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STATEMENT OF OLENA BERG LACY

ON BEHALF OF THE PENSION RIGHTS CENTER

BEFORE THE

COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS

UNITED STATES SENATE

SEPTEMBER 17, 2008

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Thank you, Mr. Chairman and members of the committee, for inviting me here to speak to you about the important issue of fee disclosure to 401(k) plans and their participants. My name is Olena Berg Lacy and I was head of the Department of Labor's Employee Benefits Security Administration (EBSA) during the Clinton administration. I am also a member of the Board of Directors of the Pension Rights Center, which I am representing today. The Center is a nonprofit consumer organization that has been working since 1976 to promote and protect the retirement security of American workers and their families. I would like to address the fee issue from the perspective of what level of disclosure is in the best interests of plan participants.

While I was with EBSA, we held hearings on 401(k) fees in November 1997 and issued a report in April of 1998. I recently went back to review that report and see what had changed since. I am sorry to say that not a lot has changed in the intervening decade – except that substantially more assets are in plans that are subject to these fees.

Of course, the major development that has occurred in the last decade is the increase in the shift from defined benefit plans to defined contribution plans so that increasingly a DC plan – a 401(k), a 457, or a 403(b) – will be the only or the primary supplement to Social Security for millions of workers.

Fees are important. We cannot predict future returns on investments, but fees are a certainty. They can make a substantial difference in a retirement account balance. The Government Accountability Office has pointed out that a one percent increase in fees on an account achieving a seven percent rate of return annually will reduce retirement savings by 17 percent over 20 years. The impact of fees is greater still on smaller account balances or over a longer period of years.

Fees are also important because of the magnitude of dollars involved. More than $3 trillion is invested in these plans. If you assume that collectively, they are operated for just 100 basis points (one percent), that amounts to more than $30 billion per year taken from retirement saving accounts in fees. The significance of this loss of retirement income is greatly magnified when markets are in turmoil and participants are incurring losses in their accounts.

For fee disclosure to truly benefit plan participants, it must occur at two levels: disclosures from service providers to plan sponsors on fees assessed to the plan, and from plan sponsors to plan participants on the fees participants are paying. Disclosure to sponsors at the plan level is critically important to participants because it is the sponsor who makes the determination of what services to provide and what investment alternatives to include in the plan. The sponsor has a

fiduciary duty to ensure that these decisions are made prudently and for the sole and exclusive benefit of the participants.

You might expect that in order to fulfill this duty, plan sponsors would simply “shop” among service providers to find the best deal for their plans. In the large plan market, this is largely the case. But as the DOL report pointed out in 1998, the market is not efficient in allowing small- and medium-sized plan sponsors to be aware of what is available to them. They have difficulty in getting the information they need to make informed decisions. Because fees vary substantially for very similar investment products and services, it is critical that such information be provided but there is no explicit legal obligation for service providers to do so. In the absence of such a requirement, sponsors are on their own to sort out fee information. As the DOL study pointed out, there are more than 80 ways fees could be displayed. This is because there are different types of fees: asset-based, per participant fees, and itemized fixed charges. There are also different categories of fees, such as administrative costs, communications, investment management and sales charges. Many of these categories have subcategories.

Given the lack of information available and the confusing array of ways in which it is presented, it is reasonable to ask if some plan sponsors are selecting investment and service options with excessive fees. While there is not a lot of data, a 2007 study might be indicative. IMC, a consulting firm, examined the offerings of thousands of plans of all sizes and different categories of investment offerings. Based on their findings and extrapolating what they found to the entire market, they estimated that as many as 5.5 million of more than 55 million participants may be paying some unreasonable fees, and the assets subject to these fees total almost $300 billion. If you add in plans paying some high fees, 26 percent of total assets may be subject to high or excessive fees. In small plans with under $5 million in assets, almost 50 percent may be paying some high or excessive fees.

In general, large plan-sponsors have the ability to issue RFPs to numerous service providers and to demand that information be provided in a consistent format so that comparisons may be easily made. They have the sophistication to evaluate the information they receive. Small plan-sponsors probably do not. In fact, the DOL report noted that surveys showed that cost was not a primary consideration for them and that, in fact, many select as their 401(k) provider financial institutions that provide them with other financial services. Yet these sponsors have the same fiduciary duty to make these decisions for the sole and exclusive benefit of plan participants.

To level the playing field, it is important that explicit disclosure requirements exist for the information that service providers must provide plan sponsors and that there be uniformity in the format so that comparisons are easy to make. The EBSA undertook a regulatory project earlier this year to effect such requirements and should be commended for undertaking this important effort. Its proposal provides much-needed information to plan sponsors to allow them to make reasonable decisions. Unfortunately, the proposed regulations do not go far enough.

Most importantly, the DOL failed to require that expenses be unbundled.[1] Without separation of fees for the different categories of investment management, plan administration, and participant services, it will be difficult, if not impossible for small- and medium-sized plan sponsors to make comparisons among different offerings. And as they monitor the reasonableness of the fees they pay, without unbundling, they will be unable to determine if investment managers and other service providers are reaping windfalls when the growth in assets subject to an all-in management fee exceeds the incremental costs of providing administrative and other services.

Aggregating fees can also disguise potential conflicts of interest. For example, assume there is a plan with 15 different investment offerings, but the record-keeper is getting 65 percent of its revenue from just one or two of those offerings – and those are proprietary offerings. If the funds under-perform, the record-keeper may well resist removing them from the investment line-up because of the difficulty in replacing that lost fee revenue.

Also, if regulations or legislation were to allow aggregate-level disclosure, we would be concerned that plan sponsors might assume that their duty to examine fees extended no further than what was required to be revealed to them. In reality, ERISA requires that they ferret out such conflicts of interest. And they need sufficient information to do so.

It is vital that we get this right and there is a need for Congressional action to go beyond the DOL proposal.

As I mentioned earlier, the second level of disclosure is from plan sponsors to plan participants on the fees they are paying. In discussions about this issue, I have noticed that even those who support better disclosure to plan sponsors are less willing to concede that greater disclosure to participants is also needed. I respectfully disagree. Plan participants also have important decisions to make that such disclosures would support. The first critical decision is whether to participate in the plan in the first place. Most participants to not contribute anywhere near the maximum annual limit and many do not contribute enough to maximize the company match. Many lower-wage workers do not even contribute beyond the IRA limit and may well be better off with an IRA if the costs of operating the 401(k) plan exceed the value of the company match.

Furthermore, participants often have the ability to influence plan design and investment offerings by making their desires known to their employer. So they need to understand what they are paying for. The DOL study posed it this way: "If participants knew how much optional features of their plans cost, would they demand so many?" An internet study showed that 85 percent of 1000 respondents voted for greater investment returns versus more services from their plans.

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[1] 401(k) plan fees and expenses generally fall into three categories: plan administration fees, individual service fees, and investment fees. Some employers may provide for or negotiate these services separately and the expenses charged by each provider (record keeper, investment manager, etc.) are charged separately. This is referred to as an "unbundled" arrangement. In the case of unbundled arrangements, the proposed regulations require that the dollar amount of plan administration fees be disclosed to participants in quarterly benefit statements. Other plans may have some or all of the services offered by one provider for a single fee and that provider will then pay out of its fee any other service providers it may have contracted with to provide services. This is a "bundled" arrangement. The proposed regulations do not require disclosure of plan administration fees in bundled arrangements.

Again, in addition to plan features, participants may influence which investment options are offered. And certainly they need fee comparisons to select among those options.

The DOL has also undertaken a regulatory effort to address disclosure to plan participants and recently issued proposed regulations. By requiring a single, tabular description of fees to participants, the department's proposal will significantly improve the transparency of fees. However, as with the DOL's approach to service provider disclosure to plan sponsors, these regulations fall short. Indeed, one can assume that if the plan sponsor disclosures are inadequate, they will not be conveyed to participants in a way that is meaningful and can be easily understood. The information should be unbundled at the participant, as well as the sponsor level. While participants may not need the same level of disaggregation of fees that plan sponsors should have, at the very least, fees for the different categories of services should be separately disclosed.

For disclosure to participants to be helpful, it needs to be clear, concise, and readily accessible. Financial terminology needs to be explained in simple terms. The regulation as proposed does not require sufficient explanation of either fees or investment choices. While too much information may overwhelm participants, too little will not support reasonable decision-making. And the information must be presented using terms that most participants will understand. Effective disclosure also requires easy access to the information. Electronic means of disclosure will not be appropriate for participants without access to computers or knowledge of how to use them.

There are other issues with the proposed regulations, as well. They require the provision of summary investment performance information. This requirement is undoubtedly in response to the concern expressed by many industry observers that the provision of fee information only might lead some financially unsophisticated participants to opt for the lowest fee funds without regard to performance. Unfortunately, the summary performance information could result in a similar problem with this group of participants: that they opt for the highest performing funds without regard to risk. We submit that this is a far greater danger and, if it cannot be averted, the fee information should stand alone.

Finally, in some respects, the proposed regulations weaken currently required disclosures. (Please see the attached letter from the Pension Rights Center to the DOL commenting on the regulations for more detail). So as with disclosure to plan sponsors, there is a need for Congress to step in.

I mentioned at the beginning of my remarks that not much has changed in the last decade. But there is some new evidence that just your interest in this issue is making a difference. A recent article in *Investment News* reported on a survey that showed that 30 percent of plan sponsors cited costs and fees as their reason for switching plan providers. This marks a significant change from the last survey in 2005, when only 18 per cent changed for this reason. The article mentioned that discussions in Congress, as well as the recent DOL activity, has brought the issue of fees to the forefront. We believe that without further Congressional action, this momentum could fade. So we thank you for holding this hearing and for your interest in this issue of paramount importance to the retirement well-being of millions of American workers.