

Washington update:

## Participant fee disclosure and its implications for 401(k) plan sponsors

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One of the most important challenges facing 401(k) plans today is the incomplete understanding of fees paid for services rendered. Unfortunately, plan providers have been reluctant to break out fees in formats understandable to sponsors and participants. The Department of Labor's Employee Benefits Security Administration (DOL EBSA), which oversees these plans, has tackled the problem in three distinct ways: by amending Form 5500 filing requirements, by regulating provider-to-sponsor disclosure and by regulating sponsor-to-participant disclosure.

The DOL's latest regulation on participant disclosure, recently finalized, is the subject of this note. It requires sponsors to make several specific disclosures to participants in formats that not only facilitate participants' understanding of the fees they pay, but also enable the intuitive comparison of investment alternatives. We support the DOL's efforts on this issue. While there are some hurdles participants and sponsors need to clear, the new requirements should promote a better environment for participants and support a continuation of broader positive trends in the 401(k) industry.

### Background

Per ERISA's fiduciary standards, in the investment of participant assets, plan fiduciaries are required to act prudently and exclusively in the interest of these participants. Unfortunately, gaps exist for plans that allocate investment responsibility to participants — i.e., all 401(k) plans. Sponsors' compliance with current law has not guaranteed that workers have sufficient information to make effective decisions. Perhaps more significantly for novice investors, compliance with current law has not ensured that this information, particularly as regards fees and expenses, is presented in a useful format.

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On October 14, 2010, EBSA announced regulations designed to change the status quo. The process originated in April 2007, when EBSA issued a request for information that asked whether current rules needed to be modified to make certain that 401(k) participants had adequate information to manage their accounts. Proposed regulations followed in July 2008, and the final regulations, called "Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans" were recently announced. These rules will take effect for plan years beginning on or after November 1, 2011.

### Summary of requirements

The new requirements are that sponsors take steps to make participants aware of their rights, responsibilities and options in their 401(k) plans. These steps generally fall under plan-related and investment-related information disclosure. The new disclosures must be presented in a user-friendly comparative table. All disclosures must be provided on or before the date participants make their first direct contributions, and annually thereafter.

Plan-related requirements cover disclosure of:

- General information about plan mechanics
- Administrative expenses, such as legal, accounting and recordkeeping fees paid by the participant
- Revenue-sharing arrangements with providers
- Individual expenses, such as 401(k) penalties or fees for taking out a loan, paid by the participant
- Quarterly detailing of services provided and fees paid for them in hard dollar amounts

Investment-related requirements cover disclosure of:

- The performance of investment alternatives and of the benchmarks for each (for fixed rate investments, the annual return and term of investment are enough)
- Operating fees for each option, as a percentage of assets and as a dollar amount per \$1,000 invested
- Shareholder-specific rules, such as withdrawal penalties and restrictions
- A specific web link to detailed investment information on each option
- A glossary of relevant investment terms

All of this information must be presented in a format that facilitates the participants' easy comparison of investment options. (EBSA provides a model comparison chart that may be used to satisfy this requirement. We include it in the appendix to this note.)

The final rule protects plan sponsors from liability arising from the provision of inaccurate and/or incomplete information by third-party service providers or issuers of investment options. Safe harbor is provided to sponsors who in good faith rely on external provider data.

The new regulation is a positive step toward better outcomes for participants. The focus on fee disclosure and easier access to information could encourage participants to really focus on getting a fair deal in their 401(k)s. We'll share our reasons for optimism and suggest some of the hurdles participants, sponsors and service providers may need to clear.

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### What's supposed to happen

The new regulation will shed light on the fees paid by participants and level the playing field for record keepers, fund managers and consultants. Participants should have a much better idea of what they are paying for. Consequently, they will demand to pay no more than reasonable fees for services received. In response, plan sponsors will likely begin to measure and benchmark fees for services which previously received minimal scrutiny.

According to the DOL, which conducted extensive testing in advance of issuing its recent rule, increased participant and sponsor understanding should have the effect of reducing fees through increased competition. The market should migrate toward simpler fee structures and increased efficiency. "The more transparency, the more people will be likely to reduce their fees. That is, of course, what we hope," noted Phyllis Borzi, assistant secretary of labor for EBSA.<sup>1</sup>

In a broader context, the regulation could accelerate the trend toward focusing on fees and open-architecture structures in 401(k) plans. We have seen significant 401(k) litigation in recent years, including class-action lawsuits asserting that sponsors did not exercise due diligence in monitoring investment fees. We expect that the new regulations will draw increased scrutiny to plan expenses and fees. In turn, this scrutiny could encourage sponsors to move from proprietary platforms to open-architecture platforms. On an open platform, sponsors have the opportunity to choose their managers. This could not only lower costs, but also improve manager quality, given that it's very difficult for a single proprietary manager to offer best-in-class funds for all asset classes.

### Challenges participants and plan sponsors face

A potential conundrum is that for participants, the new disclosures may confound, not clarify, the issues. Participants may react to a litany of new fee disclosures with a collective "Huh?" In addition to the new fee disclosure requirements, the emphasis on past performance of investment options could backfire. How much to focus on past performance is an issue that confronts even the most sophisticated investors. Will increasing the prominence of past returns data distract participants from the improved disclosure of investment fees? When it comes to investment performance, we believe, participants and fiduciaries should understand and focus more on future net-of-fees results, not past gross-of-fees results.

The new administrative burden on plan sponsors appears to be significant. Non-public funds will need to have websites where participants can learn more about them. Participant communications systems need to be created. Data collection, particularly the quarterly expense updates, will add a new, ongoing task to the sponsor's to-do list.

Service providers face difficulties as well. According to a recent Sway Research Survey, service providers need help with fee disclosure issues.<sup>2</sup> When asked an open-ended question about key challenges in the months ahead, nearly half of gatekeepers mentioned fee disclosure. Many are struggling to meet this challenge with existing staff and without additional spending. If providers have issues, how can plan sponsors depend on them for disclosure data?

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<sup>1</sup> Lemann, Mariana. "DOL Issues Final 401(k) Fee Disclosure Rule." *Ignites*, 14 October 2010.

<sup>2</sup> Sway Research Survey: "The State of DCIO Distribution: 2011", slide 87. October 2010.

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## Conclusion

Historically, 401(k) participants and sponsors have not paid enough attention to fees. Change is on the way; and despite the initial difficulties that inevitably accompany any change, we believe the DOL's recent fee-disclosure regulation will shed much-needed light on hitherto obscure facets of 401(k) accounts. We support the DOL's effort, and agree with EBSA that the regulation could help participants and plan sponsors better understand what they're paying for and promote competition among industry providers.

Ultimately, the new rules mean that plan sponsors and providers will be held to a higher standard. The new standard should benefit participants. And that's the way Washington likes it.

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## Appendix

### **Model Comparative Chart**<sup>3</sup>

#### **ABC Corporation 401k Retirement Plan**

Investment Options – January 1, 20XX

This document includes important information to help you compare the investment options under your retirement plan. If you want additional information about your investment options, you can go to the specific Internet Web site address shown below or you can contact [insert name of plan administrator or designee] at [insert telephone number and address]. A free paper copy of the information available on the Web site[s] can be obtained by contacting [insert name of plan administrator or designee] at [insert telephone number].

#### **Document Summary**

This document has 3 parts. Part I consists of performance information for plan investment options. This part shows you how well the investments have performed in the past. Part II shows you the fees and expenses you will pay if you invest in an option. Part III contains information about the annuity options under your retirement plan.

#### **Part I. Performance Information**

**Table 1** focuses on the performance of investment options that do not have a fixed or stated rate of return. Table 1 shows how these options have performed over time and allows you to compare them with an appropriate benchmark for the same time periods. Past performance does not guarantee how the investment option will perform in the future. Your investment in these options could lose money. Information about an option's principal risks is available on the Web site[s].

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<sup>3</sup> Accessed at <http://www.dol.gov/ebsa/participantfeerulemodelchart.doc> on October 22, 2010.

Sample table provided by the DOL

| <b>Table 1—Variable Return Investments</b>               |                                    |       |        |                    |                  |       |       |                    |                                   |
|--|------------------------------------|-------|--------|--------------------|------------------|-------|-------|--------------------|-----------------------------------|
| <b>Name/<br/>Type of Option</b>                          | <b>Average Annual Total Return</b> |       |        |                    | <b>Benchmark</b> |       |       |                    |                                   |
|  | <b>as of 12/31/XX</b>              |       |        |                    |                  |       |       |                    |                                   |
|  | 1yr.                               | 5yr.  | 10yr.  | Since<br>Inception | 1yr.             | 5yr.  | 10yr. | Since<br>Inception |                                   |
| <b>Equity Funds</b>                                      |                                    |       |        |                    |                  |       |       |                    |                                   |
| A Index Fund/ S&P 500<br>www. website address            | 26.5%                              | .34%  | -1.03% | 9.25%              | 26.46%           | .42%  | -.95% | 9.30%              | S&P 500                           |
| B Fund/ Large Cap<br>www. website address                | 27.6%                              | .99%  | N/A    | 2.26%              | 27.80%           | 1.02% | N/A   | 2.77%              | US Prime Market 750 Index         |
| C Fund/ Int'l Stock<br>www. website address              | 36.73%                             | 5.26% | 2.29%  | 9.37%              | 40.40%           | 5.40% | 2.40% | 12.09%             | MSCI EAFE                         |
| D Fund/ Mid Cap<br>www. website address                  | 40.22%                             | 2.28% | 6.13%  | 3.29%              | 46.29%           | 2.40% | -.52% | 4.16%              | Russell Midcap                    |
| <b>Bond Funds</b>  |                                    |       |        |                    |                  |       |       |                    |                                   |
| E Fund/ Bond Index<br>www. website address               | 6.45%                              | 4.43% | 6.08%  | 7.08%              | 5.93%            | 4.97% | 6.33% | 7.01%              | Barclays Cap. Aggr. Bd.           |
| <b>Other</b>   |                                    |       |        |                    |                  |       |       |                    |                                   |
| F Fund/ GICs<br>www. website address                     | .72%                               | 3.36% | 3.11%  | 5.56%              | 1.8%             | 3.1%  | 3.3%  | 5.75%              | 3-month US T-Bill Index           |
| G Fund/ Stable Value<br>www. website address             | 4.36%                              | 4.64% | 5.07%  | 3.75%              | 1.8%             | 3.1%  | 3.3%  | 4.99%              | 3-month US T-Bill Index           |
| Generations 2020/ Lifecycle Fund<br>www. website address | 27.94%                             | N/A   | N/A    | 2.45%              | 26.46%           | N/A   | N/A   | 3.09%              | S&P 500                           |
|  |                                    |       |        |                    | 23.95%           | N/A   | N/A   | 3.74%              | Generations 2020 Composite Index* |

\*Generations 2020 composite index is a combination of a total market index and a US aggregate bond index proportional to the equity/bond allocation in the Generations 2020 Fund.

**Table 2** focuses on the performance of investment options that have a fixed or stated rate of return. Table 2 shows the annual rate of return of each such option, the term or length of time that you will earn this rate of return, and other information relevant to performance.

Sample table provided by the DOL.

| <b>Table 2—Fixed Return Investments</b>  |               |             |   |
|--|---------------|-------------|---|
| <b>Name/<br/>Type of Option</b>  | <b>Return</b> | <b>Term</b> | <b>Other</b>  |
| H 200X/ GIC<br>www. website address  | 4%            | 2 Yr.       | The rate of return does not change during the stated term.  |
| I LIBOR Plus/ Fixed-<br>Type Investment<br>Account<br>www. website address       | LIBOR<br>+2%  | Quarterly   | The rate of return on 12/31/xx was 2.45%. This rate is fixed quarterly, but will never fall below a guaranteed minimum rate of 2%. Current rate of return information is available on the option's Web site or at 1-800-yyy-zzzz. |
| J Financial Services<br>Co./ Fixed Account<br>Investment<br>www. website address | 3.75%         | 6 Mos.      | The rate of return on 12/31/xx was 3.75%. This rate of return is fixed for six months. Current rate of return information is available on the option's Web site or at 1-800-yyy-zzzz.   |

## **Part II. Fee and Expense Information**

**Table 3** shows fee and expense information for the investment options listed in Table 1 and Table 2. Table 3 shows the Total Annual Operating Expenses of the options in Table 1. Total Annual Operating Expenses are expenses that reduce the rate of return of the investment option. Table 3 also shows Shareholder-type Fees. These fees are in addition to Total Annual Operating Expenses.

Sample table provided by the DOL.

| <b>Table 3—Fees and Expenses</b> |  |               |  |
|----------------------------------|--|---------------|--|
| <b>Name /<br/>Type of Option</b> | <b>Total Annual<br/>Operating<br/>Expenses</b> |               | <b>Shareholder-Type Fees</b>   |
|                                  | As a %   | Per<br>\$1000 |  |
| <b>Equity Funds</b>              |  |               |  |
| A Index Fund/<br>S&P 500         | 0.18%  | \$1.80        | \$20 annual service charge subtracted from investments held in this option if valued at less than \$10,000.  |
| B Fund/<br>Large Cap             | 2.45%  | \$24.50       | 2.25% deferred sales charge subtracted from amounts withdrawn within 12 months of purchase.                  |
| C Fund/ International Stock      | 0.79%  | \$7.90        | 5.75% sales charge subtracted from amounts invested.   |
| D Fund/<br>Mid Cap ETF           | 0.20%  | \$2.00        | 4.25% sales charge subtracted from amounts withdrawn.  |
| <b>Bond Funds</b>                |  |               |  |
| E Fund/<br>Bond Index            | 0.50%  | \$5.00        | N/A  |
| <b>Other</b>                     |  |               |  |
| F Fund/<br>GICs                  | 0.46%  | \$4.60        | 10% charge subtracted from amounts withdrawn within 18 months of initial investment.                         |
| G Fund/<br>Stable Value          | 0.65%  | \$6.50        | Amounts withdrawn may not be transferred to a competing option for 90 days after withdrawal.                 |
| Generations 2020/ Lifecycle Fund | 1.50%  | \$15.00       | Excessive trading restricts additional purchases (other than contributions and loan repayments) for 85 days. |
| <b>Fixed Return Investments</b>  |  |               |  |
| H 200X / GIC                     | N/A  |               | 12% charge subtracted from amounts withdrawn before maturity.  |

|  |     |   |
|--|-----|---|
| <b>I LIBOR Plus/ Fixed-Type Invest Account</b>         | N/A | 5% contingent deferred sales charge subtracted from amounts withdrawn; charge reduced by 1% on 12-month anniversary of each investment. |
| <b>J Financial Serv Co. / Fixed Account Investment</b> | N/A | 90 days of interest subtracted from amounts withdrawn before maturity.  |

The cumulative effect of fees and expenses can substantially reduce the growth of your retirement savings. Visit the Department of Labor's Web site for an example showing the long-term effect of fees and expenses at <http://www.dol.gov/ebsa/publications/401kemployee.html>. Fees and expenses are only one of many factors to consider when you decide to invest in an option. You may also want to think about whether an investment in a particular option, along with your other investments, will help you achieve your financial goals.

### Part III. Annuity Information

**Table 4** focuses on the annuity options under the plan. Annuities are insurance contracts that allow you to receive a guaranteed stream of payments at regular intervals, usually beginning when you retire and lasting for your entire life. Annuities are issued by insurance companies. Guarantees of an insurance company are subject to its long-term financial strength and claims-paying ability.

Sample table provided by the DOL.

| <b>Table 4—Annuity Options</b>                     |   |   |  |
|--|---|---|--|
| <b>Name</b>  | <b>Objectives / Goals</b>   | <b>Pricing Factors</b>  | <b>Restrictions / Fees</b>   |
| Lifetime Income Option<br><br>www. website address | To provide a guaranteed stream of income for your life, based on shares you acquire while you work. At age 65, you will receive monthly payments of \$10 for each share you own, for your life. For example, if you own 30 shares at age 65, you will receive \$300 per month over your life. | The cost of each share depends on your age and interest rates when you buy it. Ordinarily the closer you are to retirement, the more it will cost you to buy a share.<br><br>The cost includes a guaranteed death benefit payable to a spouse or beneficiary if you die before payments begin. The death benefit is the total amount of your contributions, less any withdrawals. | Payment amounts are based on your life expectancy only and would be reduced if you choose a spousal joint and survivor benefit.<br><br>You will pay a 25% surrender charge for any amount you withdraw before annuity payments begin.<br><br>If your income payments are less than \$50 per month, the option's issuer may combine payments and pay you less frequently, or return to you the larger of your net contributions or the cash-out value |

| Name  | Objective/Goals   | Pricing Factors   | Restrictions/Fees   |
|---|---|---|---|
| <p data-bbox="201 353 451 409">Generations 2020 Variable Annuity Option</p> <p data-bbox="221 591 430 613">www. website address</p> | <p data-bbox="504 353 772 555">To provide a guaranteed stream of income for your life, or some other period of time, based on your account balance in the Generations 2020 Lifecycle Fund.</p> <p data-bbox="504 633 751 801">This option is available through a variable annuity contract that your plan has with ABC Insurance Company.</p> | <p data-bbox="804 353 1101 768">You have the right to elect fixed annuity payments in the form of a life annuity, a joint and survivor annuity, or a life annuity with a term certain, but the payment amounts will vary based on the benefit you choose. The cost of this right is included in the Total Annual Operating Expenses of the Generations 2020 Lifecycle Fund, listed in Table 3 above.</p> <p data-bbox="804 846 1066 1160">The cost also includes a guaranteed death benefit payable to a spouse or beneficiary if you die before payments begin. The death benefit is the greater of your account balance or contributions, less any withdrawals.</p> | <p data-bbox="1126 353 1410 409">Maximum surrender charge of 8% of account balance.</p> <p data-bbox="1126 495 1426 551">Maximum transfer fee of \$30 for each transfer over 12 in a year.</p> <p data-bbox="1126 629 1430 730">Annual service charge of \$50 for account balances below \$100,000.</p> |

**Please visit [www.ABCPlanglossary.com](http://www.ABCPlanglossary.com) for a glossary of investment terms relevant to the investment options under this plan. This glossary is intended to help you better understand your options.**

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## References

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"Final Rule to Improve Transparency of Fees and Expenses to Workers in 401(k)-Type Retirement Plans." Department of Labor's EBSA fact sheet. Available at <http://www.dol.gov/ebsa/newsroom/fsparticipantfeerule.html>.

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