest.

<sup>13</sup>In addition, the law states that a person acts as a fiduciary when he or she exercises any discretionary control or authority over plan management or any authority or control over plan assets, or has any discretionary authority or responsibility in the administration of a plan. 29 U.S.C. § 1002(21)(A).

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definition of fiduciary for investment advice is currently subject to a five-part test, set forth in regulations, each element of which must be met for an individual to be considered a fiduciary.<sup>14</sup> Specifically, under this test, a consultant or adviser is determined to be providing investment advice only if the advice was provided for a fee either direct or indirect, and the advice was provided

1. as to the value of securities or other property or as to the advisability of investing in, purchasing, or selling securities or other property;
2. on a regular basis;
3. pursuant to a mutual agreement, arrangement, or understanding;
4. as a primary basis for investment decisions; and
5. based on the particular needs of the plan.<sup>15</sup>

Although plan sponsors often rely on consultants and other service providers to assist them in asset management, which includes selecting money managers and monitoring money managers' performance and brokerage transactions, not all of these consultants and service providers are at all times fiduciaries under ERISA based on the application of the five-part test.

For plan sponsors and other service providers who are fiduciaries, ERISA requires they discharge duties solely in the interest of the participants and

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<sup>14</sup>On October 22, 2010, EBSA proposed regulations that would eliminate the five-part test described here. These regulations, which would encompass certain advisory relationships not currently covered under the five-part test, have not been finalized, and as a result, the five-part test was in effect when our work was conducted and the regulations are still in effect as of the issuance date of this report. Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (October 22, 2010)(to be codified at 29 C.F.R. pt. 2510).

<sup>15</sup>29 C.F.R § 2510.3-21(c).

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beneficiaries with care, skill, prudence, and diligence.<sup>16</sup> Although ERISA generally prohibits fiduciaries from acting on conflicts of interest, certain transactions are strictly precluded under prohibited transaction rules, regardless of whether or not participants are harmed.<sup>17</sup> In particular, prohibited transaction rules preclude fiduciaries from “self-dealing,” which includes an individual dealing with plan assets for his or her own benefit.<sup>18</sup> In addition, EBSA has explained that ERISA obligates fiduciaries to obtain and consider information relating to the cost of plan services and potential conflicts of interest presented by such service arrangements.<sup>19</sup>

EBSA is responsible for enforcing these provisions of Title I of ERISA, as well as educating and assisting plan participants, beneficiaries, and plan sponsors. Fiduciaries that breach their plan duties are personally liable for making up losses to the plan and restoring any profits made through the

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<sup>16</sup>ERISA’s prudent man standard of care is articulated by the requirement that a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. In addition, the fiduciary is required to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Furthermore, the fiduciary is to diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly not prudent to do so, and act in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of Title I and Title IV of ERISA. 29 U.S.C. § 1104(a)(1).

<sup>17</sup>29 U.S.C. § 1106. There are two main categories of prohibited transactions: (1) transactions between a plan and a party in interest and (2) fiduciary self-dealing. ERISA also provides, however, a number of detailed exemptions to these prohibitions and permits Labor to establish administrative exemptions as well. 29 U.S.C. § 1108.

<sup>18</sup>Under self-dealing prohibited transaction rules, fiduciaries are prohibited from (1) dealing with plan assets for his or her own interest or for his or her own account, (2) acting adverse to the plan in a transaction involving the plan, and (3) receiving consideration from a party dealing with the plan in a transaction involving plan assets. 29 U.S.C. § 1106(b).

<sup>19</sup>The preamble to the interim final regulations of July 16, 2010 under 29 C.F.R. § 2550.408b-2 provide that “[t]he Department notes, however, that...ERISA § 404(a) continues to obligate fiduciaries to obtain and consider information relating to the cost of plan services and potential conflicts of interest presented by such service arrangements.” Reasonable Contract or Arrangement Under Section 408(b)(2)—Fee Disclosure; Interim Final Rule, 75 Fed. Reg. 41,600 (July 16, 2010) (to be codified at 29 C.F.R. pt. 2550). To provide plan sponsors and other fiduciaries with sufficient information to determine that plan expenses are reasonable and identify potential conflicts of interest, EBSA issued interim final regulations on July 16, 2010, that require service providers to disclose direct and indirect compensation to plan fiduciaries. 29 C.F.R. § 2550.408(b)(2) (2010).

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use of plan assets. In addition, they may face removal as plan fiduciaries.<sup>20</sup> Participants may also seek recovery against nonfiduciaries in certain circumstances.<sup>21</sup> In addition to carrying out its enforcement responsibilities, EBSA assists regulated parties in complying with ERISA by issuing technical guidance, including advisory opinions and interpretive bulletins, and educating plan participants, beneficiaries, and plan sponsors.

## Securities Laws

In addition to being regulated by ERISA, investment advice and conflicts of interest are also regulated under securities laws. SEC regulates certain money managers and pension consultants under the Investment Advisers Act of 1940 (Advisers Act), which requires those firms meeting certain criteria to register with the commission as investment advisers.<sup>22</sup> For these registered investment advisers, SEC requires that they disclose information about affiliations, business interests, and compensation arrangements to their advisory clients, primarily by providing a brochure that meets the requirements of Part 2 of SEC's Form ADV to new and prospective clients. In addition, registered investment advisers must annually deliver either an updated brochure with a summary of material changes or a summary of material changes and offer to provide an updated copy of the brochure.<sup>23</sup> According to SEC, all investment advisers—whether registered with SEC or not—have a fiduciary obligation under the Advisers Act to avoid conflicts of interest and, at a minimum, make full disclosure of material conflicts of interest to their clients. When an adviser fails to disclose information regarding material conflicts of interest, clients

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<sup>20</sup>29 U.S.C. § 1109.

<sup>21</sup>*Harris Trust & Savings Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238 (2000).

<sup>22</sup>15 U.S.C. §§ 80b-1 et seq. Under current law, most investment advisers must have a minimum of \$25 million in assets under management in order to register with SEC. However, current rules under the Advisers Act require pension consultants to plans having an aggregate value of at least \$50 million to register with the commission (Rule 203A-2(b)). The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 410, 124 Stat. 1376, 1576 (2010), raised the threshold requirement for SEC registration to \$100 million for most investment advisers, and SEC has proposed to raise the threshold for pension consultants to \$200 million (in plan assets). 75 Fed. Reg. 7,7052 (Dec. 10, 2010).

<sup>23</sup>Investment advisers use Form ADV under the Advisers Act to register with SEC or state securities authorities or to amend those registrations. SEC adopted amendments to Form ADV that were effective October 12, 2010, requiring a narrative brochure written in plain English. Part 1 of Form ADV provides regulators with information necessary to process registration and manage their regulatory and examination programs. See Amendments to Form ADV, 75 Fed. Reg. 49,234 (August 12, 2010) (to be codified at 17 C.F.R. pt. 275 and 279).

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are unable to make informed decisions about entering into or continuing the advisory relationship. Failure to act in accordance with requirements under the Advisers Act may constitute a violation. If SEC becomes aware of conflicts of interest that are inadequately disclosed or pose harm to investors, it can take enforcement action against the service provider.

SEC also regulates broker-dealers under the Securities Exchange Act of 1934 (Exchange Act), which requires that broker-dealers register with SEC, unless an exception or exemption applies. In addition, broker-dealers that deal with the public must become members of the Financial Industry Regulatory Authority, Inc. (FINRA).<sup>24</sup> Under the anti-fraud provisions of the federal securities laws, including just and equitable principles of trade, broker-dealers are required to deal fairly with their customers. Salespersons of broker-dealers are subject to licensing requirements, including examinations. Broker-dealers are held to a suitability standard when rendering investment recommendations.<sup>25</sup> When a broker-dealer makes a recommendation to buy, exchange, or sell a security to a retail investor, that broker-dealer must recommend only those securities that the broker reasonably believes are suitable for the customer. In addition, a broker-dealer must disclose all material information regarding the security and the recommendation,<sup>26</sup> including, among other things, any material

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<sup>24</sup>15 U.S.C. §§ 78a et seq. Broker-dealers are regulated by FINRA and by SEC under the federal securities laws and FINRA rules.

<sup>25</sup>The major securities industry self-regulatory organizations (SRO), such as FINRA, impose suitability rules that members must follow. For example, under National Association of Securities Dealers (NASD) Conduct Rule 2310, a FINRA member making an investment recommendation to a customer must have grounds for believing that the recommendation is suitable for that customer's financial situation and needs. In August 2010, FINRA proposed new consolidated rules governing the suitability obligations and know-your-customer obligations of its members. The new rules retain the core features of the current rules, while modifying both rules to strengthen and clarify them. On November 17, 2010, SEC approved the rule changes with slight modifications. See Securities Exchange Act Release No. 63325. 75 Fed. Reg. 71,479 (Nov. 23, 2010). The new rules are effective on October 7, 2011.

<sup>26</sup>See, e.g., *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002) (broker-dealer "is obliged to give honest and complete information when recommending a purchase or sale"); *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 459-61 (9<sup>th</sup> Cir. 1986) (vacating directed verdict for broker-dealer where evidence showed broker-dealer may have violated Exchange Act by failing to disclose material facts relating to risk to his unsophisticated customer and may effectively have exercised control over account); *SEC v. R.A. Holman & Co.*, 366 F.2d 456, 458 (2d Cir. 1966) (salespersons failed to disclose that company had significant losses).

adverse facts or material conflicts of interest.<sup>27</sup> However, according to FINRA staff, up-front general disclosure of a broker-dealer’s business activities and relationships that may cause conflicts of interest with retail customers is not required.<sup>28</sup> SEC staff has noted that, in practice, with broker-dealers, required disclosures of conflicts have been more limited than with investment advisers and apply at different points in the relationship.<sup>29</sup> Table 2 provides a comparison of the standards of conduct required by ERISA, and those required of investment advisers and broker-dealers.

**Table 2: Basic Summary of Standards of Conduct for Investment Service Providers under Federal Law**

Applicable federal law	Standard of conduct	Who must abide by standard of conduct	Specific requirements and prohibitions
Employee Retirement Income Security Act of 1974	<i>ERISA fiduciary standard (prudent man standard of care)</i> : <sup>a</sup> Fiduciary must render services solely in the best interest of plan participants and beneficiaries.	<i>ERISA fiduciary</i> : A person who renders investment advice for a fee or other compensation. Additionally, a person is a fiduciary with respect to a plan to the extent (1) he exercises any discretionary authority or control respecting management of such plan and plan assets, and (2) he has any discretionary authority or responsibility in the administration of such plan. See 29 U.S.C. § 1002(21) for a more detailed description of this provision.	Requires that fiduciaries with respect to the plan not engage in prohibited transactions, as specified in the statute. <sup>b</sup> As such, a conflict of interest does not represent a violation of ERISA’s prohibited transaction rules unless, based on the facts and circumstances, it constitutes self-dealing. EBSA notes that ERISA §404(a) continues to obligate fiduciaries to obtain and consider information relating to potential conflicts of interest by such service arrangements. <sup>c</sup>

<sup>27</sup>See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *SEC v. Hasho*, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992); *In re Richmark Capital Corp.*, Exch. Act Release No. 48758 (Nov. 7, 2003) (SEC opinion) (“When a securities dealer recommends stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware. That includes disclosure of ‘adverse interests’ such as ‘economic self interest’ that could have influenced its recommendation.”)(citations omitted).

<sup>28</sup>Letter from Marc Menchel, Executive Vice President and General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, SEC 4 (Aug. 25, 2010), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121983.pdf>. See, also, GAO, *Consumer Finance: Regulatory Coverage Generally Exists for Financial Planners, but Consumer Protection Issues Remain*, GAO-11-235 (Washington, D.C.: January 2011).

<sup>29</sup>SEC, *Study on Investment Advisers and Broker-Dealers* (Washington, D.C.: January 2011).

Applicable federal law	Standard of conduct	Who must abide by standard of conduct	Specific requirements and prohibitions
The Investment Advisers Act of 1940	<i>Advisers Act fiduciary standard.</i> <sup>d</sup> Person has an affirmative duty to render services solely in the best interests of clients.	<i>Investment adviser:</i> Person who, for compensation, is engaged in the business of advising others as to the value of securities or the purchase or sale of securities.	Requires advisers to eliminate or disclose material conflicts of interest to clients. <sup>e</sup>
Securities Exchange Act of 1934 and rules from SEC and self-regulatory organizations	<i>Regulatory requirements.</i> <sup>f</sup> Broker-dealers are required to deal fairly with customers. Specific obligations are imposed regarding suitability, fair pricing, communications with customers, disclosure, and other business conduct obligations. <sup>g</sup>	<i>Brokers or dealers:</i> <i>Brokers:</i> Person engaged in the business of effecting transactions in securities for the account of others. <i>Dealers:</i> Person engaged in the business of buying and selling securities.	Requires brokers to comply with rules governing their conduct, including the suitability standard, as well as to disclose material conflicts of interest when making recommendations to customers.

Source: GAO analysis of ERISA and securities laws and regulations.

<sup>a</sup>ERISA requires a fiduciary to render services in accordance with a prudent man standard of care, with the care, skill, prudence, and diligence that a prudent man acting in a like capacity and familiar with such matter would use in the conduct. See 29 U.S.C. §1104(a)(1) for a more detailed description of this provision.

<sup>b</sup>See 29 U.S.C. § 1106 for more information about ERISA's prohibited transactions rules.

<sup>c</sup>45 Fed. Reg. 41,603 (Preamble to the Interim Final 408(b)(2) regulations) (July 16, 2010).

<sup>d</sup>In *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963), the Supreme Court recognized that the Advisers Act imposes a fiduciary duty on investment advisers. This standard imposes an affirmative duty to act solely in the best interests of the client. The investment adviser must eliminate or disclose all conflicts of interest.

<sup>e</sup>SEC has, in effect, established rules of conduct for investment advisers, including requirements for disclosing of conflicts of interest, obtaining the best execution on behalf of clients, allocating investments among clients fairly, ensuring that investments are suitable for clients, and ensuring that there is a reasonable basis for recommendations. SEC also requires investment advisers to maintain records pertaining to client accounts and business operations.

<sup>f</sup>The standards of conduct for broker-dealers are also based on antifraud provisions of the securities law and agency principles. Broker-dealers also have a duty of fairness in their contracts with customers and specific business conduct obligations under SRO rules. Broker-dealers that handle discretionary accounts or that have a relationship of trust and confidence are generally thought to owe fiduciary obligations to their customers.

<sup>g</sup>Duties imposed on broker-dealers by the Exchange Act include the duty to supervise persons subject to supervision and the duty to keep records and file reports.

## Recent Legislation

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), signed into law on July 21, 2010, includes provisions that amend the Advisers Act and the Exchange Act that affect investment advisers and broker-dealers. Under these provisions, SEC, among other things, conducted a 6-month study on the effectiveness of existing standards of care for broker-dealers and investment advisers and examined whether there are legal and regulatory gaps, shortcomings, or overlaps in legal or

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regulatory standards in the protection of retail customers.<sup>30</sup> Based on its review, SEC staff recommended that SEC propose rules that apply a uniform standard of conduct which requires broker-dealers and investment advisers, when providing personalized investment advice to retail customers, to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser. SEC staff also recommended that SEC should facilitate the provision of uniform, simple and clear disclosures to retail customers about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest.<sup>31</sup>

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## Service Providers May Have Conflicts of Interest in Providing Investment Assistance to Plan Sponsors because of Third-Party Payments and Other Business Arrangements

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<sup>30</sup>Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824 (2010). A retail customer is defined as a natural person, or the legal representative of a natural person, who receives personalized investment advice from a broker, dealer, or investment adviser and uses the advice primarily for personal, family, or household purposes.

<sup>31</sup>SEC, *Study on Investment Advisers and Broker-Dealers* (Washington, D.C.: January 2011). Dodd-Frank requires that any rules that SEC proposes under the uniform fiduciary standard would be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of the Advisers Act when providing personalized investment advice about securities.

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## Service Providers' Business Arrangements May Create Conflicts of Interest in Investment Assistance Provided to Plan Sponsors

Several industry experts we spoke with cited third-party payments, also known as revenue sharing, as a potential conflict of interest for service providers involved in the fund selection process for a 401(k) plan. Revenue sharing, in the pension 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.<sup>32</sup> According to industry experts, revenue sharing is a widespread practice among 401(k) service providers. As we have previously reported, revenue-sharing payments can be used to offset expenses the plan has agreed to pay and thus be cost-neutral to the plan.<sup>33</sup> However, as shown in figure 2, revenue sharing may, depending on the circumstances, also create a conflict of interest if it is not structured to be cost-neutral to the plan and may result in increased compensation to service providers. Industry experts we spoke with explained that this situation creates an incentive for the service provider to suggest funds with higher revenue-sharing payments. Because of these conflicts of interest, the service provider may suggest funds that have poorer performance or higher costs for participants compared with other available funds. The amount of revenue-sharing payments can vary considerably, both across investment funds and within a fund through different share classes.<sup>34</sup> Documentation we obtained showed revenue-

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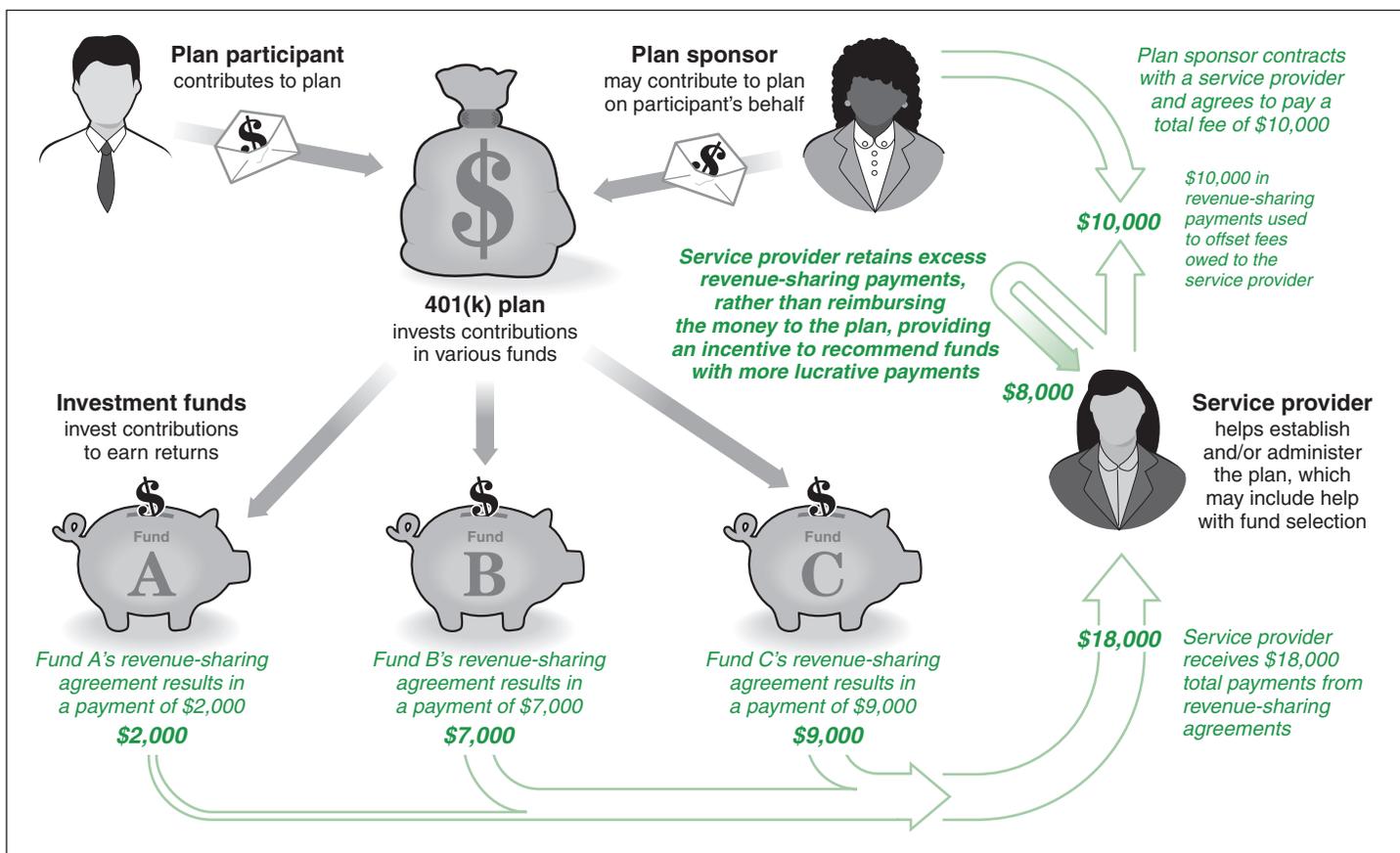
<sup>32</sup>As noted by the 2007 ERISA Advisory Council's Working Group on Fiduciary Responsibilities and Revenue Sharing Practices, "revenue sharing" is a broad term that has a variety of interpretations by industry stakeholders. For example, in the context of investment companies, revenue sharing generally refers to payments by a company's investment adviser, typically to a broker-dealer or other party distributing the company's shares. See SEC, *Mutual Fund Distribution Fees; Confirmations*, 75 Fed. Reg. 47,064 (August 4, 2010). For purposes of our report, we consider revenue sharing to be payments made from one service provider to another in connection with services provided to the plan. In its report, the Working Group recommended that Labor develop definitions of revenue sharing-related terms designed to assist benefit plan sponsors, fiduciaries, service providers, and participants. To date Labor has not acted on this recommendation.

<sup>33</sup>GAO, *Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, GAO-09-503T (Washington, D.C.: Mar. 24, 2009). In the Frost Advisory Opinion 97-15A, regarding ERISA section 406(b)(1) and (3), Labor specifies that revenue-sharing payments should be fully disclosed to the plan and used to offset expenses on a dollar-for-dollar basis or else rebated to the plan if the revenue-sharing payments are made to benefit the fiduciary with discretion over the plan or participant investment or a person in whom the fiduciary would have an interest.

<sup>34</sup>Many mutual funds offer different classes of shares. While each share class in a fund invests in the same pool of securities, the share classes can vary in the shareholder services and fees charged. Consequently, different share classes of the same fund can have different net returns.

sharing payments from hundreds of share classes of different investment funds that ranged from 5 to 125 basis points (bps). Given this variation, EBSA field investigators told us that a service provider might only recommend or include fund share classes that pay higher revenue sharing and exclude other fund share classes that pay lower or no revenue sharing.

**Figure 2: Revenue-Sharing Arrangement That Entails a Conflict of Interest for the Service Provider**



Source: GAO analysis of information from industry practitioners.

Note: In the example above, the service provider receives revenue-sharing payments from three funds offered by the 401(k) plan, which amount to \$18,000. The service provider is owed \$10,000 in fees for assistance provided to the plan. Of the \$18,000 received in revenue-sharing payments, \$10,000 is used to offset the fees owed to the service provider. The service provider has a conflict of interest because, rather than reimbursing the remaining \$8,000 to the plan, the service provider retains the remainder as revenue.

As described in table 3, revenue sharing can include various forms of payments, such as 12b-1 fees, that may create conflicts of interest for

service providers assisting with the selection of investment options for a 401(k) plan.

**Table 3: Examples of Potential Conflicts of Interest for Service Providers from Revenue Sharing and Other Third-Party Payments**

Source of potential conflict	Explanation of payments	Potential conflict of interest
12b-1 fees	<p>Fees known as 12b-1 fees, which EBSA field investigators told us can range from 25 to 100 bps, are paid out of fund assets to other service providers for several purposes, including the following:</p> <ul style="list-style-type: none"> <li>• paying sales-based compensation,</li> <li>• covering marketing expenses,<sup>a</sup> or</li> <li>• for shareholder services.<sup>b</sup></li> </ul>	<p>A service provider may increase its compensation by not refunding or only partially refunding 12b-1 fees to the plan. In some cases, EBSA officials and an industry expert told us that if a fund stops paying 12b-1 fees to a service provider, the service provider may recommend changes to plans to replace funds that no longer pay 12b-1 fees with other funds that pay these fees.</p>
Other sales-based payments, such as front-end or deferred sales loads	<p>A front-end or deferred sales load is charged to investors as a percentage of their investment, generally when they initially invest or redeem their shares, and is used to compensate another party for selling fund shares.<sup>c</sup></p> <p>EBSA field investigators and a service provider representative said that some service providers receive payments of about 100 bps in addition to 12b-1 fees.</p>	<p>If a service provider can increase its compensation through payments from investment funds, it creates a conflict of interest. The service provider has the incentive to recommend funds with higher sales loads or other payments over funds that have lower or no such payments. Example:</p> <ul style="list-style-type: none"> <li>• In a 2006 EBSA enforcement case, a service provider was found to have steered pension plan clients, including 401(k) plans, to invest in a hedge fund that, in turn, paid the service provider an incentive fee. The service provider did not disclose the incentive fee arrangement it had with the hedge fund to its pension plan clients, although it was required to do so. This case is still in litigation.</li> </ul>
Subtransfer agent fees	<p>Subtransfer agent fees are used to reimburse a plan's record keeper for shareholder services the fund would have otherwise provided, such as maintaining participant-level accounts and distributing the fund's prospectus. EBSA field investigators told us that some funds do not pay any subtransfer agent fees, while others pay between 10 and 20 bps. A representative from a large bundled service provider told us the fees received for record-keeping reimbursements from outside funds can range from zero to 40 bps.</p>	<p>According to an industry expert, the payment of subtransfer agent fees is a potential conflict of interest because a service provider may receive most of its compensation from a few funds, so it has the incentive to recommend that those funds be kept in the plan even if they offer inferior performance.<sup>d</sup> Representatives from an advisory firm to many large plans said that, in some cases, a service provider will only recommend funds that pay subtransfer agent fees or other fees back to the provider, which may use these fees to cover expenses or for extra revenue without disclosing this arrangement to plan sponsors or participants.</p>

Source: GAO analysis based on information from industry practitioners and EBSA enforcement cases.

Note: A conflict of interest may or may not be a violation of ERISA or applicable securities laws, depending on the facts and circumstances.

<sup>a</sup>Under FINRA rules, 12b-1 fees that are used to pay marketing and distribution expenses (as opposed to shareholder service expenses) cannot exceed 75 bps of a fund's average net assets per year. NASD Conduct Rule 2830(d)(2)(E).

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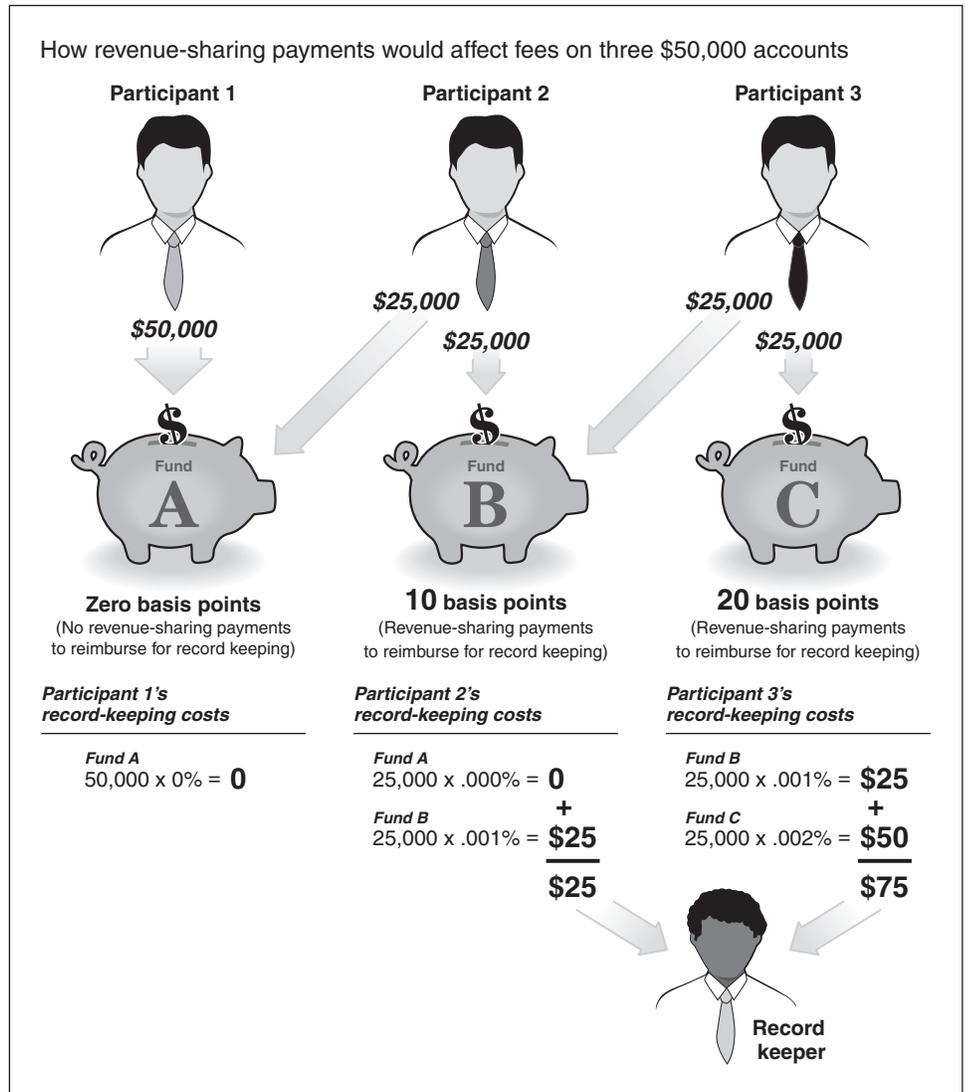
<sup>b</sup>SEC Rule 12b-1 allows mutual funds to pay for marketing and distribution expenses directly from fund assets. Not all funds pay 12b-1 fees and, within a fund, some share classes may pay 12b-1 fees while other share classes do not. While 12b-1 fees are included in a fund's expense ratio, SEC has noted that many investors do not understand these fees nor are they aware the fees are being deducted from their investments. SEC has proposed new rules to replace Rule 12b-1 with a new framework that would separately regulate service fees and asset-based sales charges. See Mutual Fund Distribution Fees; Confirmations, 75 Fed. Reg. 47,064 (August 4, 2010).

<sup>c</sup>SEC does not limit the size of sales load a fund may charge, but FINRA does not permit mutual fund sales loads to exceed 8.5 percent. The percentage is lower if a fund imposes other types of charges. NASD Conduct Rule 2830(d)(1)(2). Both 12b-1 fees and sales loads are required to be disclosed in a fund's prospectus and annual report. A payment to sales personnel can be made through onetime charges against fund assets or it can be built into ongoing fees for the fund.

<sup>d</sup>A record keeper may function as a bundled service provider and also provide investment assistance.

Besides creating a potential conflict of interest, using revenue sharing to reimburse for record-keeping expenses can have other adverse effects on the plan and participants. Service providers told us these payments are often not clearly disclosed to the plan. As shown in figure 3, this could result in participants paying a greater or lesser share of record-keeping expenses depending on which funds they choose to invest their assets. Further, because subtransfer agent fees are based on the amount of assets under management, the record-keeping costs increase as the fund grows and may get quite large if not revised. According to one service provider we interviewed, these fees can result in the plan continuing to pay more for record-keeping services as assets grow, although the cost of providing record-keeping services tends to remain the same.

**Figure 3: Potential Impact of Revenue Sharing on Distribution of Record-Keeping Costs among Participants with Equivalent Account Balances**



Source: GAO analysis of information from industry practitioners.

Note: In the example above, each participant has an account balance of \$50,000 that he allocates to different investment options in his 401(k) plan. Record-keeping expenses for the plan are paid through revenue-sharing payments from funds B and C. Because participant 1 invests exclusively in fund A, which does not have any revenue-sharing payments, he does not pay any record-keeping fees. Participant 2 invests half of his account balance in fund A, which has no revenue-sharing payments, and half in fund B, which has revenue-sharing payments. Thus, participant 2 pays some record-keeping fees through his investments in fund B. Participant 3 pays the most in record-keeping fees because he invests exclusively in funds that make revenue-sharing payments.

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Payments from Brokerage  
Firms to Other Service  
Providers

In addition to revenue-sharing payments from fund companies, payments from brokerage firms, which execute trades for participants' investment funds, to other service providers can also create conflicts of interest related to a 401(k) plan's investments. For example, in a 2007 SEC case, an investment adviser was alleged to have advised its pension plan clients, including 401(k) plans, to use a specific brokerage firm under certain circumstances. The brokerage firm allegedly paid the service provider annual compensation based in part on the amount of commissions generated, which the adviser failed to disclose to its pension plan clients although the adviser was required to do so.<sup>35</sup> The contingent compensation from the brokerage firm to the investment adviser created an incentive for the service provider to steer plans to use that particular brokerage firm.

In other cases, industry experts told us that, at the request of an investment adviser, brokerage firms can use commission revenues from trading shares to make payments to other service providers that can create conflicts of interests if not handled properly. Under the Securities Exchange Act of 1934, investment advisers are permitted to pay broker-dealers more than the lowest available commission rate for trading shares under certain circumstances.<sup>36</sup> The investment adviser can direct the broker-dealer to use the commission revenues to pay the fees of other service providers or to purchase services of value to investors, such as investment research to improve the management of the fund.<sup>37</sup> However, if the commission revenues are not used for the benefit of the plan, it could create a conflict of interest. A 2005 SEC report concerning examinations

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<sup>35</sup>*In the Matter of Callan Associates*, Order Instituting Administrative And Cease-And-Desist Proceedings, Advisers Act Release No. 2650 (September 19, 2007). Following the SEC investigation, the service provider revised its disclosures to include the compensation contingent from the brokerage firm. In addition, SEC ordered the respondent to cease and desist from committing or causing any violations and any future violations of section 207 of the Advisers Act.

<sup>36</sup>Under a safe harbor provision in section 28(e) of the Securities Exchange Act of 1934, advisers are permitted to pay more than the lowest available commission rate for security transactions in return for research and brokerage services and not be in breach of their fiduciary duty. 15 U.S.C. § 78bb(e). In order to be protected against a claim of breach of fiduciary duty under this safe harbor provision, the adviser must make a good faith determination that the amount of commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

<sup>37</sup>Commission revenues can be used to pay fees of other service providers through a directed brokerage arrangement, also referred to as "commission recapture." In a directed brokerage arrangement, the plan directs the fund manager to use a specified broker-dealer, which will then rebate all or a portion of the commission revenues to the plan or pay the fees of another service provider, such as the investment adviser.

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of pension consultants identifies several areas of concern and examples of poorly managed conflicts of interest.<sup>38</sup> For example,

- Using commission revenues to pay for another service provider’s fees, (i.e., a “commission recapture” arrangement) such as for a pension consultant, can result in greater compensation to that service provider, because such arrangements may not be capped to terminate when fees due to the service provider have been paid in full, resulting in the plan overpaying for services.
- These arrangements are not always well documented and raise concerns that plans may not receive “best execution,” meaning that the plan’s service provider may recommend that the plan use a broker-dealer with whom it has such an arrangement even if the broker-dealer does not offer the most favorable terms for the plan.
- These arrangements can also create the incentive for the service provider to recommend a more active trading strategy to increase the number of transactions and, consequently, the amount of commissions.

#### Other Business Arrangements That May Create Conflicts of Interest

In addition to payments among service providers, other types of business arrangements can also create conflicts of interest. As shown in table 4, service providers may have affiliated businesses, such as proprietary investment funds or a brokerage arm, that can profit from the investment of plan assets. For example, a service provider that offers its own investment funds has the incentive to steer plan sponsors to select these proprietary funds even if other funds are available from different providers that better suit the needs of the plan.

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<sup>38</sup>See SEC, *Staff Report Concerning Examinations of Select Pension Consultants* (Washington, D.C.: May 16, 2005), 4. SEC officials told us the issues identified in their review of pension consultants were resolved through remediation.

**Table 4: Examples of Potential Conflicts of Interest from a Service Provider’s Affiliated Businesses**

Source of potential conflict from affiliated businesses	Potential conflict of interest
Bundled service provider with proprietary investment funds	<p>A service provider has an incentive to recommend its own funds to the plan even if other funds that better suit the needs of the plan might be available from other fund providers.</p> <p>Industry experts we interviewed gave the following examples:</p> <ul style="list-style-type: none"> <li>• Bundled providers may require plan sponsors to include their proprietary funds as investment options in the plan as a prerequisite to servicing the plan.</li> <li>• Bundled providers may require the plan to designate one of their proprietary funds as the qualified default investment alternative (QDIA).<sup>a</sup></li> </ul> <p>Representatives of bundled service providers that offer proprietary funds we spoke with said that they do not offer investment advice as ERISA fiduciaries. However, representatives from other service providers told us that many plans rely on investment recommendations from these service providers without recognizing the potential conflict.</p>
Service provider with affiliated brokerage arm	<p>The service provider may advise plans to select investment funds that use the services of its affiliated brokerage arm, which results in greater revenue to the affiliate and, potentially, the service provider.</p> <p>Representatives from advisory firms we interviewed provided the following example:</p> <ul style="list-style-type: none"> <li>• A service provider with an affiliated brokerage arm only recommends investment funds that use the services of its brokerage arm; likewise, the investment fund provider uses a specific brokerage firm in order to win favorable recommendations from the brokerage firm’s affiliated service provider. Such arrangements may not be disclosed to plan sponsors or participants.</li> </ul> <p>In a 2009 case, SEC found that a service provider with an affiliated brokerage arm advised its pension plan clients, including 401(k) plans, to direct their investment fund providers to execute trades through the affiliated brokerage arm.<sup>b</sup> Although this arrangement resulted in significantly higher revenue to both the service provider and the affiliate, the service provider did not disclose the conflict of interest as required.</p>

Source: GAO analysis based on information from industry practitioners and an SEC enforcement case.

Note: A conflict of interest may or may not be a violation of ERISA or applicable securities laws, depending on the facts and circumstances.

<sup>a</sup>For more information on QDIAs, see a forthcoming GAO report.

<sup>b</sup>In the Matter of Merrill Lynch, Pierce, Fenner, and Smith, Inc., Investment Advisers Act Release No. 2834 (January 30, 2009). The firm agreed to settle charges with SEC and pay a civil money penalty of \$1 million.

**Many Service Providers Are Reported to Arrange Their Association with Plan Sponsors in a Manner That Avoids ERISA Fiduciary Responsibility**

Although service providers that are subject to ERISA fiduciary standards are prohibited from benefiting from the investment of plan assets, many service providers that assist in selecting investment options are reported to structure their relationships with plans to avoid being subject to these standards. Under ERISA, a person who provides investment advice for direct or indirect compensation is a fiduciary; however, the EBSA regulations currently in effect establish a five-part test, each part of which must be met, to determine if a service provider is a fiduciary for purposes

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of providing investment advice.<sup>39</sup> Many industry experts we spoke with said that service providers often do not meet one or more parts of the test and thus avoid being subject to ERISA fiduciary standards. Consequently, these service providers may have a conflict of interest by increasing their compensation based on the funds selected by the plan without violating ERISA. Service providers may structure their association with a 401(k) plan to avoid meeting one or more parts of the current five-part test, as shown in figure 4. For example, an ERISA attorney said that although service providers give investment recommendations, they will include a provision in their contract that states that the investment recommendations provided are not intended to be the primary basis for decision making. A recent report by Labor’s OIG found that some service providers included in their review and identified to have significant undisclosed conflicts of interest attempted to avoid meeting the criteria for ERISA fiduciary status under the current five-part test by simply stating in their investment adviser contract that they were not fiduciaries.<sup>40</sup> The 2010 report examined EBSA’s handling of certain service providers, acting as pension consultants, that were determined by SEC in a 2005 staff report to have significant undisclosed conflicts of interest. According to the SEC report, many plan sponsors rely heavily on these pension consultants in making investment decisions. Other industry experts said that a service provider can avoid meeting the criteria of the five-part test if it offers investment recommendations as part of setting up the plan, rather than on a regular, recurring basis (see table 5). According to EBSA

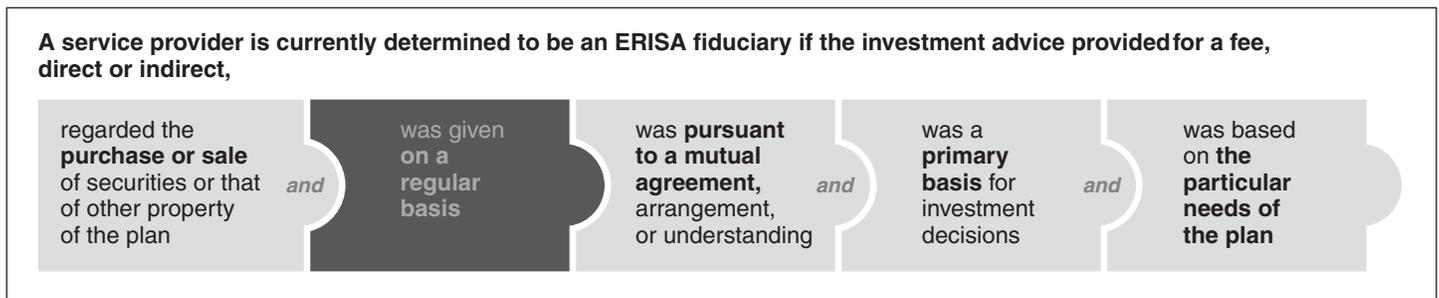
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<sup>39</sup>As mentioned previously, on October 22, 2010, EBSA published proposed regulations that would eliminate the current five-part test and establish a new definition to be used to determine whether a service provider is a fiduciary. In the preamble to the proposed regulations, EBSA acknowledge that the five-part test, which has not been updated since its promulgation in 1975, “significantly narrows” the plain language of the statutory definition of fiduciary. 75 Fed. Reg. 65,263, 65,264.

<sup>40</sup>U.S. Department of Labor, Office of Inspector General, *EBSA Needs to Do More to Protect Retirement Plan Assets from Conflicts of Interest*, Report No. 09-10-001-12-121, September 30, 2010.

officials, it can easily be asserted by a service provider that advice given on a onetime basis does not meet the five-part test.<sup>41</sup>

**Figure 4: 401(k) Service Provider May Fail to Be Deemed an ERISA Fiduciary for Purposes of Investment Advice by Not Meeting One Part of EBSA's Current Five-Part Test**



Source: GAO analysis of EBSA regulations.

Note: The current five-part test is reflected in EBSA's regulations. 29 C.F.R. § 2510.3-21(c).

<sup>41</sup>Information from EBSA generally confirms that this practice is occurring to some degree. Specifically, EBSA has acknowledged that its recent enforcement activities indicate that there are a variety of circumstances, outside those described in the five-part test, under which plan fiduciaries seek out impartial assistance and expertise of persons such as consultants and other advisers for advice on investment-related matters. According to EBSA, these persons significantly influence the decisions of plan fiduciaries and have a considerable impact on investments; however, if these advisers are not fiduciaries under ERISA (as they are often not under the current five-part test), they often operate with conflicts of interest that they do not disclose to plan fiduciaries who expect impartiality. EBSA notes further that "the current test . . . makes it easy for consultants to structure their actions to avoid fiduciary status." 75 Fed. Reg. 65,263, 65,265, 65,271.

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**Table 5: Potential Conflict of Interest Scenario for Investment Assistance Provided to Plan Sponsors**

The following example describes how a service provider may steer plan sponsors to select investment funds in which the service provider has a conflict of interest without giving formal investment advice subject to ERISA fiduciary standards:

- A plan sponsor works with a service provider to establish a 401(k) plan. The service provider presents investment fund options to the plan sponsor for consideration, but does not formally recommend the selection of any particular investment fund. The plan sponsor will select 20 funds to offer in the 401(k) plan.
- The service provider representative can receive compensation, such as through 12b-1 fees or a sales load, from these funds and selects those 20 funds that provide the highest payments for the plan's consideration.
- The representative does not consider himself to be acting as an ERISA fiduciary because the plan sponsor makes the final decision about which investment options to include in the plan.

Alternatively, the representative may provide a larger pool of funds (e.g., 50 funds) for the plan's consideration. Although the plan sponsor selects from a larger pool of funds, the service provider still has a conflict of interest because the representative chooses the 50 funds that provide the highest payments.

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Source: GAO example based on information from industry practitioners.

When selecting investment options for the plan, plan sponsors can work with various types of service providers subject to different regulations, some of which may not be required to provide advice in the best interest of the plan or disclose conflicts of interest. Several industry experts we interviewed said that while some plan sponsors hire registered investment advisers (RIA) who are subject to SEC regulations and often acknowledge ERISA fiduciary responsibility, many other plan sponsors work with broker-dealer or insurance company representatives who are not subject to ERISA fiduciary responsibility and may also not be subject to SEC regulations. Under the Advisers Act, RIAs must seek to avoid conflicts of interest and, at a minimum, make full disclosure of material conflicts of interest.<sup>42</sup> However, other service providers, such as insurance company representatives, may not be subject to ERISA fiduciary duty or certain SEC regulations and thus may not be required to make recommendations in the best interest of their clients, or to disclose all conflicts of interest.<sup>43</sup> Furthermore, plan sponsors may contract directly with a bundled service

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<sup>42</sup>15 U.S.C. § 80b-1 et seq., Rule 204-3, and Form ADV.

<sup>43</sup>However, Labor issued interim final regulation due to take effect in July 2011 that will require certain service providers to disclose information to assist plan fiduciaries in assessing the reasonableness of contracts or arrangements, including the reasonableness of the service providers' compensation and potential conflicts of interest, that may affect the service providers' performance. 75 Fed. Reg. 41,600.

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provider that offers its own investment funds and does not provide formal investment advice subject to ERISA or SEC regulations.

No comprehensive data are available to determine how many service providers are ERISA fiduciaries for purposes of providing investment advice. Although plan sponsors are required to provide certain information about the plan and service providers in annual filings to EBSA, this information does not include which service providers are acting as ERISA fiduciaries. As we previously reported, ERISA requires that at least one fiduciary be named in the plan documents provided to participants, although others may be identified voluntarily.<sup>44</sup> Consequently, determinations as to ERISA fiduciary status of service providers may not be made unless an investigation by EBSA is initiated or a lawsuit is filed claiming that the plan has been harmed. Misunderstanding can also occur because many large providers offer a range of services that a sponsor can choose from, including some that involve fiduciary duties and others that may not.<sup>45</sup>

Despite reports indicating that many service providers are not acting as ERISA fiduciaries in providing investment assistance, industry experts and EBSA field investigators told us that plan sponsors are often not aware when a service provider is not an ERISA fiduciary and often assume the advice they receive from them is subject to these standards.<sup>46</sup> Consequently, plan sponsors may not be aware that service providers can have a financial incentive to recommend certain funds that would be prohibited if they were ERISA fiduciaries. As we previously reported, plan sponsors may also assume they have delegated all of their fiduciary duties to an outside professional hired to run the plan, even though the sponsor always retains some fiduciary obligation.<sup>47</sup> Several industry experts we

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<sup>44</sup>29 U.S.C. § 1102(a) and GAO, *Private Pensions: Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors*, [GAO-08-774](#) (Washington, D.C.: July 16, 2008).

<sup>45</sup>A service provider may be a fiduciary for purposes of some services it provides to a plan, but not others. For example, a service provider may be an ERISA fiduciary by virtue of having responsibility for the administration of a plan, but the same company may not be an ERISA fiduciary when providing investment assistance that does not meet the five-part test.

<sup>46</sup>EBSA's interim final regulations scheduled to take effect in July 2011 require certain service providers to disclose to plan sponsors whether they reasonably expect to provide services as a fiduciary under their contract or arrangement with the plan. See proposed 29 C.F.R. § 2550.408b-2(c)(1)(iv)(B), 75 Fed. Reg. 41,600, 41,635.

<sup>47</sup>[GAO 08-774](#).

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spoke with, including EBSA field investigators, indicated that there is a considerable amount of confusion among plan sponsors about whether or not they are receiving investment advice subject to ERISA fiduciary standards. For example, unless disclosed on the schedule A of the annual form 5500, they noted that, in their opinion, plan sponsors are generally not aware, when dealing with service providers who are broker-dealers or insurance company representatives, that the providers are not giving formal investment advice subject to ERISA fiduciary standards and thus may be earning sales-based compensation on fund sales. Contributing to the confusion, broker-dealers or insurance company representatives can refer to themselves as advisers even though they are not providing advice as ERISA fiduciaries and are receiving sales-based compensation.<sup>48</sup> A service provider representative said that, from the plan sponsor's perspective, investment assistance provided by a nonfiduciary service provider that may have conflicts of interest often looks very similar to investment advice provided by an independent service provider with no ties to investment funds.

Smaller plans may be more exposed to conflicts of interest on the part of service providers because they are less likely than larger plans to receive investment assistance from a service provider that is acting as a fiduciary. Several industry experts we spoke with said that larger plans are much more likely to employ RIAs who are subject to fiduciary standards under the Advisers Act in providing investment advice. Larger plans may also have sufficient resources and in-house expertise to make investment decisions without assistance. Smaller plans, on the other hand, often lack the resources to perform these tasks in-house or to hire an independent adviser who will act as an ERISA fiduciary. Smaller plans also often receive investment assistance from insurance brokers or broker-dealers, who are not acting as ERISA fiduciaries and also may not be subject to

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<sup>48</sup>The preamble to EBSA's proposed regulations of October 22, 2010, notes that the five-part test applies even to persons who represent themselves to the plan as fiduciaries in rendering advice. The preamble explains that a consultant could hold itself out as a plan fiduciary in a written contract with the plan, render investment advice for a fee, and still evade fiduciary status by structuring its activities to avoid meeting some element of the five-part test. 75 Fed. Reg. 65,263, 65,271.

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fiduciary standards under the Advisers Act, which requires the adviser to act solely in the best interests of the client.<sup>49</sup>

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### Conflicts of Interest in the Selection of Investment Options May Cause Problems for Plan Sponsors and Reduce Participants' Savings for Retirement

The potential conflicts of interest described by industry experts we interviewed could cause problems for plan sponsors if appropriate action is not taken. Under ERISA, plan sponsors are obligated to take steps to identify and address service providers' potential conflicts of interest and ensure that the plan is run in the best interest of participants.<sup>50</sup> For example, an advisory opinion issued by EBSA describes conditions under which revenue-sharing payments received by a fiduciary are permissible under ERISA. Specifically, the advisory opinion states that, in order for a fiduciary to avoid a prohibited transaction, revenue-sharing payments should be fully disclosed to the plan and used either to offset fees the plan is obligated to pay, on a dollar-for-dollar basis, or else be rebated to the plan.<sup>51</sup> In addition, EBSA and SEC developed a list of questions to assist plan sponsors with identifying and assessing service providers' potential conflicts of interest that is available on SEC's Web site.<sup>52</sup> The questions include inquiries about a service provider's compensation, affiliations, or other business relationships with money managers, and ERISA fiduciary status. Representatives of service providers and ERISA attorneys we spoke with also described steps plan sponsors could take to address service providers' potential conflicts of interest. For example, plan sponsors could

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<sup>49</sup>Broker-dealers are subject to a system of regulations. They generally are required to make recommendations that are consistent with the interests of their customers and generally must disclose material conflicts of interest to their customers when making recommendations. As noted above, Dodd-Frank gives SEC the authority to issue regulations harmonizing the standards of conduct required of investment advisers and broker-dealers when providing personalized investment advice about securities to retail clients and other such customers as SEC may provide by rule. If SEC promulgates such rules, broker-dealers and investment advisers would be required to act in the best interests of their customers without regard to their own financial or other interests, and disclose material conflicts of interest. The rules shall also provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under Sections 206(1) and (2) of the Advisers Act.

<sup>50</sup>75 Fed. Reg. 41,600, 41,603.

<sup>51</sup>Frost Advisory Opinion 97-15A and ERISA § 406(b)(3). In addition, Labor proposed interim final regulations in July 2010 to require service providers report sources of direct and indirect compensation to plan sponsors. These regulations are scheduled to become effective in July 2011.

<sup>52</sup>SEC and Labor, *Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries*, <http://www.sec.gov/investor/pubs/sponsortips.htm>, June 2005.

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- examine a service provider's direct and indirect compensation,
  - ensure that the investment options offered are diversified and not entirely composed of the service provider's proprietary funds,
  - negotiate for institutional fund share classes which do not have revenue-sharing payments so that fees are paid through direct charges to the plan,<sup>53</sup> or
  - specify in their contract that the service provider will not receive any compensation other than what is allowed for in the contract.

Although plan sponsors may take steps to address potential conflicts of interest, several industry experts we spoke with said that the complexity of service providers' business arrangements and insufficient disclosures pose challenges to plan sponsors who want to obtain information regarding potential conflicts. Some of these conflicts might rise to the level of a prohibited transaction, such as self-dealing. Even though revenue sharing is reported to be a widespread practice among 401(k) service providers, several industry experts we spoke with said that plan sponsors, especially of smaller plans, may not fully understand or even be aware of these payments. Further, some industry experts said that even if disclosures are provided, they are very complicated and difficult to understand.

If not addressed, conflicts of interest could lead to 401(k) plans offering investment funds with higher fees or mediocre performance, which can substantially reduce the amount of savings available for retirement. A service provider with a conflict of interest may steer plan sponsors toward investment funds that increase the service provider's compensation even if other funds with better performance are available at equal or lower cost. Several industry experts we interviewed said that the financial impact of conflicts of interest can be considerable. For example, representatives from one service provider we interviewed said fees for plans that have been managed by service providers with conflicts of interest can be reduced by 30 percent or more. Similarly, a representative from an advisory firm that does not accept payments from investment funds said that, in some cases, fees for the firm's 401(k) plan clients are reduced by 180 bps or more. As we previously reported, however, a detailed financial audit would be necessary

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<sup>53</sup>In one case, the 401(k) plan sponsor was found to have breached its fiduciary duty of prudence by choosing to offer investments in the retail share class rather than the institutional share class of certain funds, which engaged in revenue sharing. *Tibble v. Edison Int'l*, 2010 WL 2757153 (C.D. Cal. July 8, 2010).

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to precisely estimate the financial impact of a conflict of interest in a specific situation.<sup>54</sup> While the financial harm from conflicted investment advice is difficult to estimate, several studies provide a general sense of the magnitude of the effect of an increase in fees for retirement savings over a worker's career. Based on a 1 percentage point increase in fees, projections from EBSA, a prior GAO report, and an industry study range from a 17 to 28 percent decline in final account balances.<sup>55</sup> The size of the impact varies based on the time horizon, the projected rate of return, and other assumptions made in the projection.

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<sup>54</sup>GAO-07-703. In this report on DB plans, we found lower annual rates of return for ongoing plans associated with pension consultants who had failed to disclose significant conflicts of interest, with lower rates generally ranging from a statistically significant 1.2 to 1.3 percentage points over the 2000 to 2004 period. Although this negative association between the presence of a conflict of interest and investment returns is consistent with what industry experts told us, limitations of this analysis did not allow us to establish causality.

<sup>55</sup>Department of Labor, *A Look at 401(k) Plan Fees*, [http://www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html). GAO 07-21. Janet Rubenstein and Jeff Marzinsky, *A 401(k) Plan that Works—the “Bundled Unbundled” Solution*, Milliman White Paper, February 21, 2007. Over a 35-year time horizon, EBSA estimates that a 1 percentage point increase in fees reduces final savings by 28 percent. Over a 20-year time horizon, GAO estimates that a 1 percentage point increase in fees reduces final savings by 17 percent. Over a 40-year time horizon, Rubenstein and Marzinsky estimate that a 1 percentage point increase in fees reduces final savings by 26 percent. In addition, a study by the Center for Retirement Research estimates that a 0.7 percentage point fee reduces final savings by more than 12.5 percent over a 30-year time horizon. See Richard W. Kopcke, Francis M. Vitagliano, and Zhenya S. Karamcheva, *Reducing Costs of 401(k) Plans with ETFs and Commingled Trusts*, Center for Retirement Research at Boston College, July 2010.

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## Participants May Receive Conflicted Investment Education and Advice from Service Providers in Certain Circumstances, but Enhanced Disclosure Could Help Mitigate Such Conflicts

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### Participants May Perceive Investment Education as Advice and May Be Unaware of Situations when Service Providers Have Conflicts of Interest

Participants may be unaware that service providers, when furnishing education, may have financial interests in the investment options available to participants. For example, investment education, which may be provided to participants in brochures, other written materials, and computer models, can include asset allocation models that highlight specific investment options as examples of investments available under an asset class.<sup>56</sup> In particular, funds in which the service provider has a financial interest can be highlighted and participants may perceive this information as investment advice. In one case, representatives from a service provider for many large 401(k) plans told us that because the company can highlight its own funds as examples of investment options under each asset class through investor education, it has no plans to offer investment advice. While investment advice is subject to ERISA fiduciary standards, which require that the advice must be in the participant's best interest and prohibit the adviser from having a financial interest in the investment options recommended, investment education is not subject to these standards.<sup>57</sup> Thus, a provider furnishing education may do so despite a conflict of interest, such as a financial stake in the outcome of participants' investment decisions. EBSA requires providers who highlight proprietary funds as part of an asset allocation model to provide a

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<sup>56</sup>The various formats used for furnishing investment education and advice are described in appendix II. The various types of computer models used to dispense investment advice are described in appendix III.

<sup>57</sup>29 U.S.C. §§ 1002(21)(A)(ii). See also 29 C.F.R. § 2509.96-1 concerning constraints involving participant education.

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statement that other investment options may be available under a plan; however, this statement may not sufficiently prevent participants from construing information on investment alternatives as advice.<sup>58</sup> For example, the statement is not required to explain that the service provider is not providing advice as an ERISA fiduciary who is required to act in the participants' best interests, and the provider may stand to profit from participants' investment decisions. Consequently, without the benefit of an enhanced disclaimer that explicitly states that the highlighted funds are not advice and that the service provider may have a financial interest in the funds, participants may believe that providers are giving investment advice that is in participants' best interests, even in situations where this may not be the case. In addition to furnishing asset allocation models, some service providers may highlight specific investment funds in communications with participants, as part of providing investment education, by using language such as "you may wish to consider [this investment fund]" instead of "I recommend," which makes a subtle differentiation between investment education and advice that most participants will not understand. Moreover, agency field investigators said that service providers who avoid rendering formal investment advice subject to ERISA fiduciary standards may, nonetheless, refer to themselves as investment advisers to participants. Participants who confuse investment education for impartial advice may choose investments that do not meet their needs, pay higher fees than with other investment options, and have lower savings available for retirement.

Although several industry professionals said that providing investment advice to participants through computer models, subject to ERISA standards, has advantages in addressing potential conflicts of interest, others said that these models could have biases that are difficult to detect. While investment advice—through a direct service arrangement—can be provided to participants through a computer model from a service provider that does not have any affiliations with the investment options offered, two other computer model arrangements are permitted, the SunAmerica and the Pension Protection Act (PPA) eligible investment advice arrangements, in cases where the service provider may have a conflict of interest (see table 6). See appendix II for more information

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<sup>58</sup>29 C.F.R. § 2509.96-1(d)(3)(iii).

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regarding the common formats providers use to deliver investment education and advice.<sup>59</sup>

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**Table 6: Types of Investment Advice Arrangements and Computer Models**

Advisory opinions, guidance by EBSA, and the Pension Protection Act of 2006 set forth additional arrangements for investment advice that may be provided—by service providers if they meet applicable requirements—to plan participants in specified circumstances:

- **SunAmerica advice arrangement**—in December 2001, EBSA issued an advisory opinion (2001-09A), in response to a request by SunAmerica Retirement Markets Inc., asking if a retirement plan provider could hire an independent third party to provide participants in a 401(k) plan with investment advice using asset allocation models. EBSA, in the advisory opinion, specified that such advice arrangements were allowed as long as certain requirements were met. For example,<sup>a</sup>
  - The asset allocation model must be developed and maintained by an independent financial expert.
  - The advice arrangement must preserve the financial expert’s ability to develop the model portfolios solely in the interest of the plan participants and beneficiaries.
  - Participants have the option to implement or disregard the investment advice generated by the model.
- **Pension Protection Act’s eligible investment advice arrangements**—Section 601 of the PPA provided two eligible investment advice arrangements (EIAA)—in the form of statutory exemptions from ERISA’s prohibited transaction rules—for fiduciaries who might otherwise have conflicts of interest when rendering investment advice: (1) computer model-based advice arrangements and (2) level fee-based advice arrangements. For both types of arrangements, PPA provisions set forth compliance requirements. In addition, EBSA has proposed regulations pursuant to the PPA to outline additional technical requirements for PPA EIAs. 75 Fed. Reg. 9,360.
  - PPA computer model arrangement—advice may be provided to participants or beneficiaries using a computer model that, among other things, is certified by an eligible investment expert and audited annually by an independent auditor.<sup>b</sup>
  - PPA fee-leveling arrangement—advice may be provided to participants or beneficiaries by an adviser whose compensation does not vary depending on the basis of any investment option selected by plan participants or beneficiaries. This advice arrangement must be audited annually by an independent auditor. Labor has stated (see Field Assistance Bulletin No. 2007-01) that such requirements do not extend to fiduciaries’ affiliates.

<sup>a</sup>The requirements listed above are just a few examples of the requirements detailed in EBSA’s Advisory Opinion. See advisory opinion 2001-09A for a complete list of requirements.

<sup>b</sup>According to the proposed regulations, the computer model must also (1) apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time; (2) utilize relevant information about the participant, which may include age, life expectancy, retirement age, and risk tolerance; (3) utilize prescribed objective criteria to provide asset allocation portfolios composed of investment options available under the plan; (4) operate in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person with material affiliation or contractual relationship with the fiduciary adviser; and (5) take into account all investment options under the plan in specifying how a participant’s account balance should be invested and is not inappropriately weighted with respect to any investment option.

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Source: GAO review of the PPA and EBSA regulations and materials.

Several industry professionals we interviewed said these models ensure consistency in the content of the advice rendered to multiple participants.

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<sup>59</sup>A service provider who may otherwise have a conflict of interest may furnish investment advice using either the SunAmerica arrangement (EBSA Advisory Opinion 2001-09A), which requires a provider to contract with an independent advice provider to furnish advice, or the PPA computer model arrangement, which allows a provider to furnish advice in-house if the provider can meet specific compliance requirements. See appendix III for more information on the advice arrangements.

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In addition, unlike a one-on-one consultation or group presentation, a computer model may be audited to determine whether it is generating impartial information.<sup>60</sup> Despite these advantages of computer model-based advice, other industry professionals said that it is possible to build biases into these models that may be difficult to detect. For example, a computer model may be designed to exclude certain types of investment options, which results in situations in which participants are receiving advice that does not include all investment options available to participants. In particular, representatives from one service provider told us that a computer model's exclusion of target date funds could allow a provider to steer participants toward investment options that charge higher fees, such as managed accounts.

Although a number of studies have been conducted about the availability of investment assistance for participants, these studies do not always discern whether participants are provided investment education or advice.<sup>61</sup> According to a poll of 401(k) plan sponsors and service providers that we conducted in coordination with the Society of Human Resource Management and the Society of Professional Asset-Managers and Record Keepers, investment education is more commonly offered to participants than investment advice, although many respondents offered both.<sup>62</sup> Among respondents, brochures or other written materials were one of the most commonly used formats for delivering education and advice. Computer modeling, including Web-based tools, was also one of the most common methods of delivery reported.

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<sup>60</sup>The PPA arrangement, which allows the fiduciary adviser to design the computer model, requires the model to undergo annual audits. By contrast, the SunAmerica arrangement relies upon an independent financial expert to develop the computer model and does not require the model to undergo annual audits.

<sup>61</sup>See, e.g., Hewitt Associates. *Trends and Experience in 401(k) Plans*. (Hewitt Associates LLC, 2009); Hewitt Associates, *Help in Defined Contribution Plans: Is It Working and for Whom?* (Hewitt Associates LLC, 2010); Annamaria Lusardi, "Household Savings Behavior: The Role of Literacy, Information, and Financial Education Programs." (Dartmouth College and NBER 2008).

<sup>62</sup>Because of methodological limitations associated with the polls with SHRM and SPARK, results from these polls represent only the views of the poll respondents. Please see appendix I for further details regarding our methodology.

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## Conflicts of Interest May Arise from Compensation to Service Providers for Cross-Selling Financial Products outside of Retirement Plans to Participants

Several industry experts we spoke with said that conflicts of interest also arise for 401(k) service providers who sell nonplan products and services, such as IRA rollovers, to participants outside their 401(k) plan, a practice known as cross-selling, which can considerably increase the service provider's compensation. While IRAs may serve participants' retirement needs by assisting them in saving for retirement, industry professionals we spoke to had concerns about the manner in which providers cross-sell IRA rollovers and other products to participants. Cross-selling products outside of a plan to participants can substantially increase a service provider's compensation, which creates an incentive for the service provider to steer participants toward the purchase of these products even though such purchases may not serve the participants' best interests. For example, products offered outside a plan may not be well suited to participants' needs or participants may be able to secure lower fees by choosing investment funds within their plans comparable with products offered outside their plans.<sup>63</sup> Industry professionals we spoke with said that cross-selling IRA rollovers to participants, in particular, is an important source of income for service providers. For example, according to an industry professional, a service provider could earn \$6,000 to \$9,000 in fees from a participant's purchase of an IRA, compared with \$50 to \$100 in fees if the same participant were to invest in a fund within a plan.

Plan sponsors can take steps to preclude service providers from cross-selling nonplan products and services to plan participants. For example, some plan sponsors require their plans' service providers to sign nonsolicitation agreements that prevent the service providers from marketing nonplan products and services to participants, but such agreements may not be widely used among plan sponsors. In addition, some service providers do not directly cross-sell products and services outside of a 401(k) plan to participants unless the service providers obtain permission from plan sponsors to do so, or unless participants initiate the discussion with service providers and inquire about products and services that are outside of their plans' investment offerings. According to our poll of 401(k) plan sponsors and service providers, of the 475 SHRM respondents who sponsored a 401(k) plan, 30 respondents explicitly allowed providers to market, or cross-sell, nonplan products to participants. Among the 30 respondents who allowed providers to engage

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<sup>63</sup>A former employee with a retirement plan account balance of \$5,000 or more may keep funds in the existing plan after leaving a job. See 29 U.S.C. § 1053(e)(1) and 26 U.S.C. § 411(a)(11)(A).

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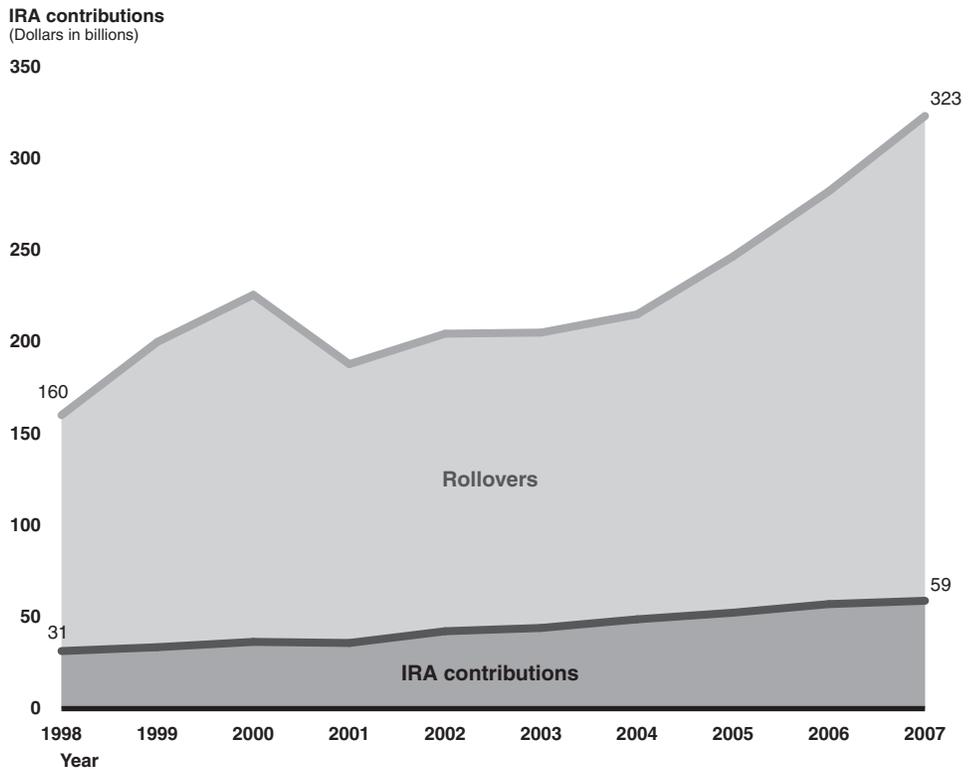
in cross-selling, IRA rollovers were the most common product marketed to participants. However, the extent of cross-selling may be greater than reflected by the poll responses because service providers may do so without explicit permission. An industry professional told us that many sponsors of small and midsized plans may not be aware that their providers are cross-selling nonplan products and services to plan participants; hence, sponsors would not know to ask their providers to stop cross-selling nonplan products to participants.

Available data on IRA rollovers indicate that many participants choose to roll their assets into an IRA rather than keep their assets in an existing plan or roll them into a new employer's plan. As shown in figure 5, from 1998 to 2007, more than 80 percent of funds flowing into IRAs came from rollovers of lump-sum payments or account balances from defined benefit and defined contribution plans.<sup>64</sup>

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<sup>64</sup>From 1998 to 2007, rollovers into IRAs constituted \$2.25 trillion of the \$2.69 trillion in total funds flowing into IRAs. As of year end 2009, an estimated \$4.2 trillion of total U.S. retirement assets was held in IRAs, while \$4.1 trillion was held in DC plans (including 401(k)s). See Investment Company Institute, "The U.S. Retirement Market, 2009," *Research Fundamentals*, Vol. 19, No. 3, 3 (May 2010).

**Figure 5: IRA Assets from Contributions and Rollovers, 1998 to 2007**



Source: Investment Company Institute.

According to data collected in 2006 from the Survey of Income and Program Participation, a survey relating to income and related information conducted by the U.S. Census Bureau, approximately 69 percent—or approximately 4.87 million—survey respondents who received a lump-sum distribution from their retirement plans rolled their distributed funds into IRAs.<sup>65</sup> Additionally, as shown in table 7, data from three large service providers indicate that, among participants who terminated their DC plan,

<sup>65</sup>The 2004 SIPP surveyed sampled U.S. households (with sample sizes ranging from approximately 14,000 to 36,700 households) in different waves over a 2.5-year period, with interviews lasting into 2006. About 7 million (7,055,207) survey respondents received a lump-sum distribution of their plan funds from a previous employer. Of these, about 69 percent—or 4,868,093 survey respondents—rolled over their funds into an IRA. See United States Department of Commerce, Bureau of the Census, 2005-11-02, “Survey of Income and Program Participation (SIPP) [2004 Panel, Wave 7].

between 42 and 48 percent of participants' plan assets were rolled into IRAs in the observed time periods.

**Table 7: Trends in Distribution of Defined Contribution Plan Assets when Participants Terminate Their Plans**

(percent)

	Service provider 1 <sup>a</sup> 03/2005 to 05/2010	Service provider 2 <sup>b</sup> 01/2008 to 03/2009	Service provider 3 <sup>c</sup> calendar year 2008
Rolled funds into IRAs	48	43	42
Took cash or other distributions	11	8	6
Took other forms of distributions	0	2	2
Moved funds into new employers' plans	3	4	0
Remained in former employers' plans	38	43	50

Source: GAO review of proprietary data from three plan service providers.

<sup>a</sup>Data based on 976,600 terminated participants in service provider 1's retirement plan services from 03/01/2005 to 05/31/2010.

<sup>b</sup>Data based on 9,790 terminated participants in service provider 2's retirement plan services 401(k) plans from 01/01/2008 to 03/31/2009.

<sup>c</sup>Reported data among participants with termination dates in service provider 3's retirement plan services in 2008. The universe consists of more than 2,200 qualified plans and more than 3 million participants.

An advisory opinion issued by EBSA states that ERISA fiduciary standards do not apply to a service provider cross-selling an IRA rollover to a participant unless the service provider is already servicing the plan as an ERISA fiduciary.<sup>66</sup> Consequently, unless the service provider is already an ERISA fiduciary, the service provider may advise a participant to roll his or her account funds into an IRA, even if such a transaction may not be in a participant's best interest. Without disclosures that indicate whether the service provider's assistance is subject to ERISA fiduciary standards and whether the service provider has a financial interest in the investment products, participants may mistakenly assume that service providers are required to act in the participant's best

<sup>66</sup>EBSA Advisory Opinion 2005-23A (December 7, 2005).

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interest.<sup>67</sup> Furthermore, while final regulations may require a service provider to furnish IRA fee disclosures—such as a disclosure statement or a fee schedule—to participants, ERISA does not impose similar disclosure requirements for IRAs. In particular, service providers are not required to provide fee disclosures that specifically alert participants to the difference in fees between comparable funds available in their plan and funds offered by the plan’s service provider. As we reported in 2009, owners of IRAs generally pay higher fees than participants in 401(k) plans because an individual IRA’s account balance is usually not big enough to purchase an amount of investments large enough to qualify for volume discounts on fees.<sup>68</sup> Representatives from a 401(k) record-keeping firm said that, typically, IRA owners pay higher fees in the range of 25 to 30 bps and, in some cases, as high as 65 bps, which can be two to three times higher than fees paid by plan participants for in-plan investments. As a result of the lack of disclosure requirements on fees associated with IRAs, participants may be unaware of the higher fees associated with IRAs’ rollovers and may not understand that paying these higher fees can reduce their retirement savings over time.

In March 2010, EBSA proposed a regulation that may improve fee disclosure to participants by requiring ERISA fiduciary advisers to disclose all fees or other compensation that they or their affiliates might receive in connection with an IRA rollover before providing investment advice on investment options for rollovers.<sup>69</sup> However, the requirements would not apply to nonfiduciaries that are providing advice to participants about IRA rollovers or inform participants that fees for IRAs may actually be higher than fees for investments in a plan. The U.S. Department of the Treasury

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<sup>67</sup>In its preamble to the proposed new definition of fiduciary, the department noted that as a general matter, a recommendation to a plan participant to take an otherwise permissible distribution does not constitute investment advice within the meaning of the current regulation, when that advice is combined with a recommendation as to how the distribution should be invested. However, the department further notes that concerns have been expressed that as a result of that position, plan participants may not be adequately protected from advisers who provide distribution recommendations that subordinate participants’ interests to the advisers’ own interests. The department then solicited comments on whether and to what extent the final regulation should define the provision of investment advice to encompass recommendations related to taking a plan distribution. 75 Fed. Reg. 65,263, 65,266.

<sup>68</sup>GAO, *Retirement Savings: Better Information and Sponsor Guidance Could Improve Oversight and Reduce Fees for Participants*, [GAO-09-641](#) (Washington, D.C.: Sept. 4, 2009).

<sup>69</sup>Investment Advice—Participants and Beneficiaries, 75 Fed. Reg. 9,360 (March 2, 2010) (to be codified at 29 C.F.R. pt. 2550).

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(Treasury) has proposed a separate regulation to require advisers to provide notice to plan participants about the consequences of taking money out of a retirement plan.<sup>70</sup> Specifically, the disclosure would state that, among other things, investment options available in a plan may not be available for the same costs outside of a plan. However, without more explicit disclosure that IRAs typically have higher fees than investments in a plan, participants may not understand the difference in fees between IRAs and investments in a plan or the implication of higher fees on retirement savings over time.

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<sup>70</sup>Notice to Participants of Consequences of Failing to Defer Receipt of Qualified Retirement Plan Distributions; Expansion of Applicable Election Period for Notices, 73 Fed. Reg. 59,575 (October 9, 2008) (to be codified at 26 C.F.R. pt. 1). Section 1102(b)(1) of the Pension Protection Act of 2006 instructs the Secretary of the Treasury to provide a description to participants of the consequences of taking a distribution.

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## EBSA's Enforcement Program and Recent Regulatory Actions Take Steps to Address the Potential for Conflicted Investment Advice, but Further Changes Could Better Address Conflicts of Interest

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### EBSA's Enforcement Efforts Do Not Address Potential Conflicts of Interest of Nonfiduciary Service Providers Involving the Selection of Investment Options

EBSA's enforcement efforts regarding potential conflicts of interest related to investment advice have not addressed potential violations by non-ERISA fiduciary service providers.<sup>71</sup> As we have previously reported, EBSA's ability to recover losses related to conflicts of interest by a service provider through its enforcement program is largely limited by the extent to which the service provider functions as a fiduciary under ERISA. For EBSA to take action against an individual or entity, there generally must be a breach of that fiduciary duty.<sup>72</sup> This can be an obstacle for EBSA given that many service providers structure their contracts with plans to attempt to avoid meeting one or more of the five parts of the current ERISA fiduciary definition reflected in EBSA regulations.<sup>73</sup> EBSA officials noted that it was rare to find a pension consultant to an employee benefit plan who acknowledged ERISA fiduciary status. Moreover, EBSA officials told us that proving ERISA fiduciary status under the five-part test tends to be a difficult and complex task because it depends on the facts and circumstances of each case. These cases are usually very resource-intensive and involve interviewing plan sponsors and service providers and reviewing a significant amount of documentation, which may need to

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<sup>71</sup>This applies to EBSA's civil investigations. For EBSA's criminal investigations, however, the subject of the investigation need not be an ERISA fiduciary because an allegation of fraud is sufficient to trigger EBSA's jurisdiction.

<sup>72</sup>[GAO-07-703](#).

<sup>73</sup>29 C.F.R. § 2510.3-21.

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be subpoenaed.<sup>74</sup> If EBSA is unable to determine that the service provider was an ERISA fiduciary pursuant to the five-part test currently in effect, or was otherwise an ERISA fiduciary, EBSA officials told us that they have the authority to cite plan sponsors or other plan fiduciaries to take corrective action for not prudently selecting and monitoring their service providers. However, according to Labor's OIG officials, EBSA does not focus its enforcement activities on plan sponsors or other plan fiduciaries that fail to detect conflicts of interest on the part of nonfiduciaries.<sup>75</sup>

Indeed, although EBSA has taken steps to address conflicted investment advice provided to plan sponsors or other plan fiduciaries by establishing the Consultant/Adviser Project (CAP), this effort is constrained by the current definition of an ERISA fiduciary investment adviser in its regulations. EBSA launched CAP, a national enforcement effort, at the beginning of fiscal year 2007 to investigate situations where ERISA fiduciary pension consultants or advisers may have used positions of trust with pension plans to generate improper, undisclosed fees for themselves or their affiliates. Since its launch, EBSA has designated 40 CAP cases and, as of August 2010, closed 16.<sup>76</sup> Of these 16 cases, only 5 yielded results, including restoration of plan assets and actions taken by ERISA fiduciaries to ensure that the conflicts of interest did not occur again. However, EBSA was unable to take action in other closed cases because it was unable to prove that service providers were ERISA fiduciaries under the five-part test or acted otherwise as fiduciaries. For example, EBSA investigated 12 of the 13 pension consultants identified in a 2005 SEC staff report for failing to disclose significant ongoing conflicts of interest to their pension fund clients<sup>77</sup>—all 13 of which were considered fiduciaries under the

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<sup>74</sup>As we reported in 2007, given EBSA's other enforcement responsibilities, EBSA officials told us that they concentrate on a relatively small number of these conflict of interest cases because they are so complex. [GAO-07-703](#).

<sup>75</sup>However, the department's new proposal to modify the definition of fiduciary should provide some relief from the problems previously associated with the five-part test. In its proposed rulemaking, EBSA explained that it is appropriate to update the "investment advice" definition to better ensure that persons, in fact, providing investment advice to plan fiduciaries and/or plan participants and beneficiaries are subject to ERISA's standards of fiduciary conduct. 75 Fed. Reg. 65,263, 65,265.

<sup>76</sup>While only 16 CAP cases have been closed, 7 of the open CAP cases involve an ongoing criminal investigation or an investigation related to a currently open ongoing criminal investigation.

<sup>77</sup>SEC, Office of Compliance Inspections and Examinations, *Staff Report Concerning Examinations of Select Pension Consultants* (Washington, D.C.: May 16, 2005).

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Advisers Act, which was used as a criterion in the SEC review—but EBSA told us that many of the 13 pension consultants were adept at avoiding fiduciary status under EBSA’s five-part test. As a result, Labor’s OIG recently reported that EBSA was only able to take action on 2 of these 13 consultants because only those 2 consultants were determined to be ERISA fiduciaries and were engaged in prohibited transactions.<sup>78</sup> The OIG report noted that without establishing ERISA fiduciary status, EBSA was unable to enforce conflict of interest issues and did not take any further action on these cases.

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### EBSA’s Approach for Initiating Enforcement Cases May Also Fail to Detect Some Conflict of Interest Violations by ERISA Fiduciaries

EBSA’s enforcement efforts through CAP may also miss violations by some ERISA fiduciaries because EBSA’s approach for detecting violations does not currently include routine compliance examinations, which could help identify these violations. We reported in 2007 that EBSA does not conduct routine compliance examinations to focus its enforcement efforts the way other agencies do, and as a result, EBSA is not positioned to focus its resources on key areas of noncompliance or have adequate measurable performance goals to evaluate its impact on improving industry compliance.<sup>79</sup> For example, EBSA officials told us that they do not assess overall service provider compliance with the SunAmerica advisory opinion, which describes an appropriate method for providing one form of advice to participants,<sup>80</sup> and that they do not plan to assess compliance with the Pension Protection Act’s eligible investment advice arrangement

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<sup>78</sup>Labor OIG-Office of Audit, *EBSA Needs To Do More To Protect Retirement Plan Assets From Conflicts Of Interest*, 09-10-001-12-121 (Washington, D.C.: Sept. 30, 2010). There is a difference between fiduciary requirements specified by ERISA and requirements specified by the Advisers Act. Because of this difference, EBSA and SEC were able to take different measures to resolve the conflicts of interest found for these 13 consultants. In accordance with the Advisers Act, the problems identified by SEC were resolved through remediation and SEC enforcement efforts. As a result, SEC reported that many of these consultants took corrective action—changed policies and procedures to insulate their advisory activities from other activities, improved disclosure of conflicts of interest, and prevented conflicts of interest in certain respects.

<sup>79</sup>GAO, *Employee Benefits Security Administration: Enforcement Improvements Made but Additional Actions Could Further Enhance Pension Plan Oversight*, GAO-07-22 (Washington, D.C.: Jan. 18, 2007). As we previously reported, a compliance examination program, in part, is designed to establish a presence by regularly reviewing entities’ operations, thereby likely creating a deterrent to noncompliance. Implementing such routine compliance examinations may displace some resources currently dedicated to enforcement efforts, but would provide an evidence-driven method for evaluating the success of those enforcement efforts.

<sup>80</sup>Advisory Opinion 2001-09A (2001).

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provisions after they are finalized.<sup>81</sup> Instead of routine compliance examinations, CAP cases have been initiated based on a variety of sources, including referrals from other agencies, spin-offs from regular enforcement cases, tips, and media reports. According to EBSA, 18 of the 40 initiated CAP cases were based on referrals from external sources, including the SEC staff report. While these leads may be specific and detailed, EBSA may not be able to rely on consistent referrals from these external sources because they may not always review the same topics. For example, many of SEC's referrals to EBSA, which resulted in CAP cases, stemmed from a onetime review by SEC of pension consultants in 2005.<sup>82</sup> In addition, 9 CAP cases were initiated by EBSA investigators based on leads from the media and participant complaints. While these sources are important, such methods may not reveal violations that are more complex or hidden. For example, it may be difficult for participants to detect conflict of interest violations and submit complaints to EBSA, since service providers' business arrangements may be complicated and their disclosures may be insufficient or difficult to understand.<sup>83</sup> Finally, Labor's OIG told us that EBSA does not have a formal process for looking at conflicts of interest regarding nonfiduciary service providers during EBSA's regular enforcement investigations—neither at the front end, when a plan hires a service provider, nor later on during transactions of plan assets. If EBSA's investigators come across a potential conflict of interest violation during their regular enforcement efforts, EBSA officials told us that the investigators refer the conflict of interest portion of the investigation to the CAP program. However, officials from Labor's OIG told us that, even though there have been numerous cases referred to the CAP program in this manner, as of July 2010, none had progressed to a CAP case in which EBSA took action against a service provider.<sup>84</sup>

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<sup>81</sup>75 Fed. Reg. 9,360.

<sup>82</sup>SEC, *Staff Report Concerning Examinations of Select Pension Consultants* (Washington, D.C.: May 16, 2005). According to EBSA officials, EBSA has fostered relationships with SEC at local levels to obtain future referrals.

<sup>83</sup>EBSA published final regulations on October 20, 2010, to improve participant fee disclosure. While these disclosures will provide information about the performance and fees of different investment options available within the plan, it does not include complete information on compensation to service providers. Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule, 75 Fed. Reg. 64,910 (October 20, 2010) (codified at 29 C.F.R. § 2550.404a-5).

<sup>84</sup>According to EBSA, several cases have also been referred to the Office of the Solicitor General for further action.

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To address such limitations, we previously recommended EBSA consider conducting routine compliance examinations.<sup>85</sup> Specifically, we recommended that EBSA evaluate the extent to which it could supplement its current enforcement practices with strategies used by similar agencies, such as routine compliance examinations and dedicating staff for risk management. EBSA officials told us that, starting in fiscal year 2011, they will implement routine compliance examinations.

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## Labor's Recent and Proposed Regulations Address Some of the Potential for Conflicts of Interest in Investment Advice and Lack of Disclosure

In addition to its enforcement efforts, EBSA has recently announced several regulatory initiatives that would address some potential conflicts of interest on the part of service providers. These efforts include (1) revising the definition of an ERISA fiduciary, (2) requiring enhanced disclosure of providers' direct or indirect compensation and fiduciary status, and (3) establishing safeguards for PPA investment advice arrangements. If the requirements specified in these regulations are implemented as they are currently written, they may help EBSA and plan sponsors detect and deter conflicted investment advice, but plan sponsors and participants still would not have sufficient and comparable information to identify potential conflicts of interest because disclosures are not required to be provided in a consistent and summary format.

## Fiduciary Definition Regulations

Proposed regulations by EBSA to amend the definition of an ERISA fiduciary for purposes of investment advice, if implemented, would help address potential conflicts of interest on the part of service providers by encompassing a greater number of advisory relationships in which the plan sponsor relies on the service provider when making investment decisions.<sup>86</sup> Existing regulations have been in effect for 35 years, and EBSA officials told us they need to be revised based on knowledge and experience EBSA has gained through its enforcement efforts, as well as the evolution of the 401(k) industry.<sup>87</sup> In addition, a 2010 report by Labor's

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<sup>85</sup>GAO-07-22.

<sup>86</sup>75 Fed. Reg. 65,263.

<sup>87</sup>In the preamble to the proposed regulations, EBSA acknowledges that the five-part test takes a narrow approach to fiduciary status that "sharply limits" its ability to protect plans and their participants and beneficiaries from conflicts of interest that may arise from the diverse and complex fee practices existing in today's retirement plan services market and to devise effective remedies for misconduct when it occurs. Accordingly, the new proposed regulations are intended to more broadly define the circumstances under which a person is considered a fiduciary by reason of giving investment advice to a plan or its participants. 75 Fed. Reg. 65,263, 65,271.

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OIG noted that the five-part test is narrow and hampers EBSA's enforcement efforts. In place of the five-part test, the proposed regulation would establish ERISA fiduciary status based on a broader standard. In particular, the proposed regulation makes the following key changes, among others:

- Acknowledgment or representation as an ERISA fiduciary is sufficient to result in ERISA fiduciary status.
- Advice does not need to be provided on a regular basis to be considered a fiduciary act.
- The parties do not need to have a mutual understanding that the advice will serve as a primary basis for plan investment decisions.

Fulfilling any of the independent and alternative conditions specified in the proposal would be sufficient to result in ERISA fiduciary status for purposes of investment advice.<sup>88</sup> By reducing the number of conditions that need to be met to be deemed an ERISA fiduciary, the proposed regulation would encompass a greater number of service providers assisting plan sponsors with selecting investment options. In addition, the revised standards more closely align with advisory relationships that industry experts and service providers told us plan sponsors rely on to make investment decisions. As a result, the proposed regulations should help reduce confusion on the part of plan sponsors, many of whom are reported to currently believe they are receiving impartial advice subject to ERISA fiduciary standards when this is not the case. Moreover, the regulation may aid EBSA's enforcement efforts regarding conflicted investment advice by simplifying the method EBSA uses to determine who is an ERISA fiduciary. In addition to amending the five-part test, the proposed regulations also state that selling or marketing investment options to a plan sponsor does not constitute investment advice if it is disclosed in writing that the person is not undertaking to provide impartial investment advice.<sup>89</sup> However, the proposed regulation does not specify the format for this disclosure. Given that industry experts told us there is a considerable amount of confusion among plan sponsors about whether or not they are receiving investment advice subject to ERISA fiduciary

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<sup>88</sup>See proposed 29 C.F.R. § 2510.3-21(c), 75 Fed. Reg. 65,263, 65,277.

<sup>89</sup>See proposed 29 C.F.R. § 2510.3-21(c)(2)(ii)(B), 75 Fed. Reg. 65,263, 65,277.

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Service Provider Disclosure  
Regulations

standards, some plan sponsors may continue to be unaware of the distinction between ERISA fiduciary advice and sales or marketing activities without a requirement that this disclosure be made in a consistent and prominent manner. While the proposed regulations should result in a greater number of advisory relationships being subject to ERISA fiduciary standards, the regulation has yet to be finalized. If EBSA does not finalize this regulation and replace the five-part test, many service providers may continue to act outside of ERISA fiduciary standards and EBSA's enforcement efforts will remain limited.

Interim final regulations released by EBSA in July 2010 require enhanced service provider disclosure of compensation and ERISA fiduciary status.<sup>90</sup> These regulations, effective on July 16, 2011, for both new and existing arrangements between service providers and ERISA plans, specify that a contract between a covered plan<sup>91</sup> and a covered service provider<sup>92</sup> is not reasonable unless certain disclosures are made to the responsible plan fiduciary.<sup>93</sup> Required disclosures include descriptions of the services to be provided to the plan and the compensation the provider expects to receive for those services. In addition, if service providers expect to provide ERISA fiduciary services to plans, they are required to make a statement to such effect.<sup>94</sup> Industry experts indicated that this regulation should help plan sponsors identify conflicts of interest and assess whether they are causing harm to participants' balances. In addition the new disclosure requirements will allow EBSA to exercise enforcement authority over service providers who refuse to disclose direct and indirect

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<sup>90</sup>75 Fed. Reg. 41,600.

<sup>91</sup>A covered plan is a pension plan—all ERISA-governed retirement plans, including 403(b) arrangements—but does not include Simplified Employee Pension IRAs, Savings Incentive Match Plan for Employees IRAs, or IRAs.

<sup>92</sup>A covered service provider is a service provider that enters into an arrangement with a plan and reasonably expects to receive \$1,000 or more in compensation, direct or indirect, in connection with the services described in the regulation. The interim final rule specifies that covered service providers include some service providers acting as ERISA fiduciaries and some service providers who may not be ERISA fiduciaries.

<sup>93</sup>ERISA § 408(b)(2) and Code § 4975(d)(2) state that services by providers are prohibited unless (1) the contract or arrangement is reasonable, (2) the services are necessary for the plan, and (3) no more than reasonable compensation is paid. The regulations provide specific definitions for plans and service providers that are covered under the revised section 408(b)(2).

<sup>94</sup>See proposed 29 C.F.R. § 2550.408b-2(c)(1)(iv)(B), 75 Fed. Reg. 41,600, 41,635.

compensation.<sup>95</sup> As shown in table 8, disclosures required by this regulation would provide plan sponsors with valuable information and could enhance their ability to evaluate compensation arrangements and potential conflicts of interest.<sup>96</sup>

**Table 8: Categories of Service Provider Disclosures Required under Interim Final EBSA Regulations Effective July 2011**

Type of disclosure	Requirement <sup>a</sup>
Primary compensation disclosures	<p>The service provider must describe all of the compensation it expects to receive.<sup>b</sup> For this purpose, the compensation will fall into one or more of the following four categories:</p> <ul style="list-style-type: none"> <li data-bbox="565 764 1521 842">• <i>Direct compensation:</i> a description of all direct compensation, either in the aggregate or by service, that the service provider reasonably expects to receive in connection with the covered plan.</li> <li data-bbox="565 852 1521 957">• <i>Indirect compensation:</i><sup>c</sup> a description of all indirect compensation that the covered service provider reasonably expects to receive. The description must include identification of the services for which the indirect compensation will be received and identification of the payer of the indirect compensation.</li> <li data-bbox="565 968 1521 1205">• <i>Compensation paid among related parties:</i> a description of any compensation that will be paid among the covered service provider, an affiliate, or a subcontractor if it is set on a transaction basis (e.g., commissions, soft dollars, finder's fees, or other similar incentive compensation based on business placed or retained) or charged directly against the covered plan's investments and reflected in the net value of the investments (e.g., 12b-1 fees). The description must include identification of the services for which the compensation will be paid and identification of the payers and recipients of the compensation (including the status of the payer or recipient as an affiliate or subcontractor).</li> <li data-bbox="565 1215 1521 1318">• <i>Compensation for termination of arrangement:</i> a description of any compensation that the service provider reasonably expects to receive in connection with termination of the contract or arrangement and how any prepaid amounts will be calculated and refunded upon such termination.</li> </ul>

<sup>95</sup>EBSA notes that this change to the regulations would permit its investigators and attorneys to focus their efforts on the adviser's conduct rather than meeting the evidentiary requirements to prove all elements of the current five-part test are satisfied and would enhance its ability to redress service provider abuses that currently exist in the market. 75 Fed. Reg. 65,263, 65,272.

<sup>96</sup>These disclosures must be made in writing and in advance of the date the arrangement is entered into, and extended or renewed, and any changes to this information must be disclosed as soon as is practicable, but not later than 60 days from the date on which the service provider is informed of the changes.

Type of disclosure	Requirement <sup>a</sup>
Additional disclosures for record-keeping services	<p>In addition, if record-keeping services will be provided to the covered plan, a covered record-keeping service provider must give a description of all direct and indirect compensation that the covered service provider, affiliate, or subcontractor reasonably expects to receive in connection with the record-keeping services, and</p> <ul style="list-style-type: none"> <li>• if the covered service provider reasonably expects record-keeping services to be provided, in whole or in part, without explicit compensation for such record-keeping services, or</li> <li>• when compensation for record-keeping services is offset or rebated based on other compensation received.</li> </ul> <p>A reasonable and good faith estimate of the cost to the covered plan of such record-keeping services, including the following:</p> <ul style="list-style-type: none"> <li>• an explanation of the methodology and assumptions used to prepare the estimate, and</li> <li>• a detailed explanation of the record-keeping services that will be provided to the covered plan.</li> </ul> <p>Under this disclosure requirement, if a provider who is a record keeper receives other compensation (e.g., revenue such as subtransfer agency fees) and offsets it against its stated fee or gives credits against its record-keeping fees (e.g., for the use of mutual funds managed by affiliated managers), the record keeper must disclose to the responsible plan fiduciary the reasonable costs of the record-keeping services without the offsets or credits. Generally speaking, the reasonable cost is what the provider would charge for those services if there was no revenue sharing and if proprietary funds were not used.</p>
Additional disclosures required for certain investments	<p><i>Fiduciary services:</i> In the case of a covered fiduciary service provider who manages a separate contract, product, or entity that holds plan assets, the provider must disclose the following information for each investment in which the plan has a direct equity interest, and for which fiduciary services will be provided:</p> <ul style="list-style-type: none"> <li>• a description of any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, or transfer of, or withdrawal from, the investment contract, product, or entity (e.g., sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees);</li> <li>• a description of the annual operating expenses (e.g., expense ratio) —if the return on the investment is not fixed, and</li> <li>• a description of any ongoing expenses in addition to annual operating expenses (e.g., wrap fees, mortality and expense fees).</li> </ul> <p><i>Record-keeping or brokerage services:</i> In the case of a covered service provider who provides record-keeping or brokerage services for a participant-directed plan with designated investment options, for each designated investment alternative for which record-keeping services or brokerage services will be provided, the same information must be provided as for fiduciaries (above).</p>

Source: EBSA's Interim Final Regulations on Service Provider Disclosures: 75 Fed. Reg. 41,600.

<sup>a</sup>The disclosures must contain a description of the manner in which the compensation will be received, such as whether the plan will be billed or the compensation will be deducted directly from the covered plan's accounts or investments.

<sup>b</sup>Compensation is defined in the regulation as anything of monetary value, such as money, gifts, awards, and trips, but excluding nonmonetary items of \$250 or less received during the term of the contract or arrangement.

<sup>c</sup>Indirect compensation is compensation that is received from any source other than the covered plan, the covered plan sponsor, the covered service provider, an affiliate of the service provider, or a subcontractor of the service provider.

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While these disclosures may help plan sponsors and EBSA detect and deter conflicted investment advice, they may leave out important information that could help plan sponsors compare compensation arrangements and assess the potential for conflicts of interest. Specifically, the interim final regulations do not specify that these disclosures be made in any particular manner or format. As a result, the disclosures may be made through multiple documents, which could reduce their usefulness for plan sponsors and EBSA in detecting conflicts of interest given that, as industry experts told us, such disclosures can be very complicated and difficult to understand. As part of the comment process on these interim final regulations, EBSA solicited comments about the feasibility of requiring the disclosures to be reported in a consistent and summary format, such as taking the form of a summary document, limited to one or two pages, that would include key information intended to provide an overview for the responsible plan fiduciary of the information required to be disclosed.<sup>97</sup> The summary also would be required to include a road map for the plan fiduciary describing where to find the more detailed elements of the disclosures required by the regulation. EBSA plans to examine the comments received before it includes this kind of requirement in the final regulations. Without being presented in a consistent summary format, the disclosure regulations may not be as effective as intended.

Another limitation of these interim final regulations is that they do not require that service providers specifically disclose whether they have conflicts of interest. Since many conflicts result from the payment of money or other items of monetary value, EBSA and others have argued that the direct and indirect compensation disclosures required by this interim regulation will reveal some conflicts of interest. But, while these regulations may provide more compensation information to plan sponsors,

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<sup>97</sup>In the preamble to the interim final regulations, EBSA noted that it is persuaded that plan fiduciaries may benefit from increased uniformity in the way that information is presented to them. However, EBSA explained that it does not want to unnecessarily increase the cost and burden for service providers to furnish information, especially because such costs may be passed along to plan participants and beneficiaries, unless it is clear that the benefit to fiduciaries outweighs such costs and burdens. EBSA requested comments addressing (1) the likely cost and burden to service providers of complying with a requirement that information be disclosed in a particular format, (2) the anticipated benefits to plan fiduciaries of including a summary disclosure statement, and (3) how to most effectively construct the requirement for a summary disclosure statement to ensure both its feasibility and its usefulness. The comment period closed on August 30, 2010, and the department has not yet issued final regulations. 75 Fed. Reg. 41,600, 41,607.

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Labor's OIG told us that the regulations do not necessarily ensure that plan sponsors understand how the compensation translates into business arrangements with potential conflicts of interest. In a recent report, Labor's OIG found that the disclosures required by EBSA's interim final regulation would not require that conflicts from two of the cases identified in the 2005 SEC study be disclosed. They pointed to these two cases as examples to show how conflicts of interest could go undetected under the interim final regulations. As a result, OIG recommended that EBSA require the disclosure of all conflicts of interest. In response, EBSA stated that it felt that the interim final regulation may already provide this requirement through the detailed disclosures of direct and indirect compensation and that it was in the process of providing clarifying interpretations. Given that plan sponsors must assess conflicts of interest when selecting service providers, it is important that such conflicts be clearly disclosed.

In addition, the interim final regulation requires service providers to disclose information to plan sponsors, but not participants.<sup>98</sup> While some of these disclosures may make it to participants through various communications by plan sponsors, complete information on service provider compensation is not readily available to participants. As an attempt to remedy this, EBSA also published final regulations on October 20, 2010, designed to improve participant-level fee disclosure by requiring that plan sponsors provide participants core information about investments available under the plan, including performance and fee information, in a chart or similar format designed to facilitate investment comparisons.<sup>99</sup>

## PPA Eligible Investment Advice Arrangement Regulations

Many industry experts we interviewed said that investment advice arrangements permitted under the PPA should make investment advice more widely available to participants; however, some industry experts said the established safeguards may not sufficiently address potential conflicts of interests on the part of service providers. ERISA generally precludes service providers with conflicts of interest from furnishing investment advice. However, in an effort to expand the availability of investment advice to more participants, the PPA created two eligible investment advice arrangements that allow service providers who have a conflict of interest to furnish advice to plan participants. Specifically, under the PPA,

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<sup>98</sup>The interim final regulations only apply to employer-sponsored plans under ERISA, not to IRAs.

<sup>99</sup>75 Fed. Reg. 64,910 (October 20, 2010).

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an otherwise conflicted service provider may furnish investment advice using either a computer model arrangement or a level fee arrangement.

EBSA proposed regulations in March 2010 to administer these requirements of the PPA and received comments from industry professionals and other interested parties.<sup>100</sup> Several industry professionals and service providers submitted comments in support of EBSA's efforts to increase participants' access to unbiased investment advice and minimize the effects of service providers' potential conflicts of interests. However, some industry professionals we interviewed expressed concerns about whether the PPA advice arrangements sufficiently minimize the risks posed by service providers' conflicts of interest since it is possible to embed investment biases into computer models, which may be difficult to detect even when computer models are audited. For example, an industry representative said that adequate monitoring and auditing of computer models may be costly and that auditors may not be aware of the various ways in which computer models could be manipulated. In addition, computer models may be designed to exclude certain types of investment options, such as target date funds. If basic investment options offered in a plan are excluded from the computer model, the advice provided will be based on an incomplete analysis of investment options or holdings the participant may have in his or her 401(k) account. The exclusion of certain investment options from computer models may have the effect of steering participants toward options that may involve higher fees. Furthermore, even in the situation where a service provider's profits do not vary depending on participants' investment decisions, the service provider may nonetheless exhibit a natural bias toward its proprietary funds when furnishing fund recommendations to participants.

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<sup>100</sup>Under the proposal, two eligible investment arrangements are available in the form of statutory exemptions from the prohibited transaction rules. These rules would normally prohibit a fiduciary who might otherwise be a party in interest from furnishing investment advice to the plan or its participants. These two arrangements are (1) a computer model arrangement, where advice is rendered that, among other requirements, must be certified by an eligible investment expert and audited annually by an independent auditor, and (2) advice may be rendered by an adviser whose compensation does not vary based on the option selected by the plan participant. 75 Fed. Reg. 9,360.

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## Conclusions

While there are no comprehensive data on the prevalence or impact of service providers' conflicts of interest, available evidence suggests that there are a broad range of potential conflicts of interests that may harm participants and beneficiaries. Numerous industry experts we spoke with identified a wide variety of arrangements, often, but not always, complex, where conflicts of interest can occur to the possible detriment of plans and their participants. The arrangements are often designed in a way that makes it difficult for conscientious plan sponsors to detect them. Participants rely on the plan and its fiduciaries to review the investment options and services provided through the plan. Given the potential for financial harm to participants, it is important to ensure that plan sponsors, as fiduciaries, are aware of whether a conflict of interest exists and that the actions of service providers are appropriate. Conflicts of interest related to the plan's investment options can negatively affect 401(k) participants through higher fees and lower investment returns, which, ultimately, reduce their income in retirement. When service providers stand to gain from a plan sponsor or participant's selection of investment options, it is important to ensure that those providers do not have an undue influence over the plan sponsor or participant's selection process—or participants' balances could suffer. However, the complexity of business arrangements with service providers presents significant challenges for plan sponsors to fulfill their obligation to identify and mitigate potential conflicts of interest and ensure that the plan is operated in the best interest of participants. This may be particularly problematic for smaller plans, which do not have the resources to hire an independent adviser to review their options. The presence of conflicts of interest and the potential for financial harm hinder participants' retirement security and call into question the integrity of the 401(k) system, and may undermine participants' trust and willingness to save for retirement.

EBSA has a pivotal role in helping plan sponsors ensure that plans are operated in participants' best interests. In order to make prudent investment decisions, plan sponsors and participants need to understand when a service provider is acting in the role of a salesperson rather than a fiduciary adviser, required by law to act in the best interests of the plan and its participants. It is especially important for plan sponsors and participants to know if a service provider stands to gain from the selection of particular investment options. EBSA has recently taken several important steps to address the potential for conflicts of interest in investment advice. In particular, EBSA's interim final regulations, which require service providers to give enhanced disclosure of compensation arrangements, could help plan sponsors more clearly identify potential conflicts of interest and the fiduciary status of service providers. These

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regulations should help address the challenges faced by plan sponsors and participants. However, unless the disclosures are presented in a format that allows for a consistent comparison across investment options, it will inhibit the effectiveness of these regulations. If changes are not made to current disclosures, plan sponsors will not be able to make meaningful comparisons among different funds and providers. In addition, given that EBSA's enforcement efforts for conflicts of interest focus on service providers rather than plan sponsors, EBSA should finalize its proposed regulations to revise the current five-part test to better ensure that service providers that recommend investment options are subject to ERISA's fiduciary standard, and enhance disclosure to plan sponsors when investment assistance is not impartial. If the five-part test is not changed, service providers may still make investment recommendations to plan sponsors without being subject to ERISA fiduciary standards, and EBSA's ability to take enforcement actions will continue to be limited. Moreover, if disclosures to plan sponsors are not required to be made in a consistent and prominent manner, some plan sponsors may continue to be unaware of the distinction between ERISA fiduciary advice and sales or marketing activities.

Additional measures are also needed to better ensure that participants are protected from the potential consequences of conflicted investment advice. To better ensure that participants are not improperly swayed by educational communications, requirements for guidance to participants on the difference between education and advice may need to be evaluated. Without a change in current standards, participants may continue to perceive education as advice and make decisions on the basis of information communicated by service providers with a financial interest in the investment funds. Improved disclosures may also be needed to help participants understand whether their service provider is acting as a salesperson rather than a fiduciary adviser when providing assistance to participants in acquiring financial products outside of the plan, such as an IRA rollover. Otherwise, participants will continue to be unaware if their plan's service provider is not required to provide advice in the best interest of the participant and may be earning a commission from these product sales. Efforts for improved disclosure may be strengthened through coordination with the Department of the Treasury on proposed regulations designed to help participants understand the potential consequences of moving assets outside of their plan. If no action is taken and conflicts of interest persist, participants' confidence and willingness to save in the 401(k) system may be weakened and an untold number of 401(k) participants may pay unnecessarily high costs, through investment fees

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and IRA rollovers; accrue lower investment returns; and have correspondingly less savings available for retirement.

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## Recommendations for Executive Action

To better ensure that plan sponsors and participants can rely on impartial information in making investment decisions, we recommend that the Secretary of Labor direct the Assistant Secretary for EBSA to take the following actions:

- Amend and finalize proposed regulations to change the definition of a fiduciary for purposes of investment advice. Specifically, the Secretary should amend the proposed regulations to require that service providers' written disclosures specifying that they are not undertaking to provide impartial investment advice be provided to the plan sponsor in a consistent and prominent manner.
- Amend and finalize interim final regulations regarding disclosure of service providers' direct and indirect compensation from plan investments and fiduciary status to require that the information be provided in a consistent and summary format.
- Evaluate and revise Labor's interpretive bulletin on investment education, which is important in helping participants and beneficiaries make investment decisions. Specifically, in light of current practices, the Secretary should revise current standards, which permit a service provider to highlight certain investment alternatives, such as proprietary funds, which may result in greater revenue to the service provider, in educational materials. Labor could consider a variety of steps to address this potential conflict of interest, such as requiring service providers to disclose that they may have a financial interest in the options highlighted or prohibiting them from using proprietary funds as examples.
- Require that service providers, when assisting participants with the purchase of investment products offered outside of their plan, disclose in a consistent and prominent manner, either before or at the point of sale, any financial interests they may have in the outcomes of such transactions and inform participants as to whether their assistance is subject to ERISA fiduciary standards.

In addition, to better ensure that plan participants have sufficient information when deciding whether to move plan funds into investment alternatives outside their plan, we recommend that the Secretary of the Treasury amend the applicable requirements of its proposed disclosure

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rule to specifically require that service providers, when recommending the purchase of investment products outside retirement plans, inform plan participants that fees applicable outside their plans may be higher than fees applicable within their plans.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Department of Labor, SEC, and Treasury for their review. Treasury generally agreed with our recommendation to amend its proposed disclosure rule to specify that fees applicable for investment products outside of plans may be higher than fees applicable within plans. Treasury and SEC also provided technical comments, which we have incorporated where appropriate.

Overall, Labor generally agreed with our findings and to consider our recommendations as it conducts a review of these issues and evaluates public comments received on pending regulations. Labor noted that the interim final regulation to require enhanced disclosure of service providers' compensation arrangements represents significant progress and disagreed with our conclusion that these disclosures will not be effective unless they are presented in a format that allows for a consistent comparison across investment options. We concur that the disclosures required by this regulation would provide plan sponsors with valuable information and could enhance their ability to evaluate potential conflicts of interest. However, industry experts we spoke with noted that such disclosures can be very complicated and difficult to understand. Furthermore, as Labor has previously pointed out in the interim final rule regarding fee disclosure (75 Fed. Reg. 41,600), in the absence of a summary format, a service provider can fulfill this requirement by providing different documents from separate sources. Providing disclosures in multiple formats in different documents will inhibit the effectiveness of this regulation, particularly for plans that do not have the requisite expertise or the resources to hire an independent adviser to review their options.

Additionally, Labor noted that GAO did not conduct a cost-benefit analysis of recommendations to address potential conflicts of interest. GAO conducts its work in response to congressional requests for information and employs a variety of qualitative and quantitative methodologies in carrying out our mission. We choose these methodologies based on a variety of factors and constraints, such as the scope of our research objectives, availability of reliable data, costs and time constraints, as well as other considerations. We acknowledge that there are a number of options Labor could consider for the format of a summary disclosure and

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we agree that this requirement should be implemented at minimal cost to service providers and sponsors. We support Labor's following the appropriate administrative procedures in conducting its regulatory reviews and initiatives, including conducting a cost-benefit analysis. In this context, we wish to reiterate our past concerns about the harm plan participants can experience from undisclosed conflicts of interest. For example, as we reported in 2007, our analysis of available data on pension consultants and DB plans revealed a statistical association between inadequate disclosure of conflicts of interest and lower investment returns for ongoing plans. We also note that disclosing potential conflicts of interest in a manner that is readily apparent could benefit EBSA's oversight and enforcement efforts. Further, if Labor found the cost to service providers in preparing a summary document to be significant, this would also point to the difficulty that plan sponsors would have in extracting this information from multiple documents to obtain consistent information to allow for comparisons across different investment options and providers.

Labor also noted, regarding our recommendation to revise the interpretive bulletin on investment education, that current standards take a number of steps to limit the potential for abuse and Labor would need to evaluate several factors in considering any changes. While we concur that the interpretive bulletin includes several requirements to address the potential for conflicts of interest, it does not specifically alert participants when the service provider has a financial interest in investment options highlighted as examples, nor does it state that these examples do not constitute investment advice. Without an explicit disclaimer to this effect, participants may believe that providers are giving investment advice that is in participants' best interests, even in situations where this may not be the case. We look forward to Labor's evaluation of this issue and options to address it.

Finally, Labor noted that it may not have the authority to act on our recommendation to require service providers to disclose financial interests they may have in the sale of financial products outside of the plan, such as IRA rollovers. In the recently proposed regulation to amend the definition of an ERISA fiduciary, Labor noted concerns that participants may not be adequately protected from advisers who provide distribution recommendations that subordinate participants' interests to the advisers' own interests and solicited comments on possible actions to take to address this issue. We look forward to Labor's evaluation of whether or not it has the authority to address conflicts of interest related to the sale of financial products outside of the plan. If Labor determines that it does not

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have the authority to act in this area, it may be appropriate for Congress to consider possible legislative remedies. In the absence of any action to address this issue, participants may continue to be unaware when their plan's service provider stands to gain from the sale of IRA rollovers and other financial products outside of the plan.

Labor also provided technical comments on the draft report, which we have incorporated where appropriate.

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As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Secretary of Labor, Secretary of the Treasury, and Chairman of the Securities and Exchange Commission.

If you or your staff have any questions concerning this report, please contact me at (202) 512-7215. Contact points for our Office of Congressional Relations and Office of Public Affairs may be found on the last page of this report. GAO staff that made major contributions to this report are listed in appendix V.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Charles Jeszeck". The signature is fluid and cursive, with the first name "Charles" being more prominent and the last name "Jeszeck" following in a similar style.

Charles A. Jeszeck, Director  
Education, Workforce,  
and Income Security Issues

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# Appendix I: Scope and Methodology

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To determine the circumstances where conflicted investment advice may be provided to plan sponsors, we analyzed available research and documentation, including a report from the Securities and Exchange Commission (SEC), industry white papers, and documentation from the Department of Labor (Labor) and SEC cases pertaining to service provider conflicts of interest. We also interviewed industry professionals; pension consulting firms and other service providers; officials from Labor, SEC, the Department of the Treasury, the Financial Industry Regulatory Authority, and the Securities Industry and Financial Markets Association; and other relevant organizations. To determine how the fiduciary duty of the Employee Retirement Income Security Act of 1974 (ERISA) applies to investment advice provided to plan sponsors and the scope of ERISA's prohibited transactions rule, we reviewed relevant laws, including ERISA securities laws, regulations, and Labor advisory opinions, and interviewed industry professionals. As part of our research, we reviewed available information, including a report from Labor's Office of Inspector General, and conducted interviews with industry professionals and Labor officials to determine the extent to which advisers to plan sponsors are considered ERISA fiduciaries.

To determine the circumstances where conflicted investment advice may be provided to plan participants, we reviewed available literature and interviewed industry professionals and plan service providers. Additionally, we reviewed relevant statutes, including ERISA and the Pension Protection Act of 2006 (PPA), as well as regulations promulgated by Labor to understand where applicable law draws the distinction between investment education and advice. To determine what is known about the extent to which plan participants have access to investment education and advice, and to identify the common formats for furnishing such information, we reviewed available data from industry studies and conducted a poll of plan sponsors and service providers, as described below:

- We reviewed data from the Profit Sharing/401(k) Council of America's (PSCA) 2008 survey of retirement plans (published in 2009, but reflecting 2008 plan experience). The results of PSCA's 2008 survey are based on the experiences of 908 plans—including 28 profit-sharing plans, 607 401(k) plans, and 273 combination profit-sharing/401(k) plans—with 7.4 million participants. The plans that participated in PSCA's survey range in size from 1 participant to 5,000-plus participants. PSCA is a nonprofit association of 1,200 companies that sponsor defined contribution plans for 5 million employees. PSCA represents the interests of its members and offers assistance with profit-sharing and 401(k) plan design, administration, investment, compliance, and communication.

- In addition to reviewing industry data to assess the availability of investment education and advice for plan participants, we created an online questionnaire in coordination with the Society of Human Resource Management (SHRM) and the Society of Professional Asset-Managers and Record Keepers (SPARK). In the questionnaire, we asked plan sponsors that are members of SHRM and service providers that are members of SPARK whether investment education and advice are provided to plan participants, the format for delivering such information, and whether investment products and services unrelated to plans are marketed to participants. We implemented the Web-based questionnaire with SPARK members using our Web application, while SHRM implemented the questionnaire with its members using SHRM's Web application. SHRM and SPARK officials solicited responses from their members by distributing, to their members, our e-mail introducing the study, describing the question topics, and directing members to an Internet address for the questions. SHRM and SPARK officials also sent out periodic reminders about the questionnaire over several weeks between July 2010 and August 2010. SHRM distributed the introductory e-mail among 2,698 of its members, and SPARK distributed the e-mail among its board members, which included representatives from every SPARK member organization (over 250 companies). In total, 700 members—627 from SHRM and 73 from SPARK—responded to the questionnaire. The survey results are not representative of the general plan sponsor and service provider populations because our respondent population excludes plan sponsors that are not members of SHRM and service providers that are not members of SPARK. Because of the methodological limitations associated with deploying these questions, information obtained represents only the views of the respondents, not the overall population of 401(k) plan sponsors and service providers. In addition, we took steps in the development of the questions to minimize the variability of survey results. Prior to administering the questionnaire, the questions were reviewed by an independent survey expert in our methodology group and officials from SHRM and SPARK. We made changes to the content and format of the questionnaire based on reviewers' feedback.
- To analyze the incidence of IRA rollovers among plan participants, a circumstance in which conflicted investment assistance may be provided to plan participants, we collected and analyzed industry data from three sources to determine the frequency with which plan participants are rolling plan funds into IRAs:
  - The Survey of Income and Program Participation (SIPP), which is a survey conducted by the U.S. Census Bureau. The main objective of the SIPP is to provide accurate and comprehensive information

about the income and program participation of individuals and households in the United States. The SIPP is conducted on a continuous series of national panels, with durations from 2 ½ to 4 years, with sample size ranging from approximately 14,000 to 36,700 interviewed households. The SIPP sample is a multistage-stratified sample of the U.S. civilian, noninstitutionalized population. We used data from the 2004 topical module 7 survey and extracted survey responses to determine the percentage of survey respondents who took cash distributions from their retirement plans and rolled distributed funds into individual retirement accounts (IRA). In particular, we used variables EPREVLMP (for survey respondents who have ever received a lump-sum payment from a pension or retirement plan from a previous job, including any lump sums that may have been directly rolled over to another plan or to an IRA) and ELMPWHER, answer choice IRA (for survey respondents who rolled lump-sum payments into IRAs). The 2004 SIPP survey results are based on responses from people surveyed in different waves over a 2 ½-year period, with survey interviews lasting into 2006. Specifically, for wave 7, interviews were conducted from February 2006 to May 2006. Results are generalizable to the population at the time of survey.

- The Investment Company Institute (ICI) is the national association of U.S. investment companies, and it works to promote public understanding of mutual funds and other investment companies. ICI publishes statistics on the U.S. retirement market every quarter as an information resource for mutual fund companies, the media, policymakers, and researchers. ICI combines data from its own mutual fund survey database and from other trade associations with data from the U.S. Department of Labor, the Federal Reserve Board, and the Internal Revenue Service (IRS) to compile detailed IRA asset information, including the portions of funds flowing into IRAs from rollovers and contributions. Total IRA market assets are derived from tabulations of total IRA assets provided by the IRS Statistics of Income Division for tax years 1989, 1993, 1996-2002, and 2004; with preliminary data provided for 2006 and 2007. Tabulations are based on a sample of IRS returns. GAO did not conduct any direct analysis of ICI data.
- Three service providers that service defined contribution plans also compiled proprietary data on what happens to plan participants' defined contribution plan funds when participants terminated their retirement plans. Results from service provider 1 were based on 976,600 terminated participants in the provider's defined

contribution retirement plan services from March 1, 2005, through May 31, 2010. Results from service provider 2 were based on 9,790 terminated participants in the provider's retirement plan services 401(k) plans from January 1, 2008, through March 31, 2009. Results from service provider 3 were based on participants with termination dates in 2008. The universe consisted of more than 3 million participants from more than 2,200 plans. In addition, the proprietary data from plan service providers are not generalizable to the universe of retirement plan participants. However, the results are consistent with and corroborate each other.

We assessed the reliability of the data we present and found the data to be sufficiently reliable as used in this report.

To describe the steps that Labor has taken to address conflicts of interest, we reviewed documentation of Labor's enforcement activities related to conflicted investment advice practices. We also reviewed past GAO and Labor Inspector General reports and interviewed Labor officials to evaluate the adequacy of Labor's enforcement efforts to prevent conflicted investment advice. In addition, we reviewed documentation from Labor and industry participants related to three recent or soon-to-be-released Labor regulations: (1) a proposed rule amending the definition of ERISA fiduciary duty regarding investment advice (published in October 2010), which would amend the regulatory definition of the fiduciary duty for plan investment advisers to include pension consultants and other plan advisers who do not fall under the current regulatory definition; (2) an interim final rule regarding service provider disclosures of direct and indirect compensation to plan sponsors (issued in July 2010); and (3) PPA eligible investment advice arrangements (issued in March 2010), which fall under a statutory exemption to the ERISA prohibited transactions rule. Finally, we interviewed Labor officials to discuss the scope of each regulation and key features that may mitigate conflicts of interest.

We conducted our review from January 2010 through January 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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# Appendix II: Common Formats for Delivering Investment Education and Advice

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Investment education and advice may be provided to participants in different formats, most commonly through brochures or other written materials and computer modeling. Other formats for providing education or advice include one-on-one sessions with service providers and seminars and workshops. A number of studies have been conducted about the availability of investment assistance for participants; however, these studies do not always discern whether participants are provided investment education or advice.<sup>1</sup> According to a poll of 401(k) plan sponsors and service providers that we conducted in coordination with SHRM and SPARK, investment education is more commonly offered than investment advice, although many respondents offered both.<sup>2</sup> As shown in figure 6, of the 475 SHRM respondents who sponsored a 401(k) plan, 380 provided investment education and 215 provided investment advice. Of these respondents, 202 provided both education and advice. Among respondents, brochures or other written materials were the most commonly used formats for delivering education and advice. Computer modeling, including Web-based tools, was the second most common method of delivery reported. Industry research by an organization of 401(k) and profit-sharing plans yielded similar results, with 51.8 percent of plans providing investment advice to plan participants and with 28.3 percent of participants using advice when it was offered.<sup>3</sup> Among plans providing investment advice, the most common methods of delivery are one-on-one counseling sessions, Internet providers (including those with computer modeling programs), and telephone hotlines.<sup>4</sup> Industry survey results also indicate that smaller plans with fewer than 50 participants are

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<sup>1</sup>See, e.g., Hewitt Associates. *Trends and Experience in 401(k) Plans*. (Hewitt Associates LLC, 2009); Hewitt Associates, *Help in Defined Contribution Plans: Is It Working and for Whom?* (Hewitt Associates LLC, 2010); Annamaria Lusardi, "Household Savings Behavior: The Role of Literacy, Information, and Financial Education Programs." (Dartmouth College and NBER 2008).

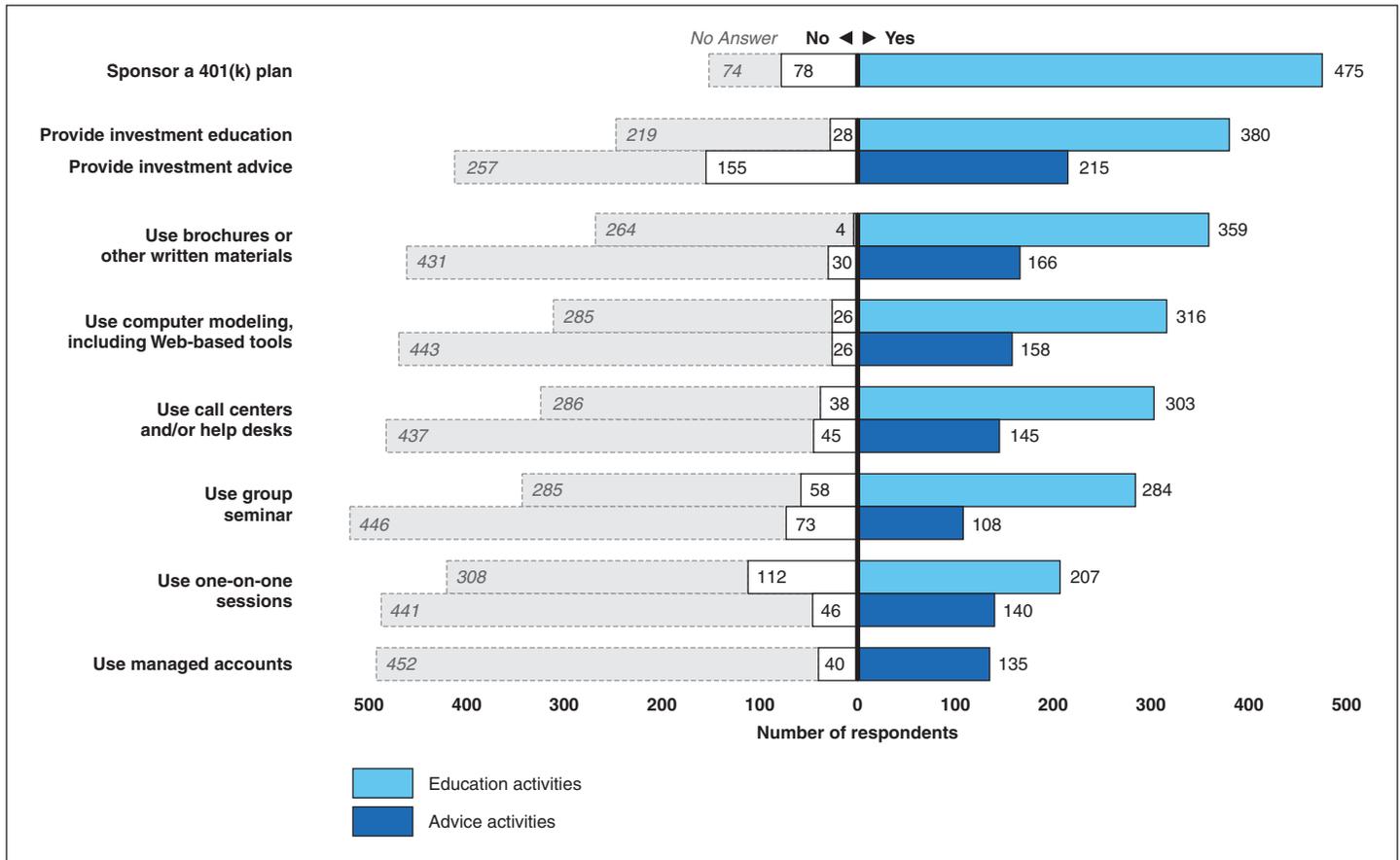
<sup>2</sup>Because of methodological limitations associated with the polls with SHRM and SPARK, results from these polls represent only the views of the poll respondents. Please see appendix I for further details regarding our methodology.

<sup>3</sup>The 52nd annual survey of profit-sharing and 401(k) plans for 2008 by PSCA. The survey was published in 2009, but reflects 2008 plan experience. The survey was based on results from 908 plans—28 profit-sharing plans, 607 401(k) plans, and 273 combination profit-sharing and 401(k) plans— with 7.4 million participants.

<sup>4</sup>Among plans that participated in PSCA's annual survey in 2008, 58 percent of plans used one-on-one counseling sessions to deliver advice, 44 percent of plans used Internet providers to deliver advice, and 31.9 percent of plans used telephone hotlines to deliver advice.

more likely to use one-on-one counseling sessions, while larger plans of 5,000-plus participants tend to use Internet providers.<sup>5</sup>

Figure 6: GAO Poll Results from SHRM Respondents



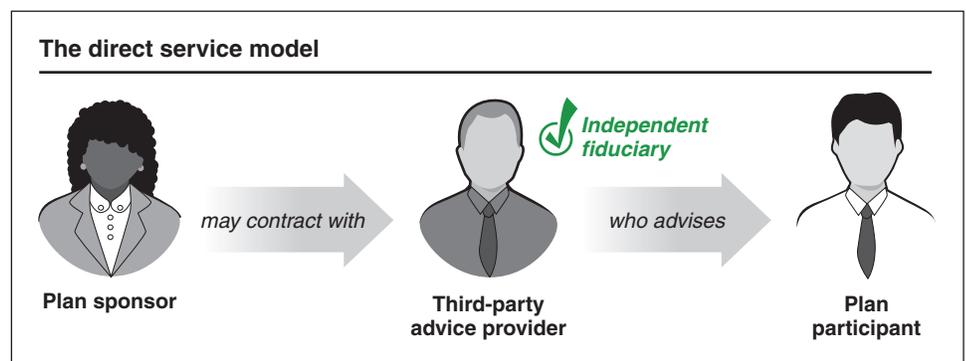
Source: GAO analysis of GAO questionnaire.

<sup>5</sup>Among plans that participated in PSCA's annual survey in 2008, 82.7 percent of plans with fewer than 50 participants use one-on-one counseling sessions to deliver advice, while 73.9 percent of larger plans with 5,000-plus participants use Internet providers to deliver advice.

# Appendix III: Types of Computer Model Advice Arrangements

Computer models can be used to render investment advice to participants in three different arrangements: (1) the direct service arrangement, (2) the SunAmerica arrangement, and (3) the PPA computer model arrangements. As shown in figure 7, the direct service arrangement is utilized when a plan sponsor contracts directly with an independent advisory firm, which develops a computer model that renders advice to plan participants. The independent advisory firm should not be affiliated with any investment fund or accept payments from funds that its model recommends as investment options. Accordingly, the firm should operate without a vested interest in its recommendations and not incur any conflicts of interest.

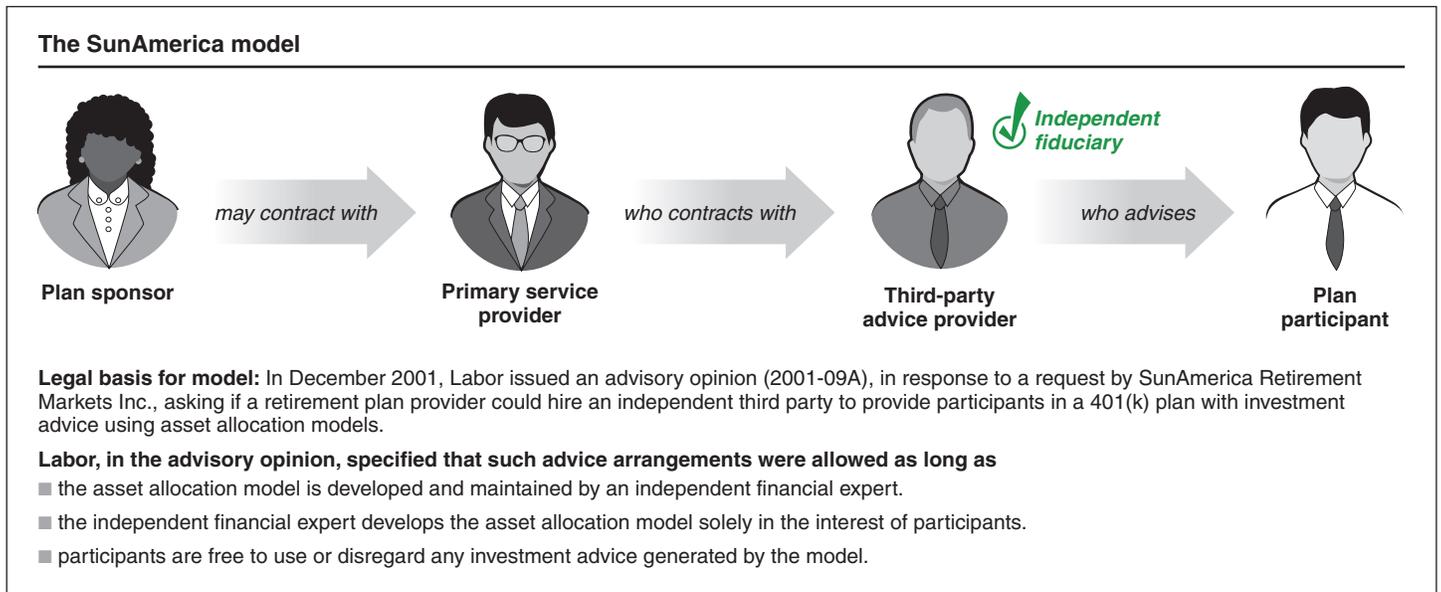
**Figure 7: The Direct Service Model Advice Arrangement**



Source: GAO analysis of information from industry practitioners.

For advice arrangements where providers offer their own investment funds and thus have a conflict of interest, Labor has set forth specific requirements under which these providers may offer investment advice. As shown in figure 8, the SunAmerica arrangement allows the service provider to contract with an independent advisory firm to develop and administer a computer model to provide investment advice. Because the primary service provider may have a conflict of interest for certain investment options offered to participants, Labor requires that, among other things, the independent financial expert—who is not the primary service provider—develop and maintain the computer model that renders advice to participants solely in the interest of plan participants.

Figure 8: The SunAmerica Advice Arrangement

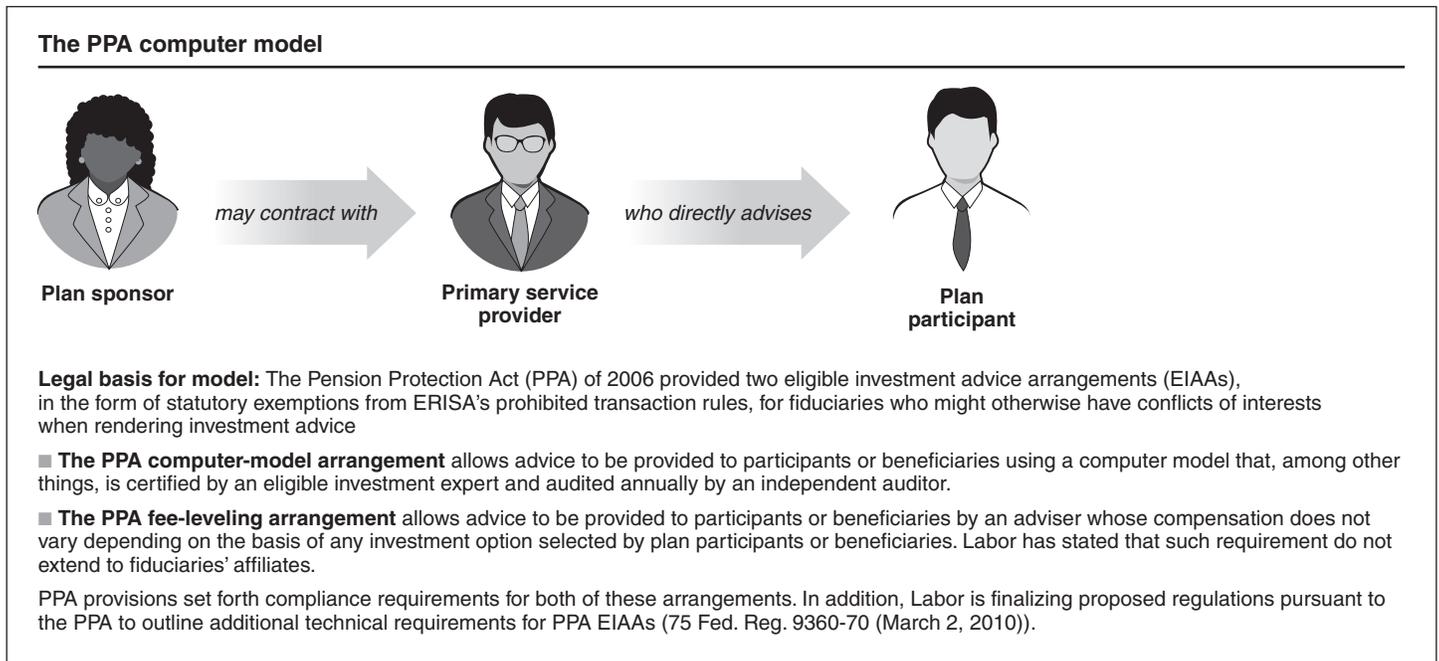


GAO analysis of information from industry practitioners and Labor's advisory opinion.

As shown in figure 9, the PPA computer model arrangement, on the other hand, allows the service provider to develop the computer model in-house, subject to certain requirements the PPA has established to address the service provider's conflict of interest.<sup>1</sup>

<sup>1</sup>EBSA officials anticipate finalizing proposed regulations for the PPA sometime during May 2011.

Figure 9: The PPA Computer Model Advice Arrangement



GAO analysis of information from industry practitioners and Labor's proposed regulation.

Labor has proposed regulations that would allow a primary service provider to develop and maintain the computer model that renders advice to participants if, among other things, the model has been certified by an independent financial expert and undergoes annual audits. Therefore, unlike the direct service or SunAmerica arrangements, where an independent advice provider is the creator of a computer model that renders advice to participants, the PPA computer model arrangement bypasses the independent advice provider and allows the primary service provider to create the computer model that renders advice to participants. In addition to permitting the use of the computer modeling advice arrangement, the PPA also permits a level fee advice arrangement, which allows a provider who may otherwise have a conflict of interest—such as a provider whose proprietary funds are part of a plan’s investment lineup—to furnish investment advice to participants. Specifically, Labor’s proposed regulations specify that a provider may furnish advice to participants if the provider’s fees do not vary depending on participants’ investment decisions. A Labor publication indicates that the level fee requirement applies to the service providers’ representatives and their employers, but not their affiliates.<sup>2</sup>

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<sup>2</sup>Department of Labor, Field Assistance Bulletin No. 2007-01 (February 2, 2007).

# Appendix IV: Comments from the Department of Labor

**U.S. Department of Labor**

Assistant Secretary for  
Employee Benefits Security Administration  
Washington, D.C. 20210



January 4, 2011

Mr. Charles A. Jeszeck  
Director, Education, Workforce, and  
Income Security Issues  
United States Government Accountability Office  
Washington, DC 20548

Dear Mr. Jeszeck:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled "Improved Regulation Could Better Protect Participants from Conflicts of Interest."

The draft report points to various conflicts of interest that can arise in the benefits area, acknowledges certain steps the Department has taken, through both enforcement and regulation, to mitigate such conflicts, and recommends that the Department take certain additional steps. The report does not attempt to assess the prevalence of conflicts, the degree of harm that results from them, the degree to which its recommendations would mitigate conflicts or avert harms, nor the costs attendant to its recommendations.

The Department believes efforts to mitigate conflicts must weigh the potential harms from conflicts against the costs and benefits such efforts will yield for participants. The Department's efforts also must fall within its authority.

With respect to the specific recommendations for executive action, we submit the following.

*GAO recommendation:* Amend and finalize proposed regulations to change the definition of a fiduciary for purposes of investment advice. Specifically, the Secretary should amend the proposed regulations to require that service providers' written disclosures specifying that they are not undertaking to provide impartial investment advice, be provided to the plan sponsor in a consistent and prominent manner.

The Department cannot agree to any specific recommendation in advance of its completing consideration of all the public comments received on the proposed regulation. We note, however, that the specific recommendation appears to be consistent with the goals of the Department's proposed regulation, *i.e.*, to ensure that plan fiduciaries can distinguish sales pitches from impartial advice. See paragraphs (c)(2)(i) and (ii)(B) and (C) of § 2510.3-21 of the proposed regulation (75 FR 65263, October 22, 2010) for the requirements specifically addressing this issue.

*GAO recommendation:* Amend and finalize interim final regulations regarding disclosure of service providers' direct and indirect compensation from plan investments and fiduciary status to require that information be provided in a consistent and summary format.

The Department cannot agree to any specific recommendation in advance of its completing consideration of all the public comments received on the interim-final regulation. Nonetheless, we wish to note our disagreement with GAO's conclusion that absent a requirement to provide consistent summaries, disclosures under the interim final rule "will not be effective" nor will plan sponsors be able to make "meaningful comparisons between different funds and providers." To the contrary, the Department believes that the regulation represents a significant step forward in ensuring that plan fiduciaries receive the information necessary to assess the reasonableness of compensation to be paid for services and potential conflicts of interest that might affect the quality of those services. Having said that, the Department currently is assessing the advisability of requiring a summary disclosure or similar tool to assist plan fiduciaries with the information they receive from service providers. In issuing its interim final rule under ERISA Section 408(b)(2) the Department requested comment on the costs and benefits of such a requirement. The Department would welcome any information GAO can provide on such costs and benefits. In particular, is there a particular disclosure format that can be demonstrated to deliver benefits that justify its cost?

*GAO recommendation:* Evaluate and revise Labor's interpretive bulletin on investment education, which is important in helping participants and beneficiaries make investment decisions. Specifically, in light of current practices, the Secretary should revise current standards which permit a service provider to highlight certain investment alternatives, such as proprietary funds, which may result in greater revenue to the service provider, in educational materials. Labor could consider a variety of steps to address this potential conflict of interest, such as requiring service providers to disclose that they may have a financial interest in the options highlighted or prohibiting them from using proprietary funds as examples.

The Department cannot agree to any specific recommendations because it has not yet completed its review of whether or to what extent the Interpretive Bulletin should be modified. In its consideration of these issues, however, it is worthwhile to ask to what extent participants treat examples as they would advice, to what extent such behavior is harmful, and to what extent such behavior would be reduced, and attendant harm averted, by disclosure of potential conflicts. It is likewise worthwhile to consider whether stricter rules for education could adversely affect its availability or utility. The Department will consider whether, in light of the foregoing questions, GAO's recommendation would be likely to help participants make better choices. The Department also notes that currently, where specific investment options are used to populate an investment education tool, Interpretive Bulletin 96-1 (29 CFR § 2509.96-1) seeks to limit the potential for abuse by providing, inter alia, that the model has to be 1) based on generally accepted investment theories, 2) accompanied by all the material facts and assumptions on which it is based, 3) accompanied by a statement that other investment alternatives having similar risks and return characteristics may be available under the plan and identifying where information on those alternatives may be obtained, and 4) accompanied by a statement indicating that, in applying particular asset allocation models to their individual situations, participants or beneficiaries should consider their other assets, income and investments.

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**Appendix IV: Comments from the Department  
of Labor**

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*GAO recommendation:* Require that service providers, when assisting participants with the purchase of investment products outside of their plan, disclose in a consistent and prominent manner, either before or at the point of sale, any financial interests they may have in the outcomes of such transactions and inform participants as to whether their assistance is subject to ERISA fiduciary standards.

The Department cannot agree to any specific recommendation in advance of its completing consideration of all the public comments received on the proposed amendments to the fiduciary definition regulation. As the GAO is aware, the Department invited comment on issues related to the GAO's recommendation. We note, however, that the report does not explain how this recommendation fits within the Department's authority or the degree to which some of the recommended disclosures may already be required independent of ERISA. The Department will evaluate these questions.

Again, thank you for the opportunity to review the draft report. Should you or your staff have any questions concerning the statements or requests contained herein, please do not hesitate to contact us.

Sincerely,



Phyllis C. Borzi  
Assistant Secretary

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# Appendix V: GAO Contacts and Acknowledgments

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## GAO Contact

Charlie Jeszeck (202) 512-7215

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## Acknowledgments

In addition to the contact named above, Tamara Cross, Assistant Director; Sharon Hermes, Analyst-in-Charge; Jessica Gray; and Kun-Fang Lee made important contributions throughout this report.

Susan Baker, James Bennett, Susan Bernstein, Rachel DeMarcus, Cody Goebel, Ying Long, Sheila McCoy, Karen O'Connor, Roger Thomas, and Walter Vance also provided key support.

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# Related GAO Products

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*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.: November 16, 2006.

*Employee Benefits Security Administration: Enforcement Improvements Made but Additional Actions Could Further Enhance Pension Plan Oversight.* [GAO-07-22](#). Washington, D.C.: January 18, 2007.

*Defined Benefit Pensions: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges.* [GAO-07-703](#). Washington, D.C.: June 28, 2007.

*Private Pensions: Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors.* [GAO-08-774](#). Washington, D.C.: July 16, 2008.

*Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans.* [GAO-09-503T](#). Washington, D.C.: March 24, 2009.

*Retirement Savings: Better Information and Sponsor Guidance Could Improve Oversight and Reduce Fees for Participants.* [GAO-09-641](#). Washington, D.C.: September 4, 2009.

*Defined Contribution Plans: Key Information on Target Date Funds as Default Investments Should be Provided to Plan Sponsors and Participants.* [GAO-11-118](#). Washington, D.C.: January 25, 2011.

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## GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

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