Secrets of the 401k Industry: How Employers and Mutual Fund Advisers Prospered As Workers' Dreams of Retirement Security Evaporated

Economic Self-Interest and "Informational Advantage" in 401ks

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I. Introduction

Beginning in 2002, with the mutual fund scandals investigated by state and federal securities regulators, compelling evidence surfaced indicating that (for decades) providers of services to defined contribution retirement plans had engaged in wrongdoing, often in collusion with one another.

In a defined contribution plan, all risk rests with the participants who have no say in the design of the plan or the economic arrangements entered into with and among providers of services to the plan. Generally participants pay most, and increasingly all costs associated with the plan and their investment results depend upon the performance of service providers chosen for them. Unfortunately, of all the parties involved with defined contribution plans, participants (whose monies are at risk) are least knowledgeable regarding complex, opaque investment management industry practices. Given that the majority of participants work 40-60 hours a week, it is unreasonable to expect that they will (in their spare time) acquire the expertise to skillfully

Key Finding:

Industry practices have played a significant role in creating the defined contribution retirement plan crisis the nation faces today. The demise of 401ks was no accident and, indeed, was predictable.

sift through the numerous investment alternatives that have been provided to them and craft an optimal retirement savings program.

Plan sponsors are more knowledgeable than participants but, given that over 92% of defined contribution plans have less than $5 million in assets[1] and have no full-time employee with investment expertise responsible solely for the plan, an overwhelming majority of sponsors rely upon providers for turnkey solutions to plan needs. These providers largely control the flow of information to sponsors and (with the consent of the sponsor) are responsible for communications to participants. Not surprising, providers of services to plans have taken advantage of their "informational advantage" and the inability of sponsors and participants to commit time to scrutinizing economic arrangements between providers and plans.

Providers have prospered even as participants have suffered mediocre results. Sponsors, freed of liability related to these plans, have little incentive to intervene.

As a result of lack of transparency regarding questionable industry practices, the market for defined contribution retirement plan service providers, including record-keepers and investment managers, remains uncompetitive despite a large number of vendors and plan sponsors. Excessive fees and poor performance are commonplace. Yet providers maintain the industry is not to blame for these unfortunate results. Industry solutions to problematic performance (such as target date funds and personalized financial advice) inevitably involve heaping even greater costs onto investors, further reducing the likelihood of satisfactory net performance. Dissatisfaction with defined contribution plans has grown as evidence of wrongdoing has mounted (and the markets have faltered) and is at an all-time high.

[1] Private Pension Plan Bulletin, Abstract of 2006 Form 5500 Annual Report, U.S. Department of Labor Employee Benefit Security Administration, December 2006.

An analysis of economic self-interest related to the providers of services to defined contribution retirement plans and plan sponsors reveals that many of the problematic investment options, practices and arrangements within plans can be readily explained as benefitting all parties except participants. The "informational advantage" that sponsors and providers enjoy over participants permits this state of affairs to endure. While the impact of economic self-interest and the informational advantage on defined contribution plans may seem remote, it is real. Recent studies confirm that plan design (almost always controlled by providers), does matter and can influence participant behavior and investment returns.

In other words, industry practices have played a significant role in creating the defined contribution retirement plan crisis the nation faces today. The demise of 401ks was no accident and, indeed, was predictable.[2]

In order to improve participant behavior and investment results, disclosure of all economic agendas at play, at a minimum, must be compelled. Absent a regulatory overhaul of defined contribution plans, increased transparency is the sole tool available to reduce the costs and improve the performance of these plans. While hardly a perfect cure, "sunshine" remains a powerful disinfectant.

A 2008 Annual Survey of 401k Plan Sponsors by Deloitte Consulting found that 80% of employers believe that 401ks are effective in **recruiting** employees to come work for them but only 13% believe that

[2] 401(k)s: Far More Dangerous Than IRAs by Edward Siedle, benchmarkalert.com, March 2001; An End to 401ks by Edward Siedle, benchmarkalert.com, February 1, 2002; 401(k) Abuses: The Mutual Fund Industry's Next Nightmare By Edward Siedle and Steve Lansing, June 2004.

the 401k plans they offer will provide retirement security for their workers.[3]

In other words, employers understand that offering a plan that **purports** to provide for workers' retirement security, without obligating the employer to pay retirement benefits, is helpful in building their businesses. However, employers privately acknowledge that these plans are not sufficient to provide for workers' retirement. On the other hand, employers believe that guaranteed retirement income, such as a traditional pension plan, would be far more costly to provide.

So, do employers tell their workers there really is no retirement security provided if they stay in their jobs and thereby risk losing employees to competitors? Or do employers maintain the charade that they offer retirement security? Has your employer told you it is virtually inconceivable that the defined contribution plan he offers will provide sufficient retirement income?

Deloitte concludes "there's still plenty of room for improvement in 401k plan design and communication, to the extent that employers have made employee retirement security a priority goal." In other words, **if** employers are truly concerned about employee retirement security, they'd better do something about it.[4]

II. Background on Defined Contribution Plans

There are two basic types of retirement plans offered by U.S. employers – defined benefit ("DB") and defined contribution ("DC"). In a DB plan, an employer promises to provide participants a specific benefit payment in retirement, which typically is based upon a formula that considers

[3] Deloitte Consulting, "Annual 401(k) Benchmarking Survey: 2008 Edition, 2008.

[4] Ibid.

years of service, compensation over some specific period, age at retirement and other factors.[5] In a DC plan, the future benefit a participant receives depends upon the level of his contributions, the fees or expenses related to the plan and the performance of the investments within the plan.

The employer's level of financial responsibility and economic self-interest is very different with respect to the two types of retirement plans. In a traditional pension plan (DB), the employer contributes to the plan and the plan fiduciary invests those funds in order to meet the plan's future pension obligations. If the plan's investment performance fails to provide for the level of benefits promised, the employer may have to increase its contributions to the plan. That is, the employer bears the risk that the investments will fail to fund the obligations of the plan. The employee is promised a certain level of benefits in retirement by the employer and, assuming the employer does not become insolvent, will receive those benefits. This certainty or control regarding monthly benefits permits the employee to plan his retirement.

On the other hand, participants in DC plans bear the entire risk that their "accounts" will be sufficient to provide retirement income. Participants in a DC plan must determine their level of contribution and direct the investment of their own and their employers' contributions, selecting from a menu of investment vehicles that have been chosen for them. Participants have no right to determine the investment options offered within the plan or the providers of services to the plan. Participants are not privy to negotiations between the plan sponsor and providers to the plan. There is no requirement that all information exchanged between sponsors and providers be shared with participants.

[5] Dan M. McGill, et al., Defined Benefit Design: Retirement and Ancillary Benefits," in Fundamentals of Private Pensions, 8th ed. (New York: Oxford University Press, 2005), 235-272.

There is no requirement that all information material to investment decision-making, including information regarding industry practices (such as "caps" on revenue sharing described below which may not be known by sponsors) be provided to participants. Each participant in a DC plan receives the accumulated assets contributed in his account minus any expenses and plus or minus any investment gains or losses. There is no certainty as to benefits upon retirement and retirement planning becomes far more problematic. In summary, in a DC plan participants bear all the risk but have no or only limited control with respect to management of the plan or the assets within their accounts.

Due to differences in the allocation of risk and responsibility, transparency and access to information, there are economic reasons to expect that the aggregate investment portfolios of the two types of plans will be dissimilar to one another. A DB plan fiduciary will make asset selection and allocation decisions with access to greater information and with the company's economic interests in mind. On the other hand, in a DC plan, the participants are forced to select among investment options that have been chosen for them (as a result of negotiations between parties that have economic interests not fully aligned with participants), with less access to information. Therefore, it is unlikely that the two types of plans will perform comparably.

In the words of Travis Plunkett, Legislative Director of the Consumer Federation of America in his testimony before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget and International Security, "A growing percentage of mutual fund transactions occur through employer- sponsored retirement plans. In these plans, investors generally have very limited options and therefore cannot effectively make cost-conscious purchase decisions. These investors must instead rely on their employers to consider cost when selecting the plan. But plans often compete for employers' business by

shifting the administrative costs onto the employees in the form of higher 12b-1 fees." [6] In other words, employers and providers of services to retirement plans pursue their own economic agendas in connection with plan management decision-making at the participants' expense.

In addition, due to differences in the allocation of risk and responsibility, transparency and access to information, the two different types of plans generally invest in different investment vehicles. For example, high cost mutual funds are the most common investment vehicle in 401k plans and are used in 91% of plans. Separate accounts are used in 20% of plans, collective trusts in 17%, and annuities in 6%.[7] While cost-effective alternatives designed specifically for defined contribution plans could have easily been developed (due to the unique economies of scale related to marketing to and managing these plans), providers of investment management services generally chose instead to market retail or so-called "institutional" mutual funds, neither of which are truly competitive with DB products to DC plans. (The fees related to institutional mutual funds, while generally lower than retail funds, are rarely as low as the fees institutions pay for non-mutual fund products.)

There are certain key features of most defined contribution retirement plans that distinguish these plans from defined benefit plans. Proponents of DC plans maintain that many of these features are attractive to participants and employers alike. The key features most commonly cited are (1) portability; (2) participant choice regarding contributions; and (3) participant control over investments.

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[6] Testimony of Travis Plunkett, Legislative Director of the Consumer Federation of America in his testimony before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget and International Security. Regarding Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors. January 27, 2004.

[7] Deloitte Consulting, Annual 401(k) Benchmarking Survey: 2005/2006 Edition.

Portability refers to the ability of the employee to change employers and maintain retirement savings from the previous employer. It is said that as American workers have become more mobile in terms of their employment choices, the need for portability in retirement accounts has become more important. The mutual fund industry and sponsors often cite portability as the justification for moving from DB to DC plans. Clearly, Americans have become more mobile in their employment in recent decades but not necessarily out of choice. Few workers today may choose to spend their entire careers with a single employer. DC plans do offer greater portability than DB plans. Unfortunately, portability, which has become more important in an era of employment insecurity, often leads to less retirement income security, not more.

According to a White Paper by the National Association of State Retirement Administrators, "studies and experience show that a majority of terminating employees with a DC plan as their primary retirement benefit, cash out their assets rather than roll them to another plan. Retirement assets that are cashed out usually become subject to federal and state taxes and sometimes a penalty. Cashing out retirement assets defeats the purpose of having a retirement plan, yet DC plans provide little defense against such "leakage" of retirement assets. An important objective of providing a retirement benefit is to retain quality employees. DC plans do not support this objective because they do not reward or encourage longevity."[8]

In testimony before Congress, the president of the Employee Benefits Research Institute stated, "Preservation (of retirement assets) in the presence of portability is, in my mind, the largest single issue in the system today in terms of determining how much money will actually be available to provide retirement income in the 21st century… Policymakers cannot fairly assess the portability issue unless they fully

[8] Myths and Misperceptions of Defined Benefit and Defined Contribution Plans by Keith Brainard, National Association of State Retirement Administrators, November 2002, Updated February 2005.

consider the consequences of money leaving the system versus money staying within the system."[9]

With respect to the second key feature of DC plans, participant choice, in the words of the National Association of State Retirement Administrators, "some employees do wish to manage their own retirement assets, and most DC plans not only allow but require participants to manage their retirement assets. DC plans also shift the risk of managing retirement assets from the plan sponsor to individual participants. Unfortunately, most employees are at best mediocre investors, unlikely to generate an investment return that will ensure an adequate level of retirement income. DB plans have a longer time horizon, enabling them to withstand market volatility better than individuals. DC investors have a shorter investment horizon, requiring them to hold a more conservative portfolio, which leads to lower returns and less retirement income…A key difference between DC and DB plans is that DC plans provide the opportunity to create wealth, while DB plans provide income security. **The purpose of a retirement plan is not to empower employees, or to create sophisticated investors, or to make participants wealthy. The chief purpose of a retirement plan should be to promote financial security in retirement. Requiring individual employees to bear the entire risk of assuring an adequate level of retirement income ignores the fact that most employees lack the knowledge of investment concepts and practices needed to succeed. When employees fail to save enough for retirement, they and their dependents may face indigence in their elder years and may be required to work in retirement. Some will become dependent on the state for public assistance (emphasis added).**"[10]

[9] The Future Role of Pensions in the Nation's Retirement System, July 15, 1997 - Panel Discussion General Accountability Office Conference, Retirement Income in the 21st Century.

The National Association of State Retirement Administrators concludes that to ensure retirement security a DB plan should constitute an employee's basic retirement benefit, but that this plan should be supplemented by a voluntary DC plan. The Association states that "This arrangement satisfies the objective of providing a guaranteed pension benefit, while giving those employees, especially those wishing to manage their own assets, the opportunity to save and invest in accounts they manage and direct." This recommendation of offering both DB and DC plans would clearly benefit workers; however, its effect upon the economic interests of sponsors and providers of services to DC plans is less certain.

With respect to the third key feature of DC plans, participant control over investments, any such "control" of investment is, in fact, very limited. As noted earlier by Plunkett of the Consumer Federation of America[11] and elaborated upon below with respect to the "informational advantage" of plan sponsors and providers of services to plans, sponsors limit or control the investment options offered to participants; providers limit or control the investment options which sponsors are offered, permitting only funds that agree to pay compensation or fix pricing to be offered on menus. Sponsors and providers also control the flow of information to participants related to the investment options offered. Often the summary information participants receive is materially incomplete or simply wrong. For example, today it is customary practice for mutual fund prospectuses to be delivered, if at all, only after participants have already made their

[10] Myths and Misperceptions of Defined Benefit and Defined Contribution Plans by Keith Brainard, National Association of State Retirement Administrators, November 2002, Updated February 2005.

[11] Testimony of Travis Plunkett, Legislative Director of the Consumer Federation of America in his testimony before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget and International Security. Regarding Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors. January 27, 2004.

initial investment in a fund. Almost always, participants base their investment decisions on incomplete summary information (i.e., something less than the full prospectus) which may be subject to errors related to the summarization process or transmission.

Given these realities, the notion that participants "control" their investments is difficult to support. Indeed, defined contribution plan participants arguably have less control over their investments than other investors.

Since their introduction more than 25 years ago, 401k plans have proliferated. The massive growth of these plans is easily explained. The plans are popular with employers because, as an employee "benefit" they are useful in attracting and retaining employees, yet employers are not obligated to provide any "benefit" upon retirement. Employees are led to believe that if they contribute to these plans and follow a disciplined investment program, i.e., behave responsibly or become "sophisticated," upon retirement they will have sufficient assets to fund their non-wage earning years. However, as indicated earlier, employers separately acknowledge they do not believe this envisioned retirement security is likely. These plans are far more popular with providers of services to retirement plans because of the high fees and lower marketing costs involved. As the pages of personal finance publications illustrate, the mutual fund industry has spent massive amounts of money promoting high cost 401k product and the explosive growth of mutual funds clearly correlates to growth of the 401k market. In summary, both employers and providers have for more than 25 years successfully promoted these plans as being good for participants, as opposed to good for them.

Employers and providers of services to defined contribution retirement plans maintain that such plans are popular among employees. They cite the proliferation of 401ks as evidence of their popularity with employers and employees alike. Given the vast marketing dollars behind 401ks, i.e.

employer and provider promotion, a certain amount of employee enthusiasm would be expected. In addition, the growing lack of any meaningful retirement plan alternatives should dampen opposition. After all, some retirement benefit is better than none.

Are 401ks, in fact, popular with employees, as employers and providers would have us believe? Do employees, when given a choice, choose defined contribution plans? (Of course, in reality, employees rarely are permitted to choose between DB and DC plans.)

When new employees of six public pension systems were given the choice between DB and DC plans, employees overwhelmingly chose DB plans.[12] As the author noted, "Most private employers provide a DC plan or no plan at all… This perhaps is the ultimate choice: Do public employees want the choices a DC plan provides or do they prefer the security of monthly payments guaranteed to last a lifetime?"[13]

According to a recent survey on behalf of the National Institute on Retirement Security, "Almost 9 in 10 Americans believe workers should participate in a defined benefit plan. Also, 83% said they were concerned about how current economic conditions would affect their retirement and 79% supported the creation of government-sponsored pension plans that small employers or individuals could join. The survey found that workers want pension plans that offer portability, employer contributions, continuation of benefits for a spouse after death and a regular check that cannot be outlived. Nearly 60% agreed with the statement that "401(k) plans force workers who might not be

[12]Defined Contribution Experience in the Public Sector, by Mark Olleman, Milliman Inc., Benefits and Compensation Digest, February 2007.

[13] Ibid.

investment experts to gamble their retirement nest eggs on[14] the stock market, so they could find themselves without the money they need for their retirement."

In conclusion, while defined contribution plans are clearly popular with employers and providers of services to such plans, it is less certain that such plans are popular with employees. At a minimum one cannot assume that the growth of such plans is attributable to their popularity with employees and employers alike.

III. Lack of Transparency and Competition in Defined Contribution Plans

Defined contribution retirement plan service providers, including record-keepers, investment managers and broker-dealers, maintain that the market for their services is highly competitive. The fact that fees are high, performance is lacking and plans fail to provide meaningful retirement security is unfortunate but the industry asserts it is not to blame.

This defense of the industry is contrary to formidable information which has surfaced within the past 7 years regarding widespread abuses in the mutual fund, securities brokerage and retirement plan investment consulting industries, all of which have been damaging to 401k plans. These abuses that have only been exposed in recent years, have endured for decades (indeed since the inception of defined contribution plans), undisclosed to investors. While there are dozens of retirement plan record-keepers (a handful of which dominate the market), hundreds of investment advisers that provide investment management services to retirement plans, dozens of retirement plan investment consultants and thousands of securities brokerages, it appears that an

[14] 87% Say Workers Should Have Pensions, by Jennifer Byrd, Pensions & Investments Online, January 14, 2009.

uncompetitive environment has resulted from a lack of transparency that permits conflicts of interest that are rampant throughout the industry and unscrupulous business practices.

In the words of Travis Plunkett, "… the mutual fund market lacks three key characteristics needed to effectively discipline costs: transparent disclosure, meaningful price competition, and, absent those two characteristics, regulatory policing of the worst abuses."[15]

Any objective history of the mutual fund industry must acknowledge that the period from 2002-2007 brought forth a succession of revelations of longstanding wrongdoing that threatened to completely undermine public confidence in the industry. Civil litigation related to these abuses continues through today and disbursement of settlement proceeds to wronged mutual fund investors has yet to be completed. The mutual fund industry has been subjected to the greatest challenge to its reputation since creation of the applicable regulatory scheme in 1940. These are not isolated instances of unscrupulous behavior; rather, the "mutual fund scandals," as they were referred to in the press, concerned practices that implicated virtually every mutual fund organization in the nation.[16]

In the words of William Donaldson, Chairman of the U.S. Securities and Exchange Commission, testifying before the Senate Banking Committee, "Like you, I am outraged by the conduct that has come to light in the recent mutual fund scandals. In large part, I believe that the industry lost sight of certain principles - in particular its responsibility to millions of investors who entrusted their life's savings in this industry for

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[15] Ibid.

[16] A Mutual Fund Scandal Explained, by James Toedtman, Newsday.com, November 5, 2003. Mutual Fund Scandal Casts Shadow: Well-Known Firms Could Be In Dire Straits In 2004 by Joel Arak, Associated Press.

safekeeping. As I said last fall when I testified before you, and I believe it bears repeating, these mutual fund investors are entitled to honest and industrious fiduciaries who sensibly put their money to work for them in our capital markets."[17]

As stated in a Forbes article titled, The Great Fund Failure, the fund business is "shortsighted, poorly governed, weak on disclosure and riddled with conflicts of interest. This is an industry that pays lip service to helping investors achieve long-term goals while spending a bundle promoting the short-term payoff of hot-for-the-moment funds. It has tossed economies of scale out the window, charging more per dollar invested as fund assets have grown. Investors pay upwards of $100 billion in annual fund costs and fees. What do they get for this? Almost by mathematical necessity, they get, on average, mediocrity."[18]

Market timing, late trading, revenue sharing, directed brokerage and other compensation arrangements involving mutual fund money managers and securities brokerages providing services to defined contribution plans resulted in numerous enforcement actions by state and federal securities regulators in recent years. The then Attorney General of the State of New York was the first to alert the nation that assets were systematically being "skimmed" from mutual funds. [19]

The SEC and National Association of Securities Dealers took action against brokerages that failed to provide quantity discounts on mutual fund sales. Again, according to Forbes, "The industry often fails to grant the discounts that customers were promised. Nearly a third of fund

[17] Testimony Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry, by William Donaldson, Chairman, U.S. Securities and Exchange Commission , Before the U.S. Senate Committee on Banking, Housing and Urban Affairs April 8, 2004.

[18] The Great Fund Failure, by Neil Weinberg and Emily Lambert, Forbes, September 13, 2003.

[19] Mutual Fund Trading Abuses: Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage, GAO-05-313 April 2005

investors eligible for quantity discounts on sales commissions haven't been receiving them, a study of 43 brokerages found. The average discount missed: $364. On another front, both the SEC and the National Association of Securities Dealers recently fined brokerages for loading investors into expensive share classes to maximize their own take."[20]

Throughout this period a consensus emerged that the mutual fund governance structure mandated by the federal statute, the Investment Company Act of 1940, long criticized by leading legal and business experts as inadequate and permissive of outrageous conflicts of interest was a model of poor corporate governance. Mutual fund boards which were supposed to function as watchdogs over the investment advisers to funds were ridiculed. As famed investor Warren Buffett opined in Berkshire Hathaway's 2002 annual report: "Tens of thousands of (mutual fund) independent directors, over more than six decades, have failed miserably." While a truly independent board would occasionally fire an incompetent or overcharging fund adviser that almost never happens in the mutual fund industry. According to Buffett, "A monkey will type out a Shakespearean play before an independent mutual fund director will suggest (it)."

Even the Investment Company Institute, the mutual fund industry powerful lobby group, acknowledged the governance failure, as did other industry experts.

"Ninety percent of the problems come down to governance," says Fundalarm's Weitz. He says that many modern fund management companies have moved far away from the tenets of the Investment Company Act of 1940. The '40 Act, as it is called, intended that individual fund boards be "real watchdogs," says Weitz. But now, with directors at some fund management companies overseeing dozens of funds, their

[20] The Great Fund Failure, by Neil Weinberg and Emily Lambert, Forbes, September 13, 2003.

ability to uphold the spirit of the Act has been greatly diluted. Indeed, the board of the Investment Company Institute, a major fund management lobbying group, has raised the white flag for correcting what appear to be systemic problems. "Our commitment to righting the wrongs that arise from these investigations comes with no caveats, limitations or qualifications," says Paul Haaga Jr., chairman of ICI and executive vice president of Capital Research and Management, which advises the $454 billion American Funds mutual fund family."[21]

It became apparent that enforcement of the laws applicable to funds on the federal level by the SEC and NASD, had failed to prevent rampant abuses in the mutual fund industry. The Government Accountability Office was asked to investigate why the SEC had failed to detect these violations earlier. [22] The SEC has yet to recover its reputation as an effective regulator. Many, including the author, concluded the SEC had become irrelevant.

"…the federal agency charged with safeguarding investors is on the verge of becoming irrelevant. If you want protection from investment pitfalls, you're going to get it from the private sector…This agency spends $888 million a year. If it were subject to disclosure laws the SEC would have to admit it could get a lot more bang for taxpayers' buck were it not so compromised by conflict of interest."[23]

The Investment Company Institute, the mutual fund industry lobby group, came under criticism for misrepresenting in its advertising that it "represented the nation's 95 million mutual fund investors" in its literature, as evidence surfaced that some of the largest mutual fund

[21] Help Wanted: Mutual Fund Execs, Ari Weinberg, Forbes, November 10, 2003.

[22] Mutual Fund Trading Abuses: Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage, GAO-05-313 April 2005.

[23] On My Mind: The Irrelevant SEC, by Edward Siedle, Forbes, November 27, 2006.

advisers had been paying their hefty ICI annual membership dues with shareholder funds. In other words, investor monies were being used against them. The only plausible explanation for this practice would be a lack of meaningful disclosure to investors.

“Little known outside the Beltway, the ICI is a powerful force dedicated to upholding the interests of the firms that run the nation's mutual funds--usually by opposing the interests of the 95 million Americans who invest in them. The twisted part: Often investors pay the ICI's tab, unknowingly… Janus says all of the money it gave to ICI came directly from its funds--meaning from investors--and Fidelity says that is true for some of the cash it contributed to ICI… The ICI uses the money to oppose virtually every pro-investor initiative to come out of the SEC or Congress. It has fought to avoid telling investors how their funds perform after taxes, how much they shell out in dollars for fund fees and how fund firms vote their proxies. If any elements of the recently proposed Mutual Funds Integrity and Fee Transparency Act of 2003 become law, it will happen only over the vehement opposition of the ICI. "The ICI and fund industry have spent a lot of time opposing whatever they could oppose," says Representative Richard Baker (R-La.), author of the bill. "It's arrogance. The attitude is we've been doing things the same way for so long you're not about to stop us."” [24]

The Attorney General of the State of New York and other industry experts observed that in a truly competitive environment (if mutual fund boards were adequately protecting the interests of mutual fund investors, as opposed to doing the bidding of the adviser), investment advisory fees would have fallen precipitously as the assets under management in mutual funds grew exponentially. Such fee reductions should have resulted from the widely-acknowledged enormous “economies of scale” enjoyed by the investment management industry.

[24] Your Money At Work--Against You by Neil Weinberg and Emily Lambert, Forbes, September 15, 2003.

However, the growth of mutual fund assets did not result in the expected reductions in mutual fund investment advisory fees.

As stated in Forbes, "Economies of scale? This is a business made for them--but, outside of some genuinely cost-conscious purveyors like Vanguard and TIAA-CREF, the customers don't see the benefit. The business grew 71-fold (20-fold in real terms) in the two decades through 1999, yet costs as a percentage of assets somehow managed to go up 29%. The recent market doldrums have caused a slip in assets to $6.8 trillion, prompting the industry to plead poverty--and foist yet more fee hikes on investors."[25]

The Forbes article went on to point out that retirement plan investors in particular are overcharged. "If fund customers aren't doing well, the vendors sure are. The average net profit margin at publicly held mutual fund firms was 18.8% last year, blowing away the 14.9% margin for the financial industry overall; the S&P 500's average was only 3%. This in a business that owes $2.1 trillion of its nearly $7 trillion in fund assets to a very easy sale--tax-deferred retirement plans."[26]

In the words of Travis Plunkett of the Consumer Federation of America, "In recent years, the debate over mutual fund management fees has focused primarily on questions of why – given the enormous growth of fund assets in the past two decades – mutual fund shareholders have not seen more benefit from resulting economies of scale. No one has made the argument that mutual fund expenses are excessive more eloquently … than …John Bogle, Founder and former CEO of the Vanguard Group. … Regardless of the outcome of this debate, we

[25] The Great Fund Failure, by Neil Weinberg and Emily Lambert, Forbes, September 13, 2003.

[26] Ibid.

believe there is compelling evidence that management costs at some funds are excessive."[27]

Why did the anticipated reduction in mutual fund fees fail to materialize? As the popularity of mutual funds grew and the number of mutual funds exploded, asset gathering or marketing grew in importance. In a world with thousands of competing funds, asset gathering became more, or at least as, important than asset management or investment results. Due to mutual fund lack of transparency, fund firms were able to divert greater percentages of the stated investment-related fees for marketing purposes through so-called revenue sharing, sub-transfer agent, directed brokerage, soft dollar and other arrangements, as opposed to reducing fees to investors. It was never adequately disclosed to investors that they were paying more in fees to help mutual fund advisers sell funds and build their businesses.

CFA's Plunkett stated that the "lack of effective price competition permits and may even encourage escalation not just of distribution costs, but also of other shareholder expenses, such as portfolio transaction costs and management and administrative fees."[28]

Plunkett commented regarding one form of mutual fund "revenue sharing," which he described as "another practice that grew out of the industry's desire **to find less visible ways to pay distribution costs.** Under this form of "revenue sharing" payment, a fund agrees to conduct portfolio transactions through a particular broker in return for an agreement by that broker to sell the funds in that fund family. In

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[27] Testimony of Travis Plunkett, Legislative Director of the Consumer Federation of America in his testimony before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget and International Security. Regarding Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors. January 27, 2004.

[28] Ibid.

practice, such agreements often mean the fund foregoes an opportunity to obtain lower transaction costs. Since transaction costs are paid directly from fund assets, any practice that drives up fund transaction costs will depress shareholder returns … The practice appears to be quite widespread. A recent SEC enforcement sweep of 15 broker-dealers that sell mutual funds found that 10 of the 15 accepted revenue sharing payments in the form of brokerage commissions on fund transactions. According to one estimate, $1.5 billion a year of the fund industry's $6 billion in trading commissions goes to pay for distribution through such arrangements, but others have suggested the percentage is much higher."[29] According to Institutional Investor, some industry experts, including the author, have estimated the amount of brokerage commissions used for marketing is closer to 75% or $4.5 billion annually.[30]

With respect to mutual fund trading costs, forbes stated, "High fees tell only part of the fund-cost story. Mutual funds also run up trading charges averaging five cents a share--five times the rate paid by retail investors to an online discounter… Funds can also use their commission dollars to reward brokers for bringing in new clients. Putnam fund prospectuses admit this is a "factor in the selection of broker-dealers." However, a Putnam spokesman insists soft dollars bring in new assets, create economies of scale and lower investor fees. Why, then, did Putnam funds' average cost rise 20% in the past decade (to $1.42 per $100 invested)--even as the company's fund assets nearly tripled to $140 billion?"[31]

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[29] Ibid.

[30] Misdirected Brokerage, by Rich Blake, Institutional Investor Magazine, June 17, 2003.

[31] The Great Fund Failure, by Neil Weinberg and Emily Lambert, Forbes, September 13, 2003.

Industry experts also observed that the huge disparity that existed between the fees that mutual funds paid advisers and pension funds paid these same advisers for the very same investment advisory services, often as much as quadruple the amount, were unjustified. Professor John P. Freeman's definitive research paper on the topic found that pension funds paid roughly half as much in advisory fees as mutual fund shareholders.[32] As Spitzer observed to the author, if mutual fund boards simply required advisers to include "most favored nation's" provisions in their contracts with funds, which is standard practice in the institutional marketplace, mutual fund investment advisory fees would be reduced dramatically to competitive levels. (In a "most favored nation's provision" the investment advisor represents to the client that the fee included in the contract is the lowest the adviser offers any client for the same service.) The universal failure of mutual fund boards to demand such provisions in fund advisory contracts was viewed as powerful evidence that boards were not effectively negotiating on behalf of shareholders.

According to Freeman's research Fund boards approved an average fee of 0.56% for the stock-picking component of expenses--double what public pension funds pay the same fund companies for the same services. This is remarkable given that, at $1.3 billion, the average mutual fund is three times as large as its pension counterpart.[33]

According to Forbes, "All told, the industry's extra levies soak mutual fund investors for $9 billion a year, the advisory fee report (Freeman) added. In the circular logic of the fund business, however, such discrepancies are irrelevant. As long as a fund's fees are not too far out

[32] Mutual Fund Advisory Fees: The Cost of Conflicts of Interest, by John P. Freeman and Stewart L. Brown, The Journal of Corporation Law, Spring 2001

[33] Ibid.

of line with its peers', the thinking goes, just about anything is justifiable."[34] In other words, despite the fact that the mutual fund industry does not attempt to be competitive, it has prospered.

While evidence of fiduciary breaches by mutual fund advisers mounted, ethical lapses involving other providers of services to retirement plans were also found to be widespread.

For example, retirement plan investment consultants, firms hired by plan sponsors to provide expert, objective advice regarding asset allocation and manager selection, were found to be subject to pervasive and poorly disclosed conflicts of interest by both the Securities and Exchange Commission and the Department of Labor in 2005. [35] As the DOL noted, "Findings included in a report by the staff of the U.S. Securities and Exchange Commission released in May 2005 …, raise serious questions concerning whether some pension consultants are fully disclosing potential conflicts of interest that may affect the objectivity of the advice they are providing to their pension plan clients… SEC staff examined the practices of advisers that provide pension consulting services to plan sponsors and trustees. These consulting services included assisting in determining the plan's investment objectives and restrictions, allocating plan assets, selecting money managers, choosing mutual fund options, tracking investment performance, and selecting other service providers. Many of the consultants also offered, directly or through an affiliate or subsidiary, products and services to money managers. Additionally, many of the

[34] The Great Fund Failure, by Neil Weinberg and Emily Lambert, Forbes, September 13, 2003.

[35] Staff Report Concerning Examinations Of Select Pension Consultants May 16, 2005 The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission.

consultants also offered, directly or through an affiliate or subsidiary, brokerage and money management services, often marketed to plans as a package of "bundled" services. The SEC examination staff concluded in its report that the business alliances among pension consultants and money managers can give rise to serious potential conflicts of interest under the Advisers Act that need to be monitored and disclosed to plan fiduciaries."[36]

To encourage the disclosure and review of more and better information about potential conflicts of interest, the Department of Labor and the SEC took the unusual step of developing and issuing a set of questions to assist plan fiduciaries in evaluating the objectivity of the recommendations provided, or to be provided, by a pension consultant.[37]

Furthermore, conflicts of interest by these firms that recommend money managers to plan sponsors and monitor and report on manager performance were found to result in substantial harm to plans by the Government Accountability Office in a 2007 report.[38] In its report the GAO took the extraordinary step of quantifying the harm a conflicted expert adviser to a plan can cause. "Defined Benefit plans using these 13 consultants (with undisclosed conflicts of interest) had annual returns generally 1.3% lower ... in 2006, these 13 consultants had over $4.5 trillion in U.S. assets under advisement," the report stated.[39]

[36] Selecting and Monitoring Pension Consultants, Tips for Plan Fiduciaries, U.S. Department of Labor, May 2005.

[37] Ibid.

[38] Defined Benefit Pensions: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges, GAO, June 28, 2007.

[39] Ibid.

Failure to disclose conflicted sources of compensation and the amounts of such compensation among these trusted advisers to sponsors of retirement plans was documented by all these federal agencies. Prominent firms providing advice to some of the nation's largest defined contribution plans, such as Callan Associates and Yanni Partners, were sanctioned by the SEC.[40] Numerous civil lawsuits were also filed against Callan and other conflicted investment consultants to retirement plans. Callan Associates agreed to pay the city of San Diego $4.5 million and PaineWebber agreed to pay the city of Nashville $10.6 million in settlements as a result of conflicted advice they provided to the cities' employee pension funds.[41]

Record-keepers for defined contribution plans were not immune from criticism. Fidelity Investments, the largest administrator of 401(k) programs for corporations, was charged by the AFL-CIO that its contract to administer Lockheed Martin's 401(k) encouraged it to side with management in supporting the re-nomination of director Frank Savage, despite his performance as an Enron director. Fidelity denied the charge but also declined to disclose to investors how it voted their shares.[42] Price-fixing or record-keeper "caps" on revenue-sharing imposed by fiat, is one of the most recent abuses to emerge. (See below)

In summary, lack of transparency regarding the economics related to the management of retirement assets and lack of competition among providers is indisputable at this time; today debate centers around the degree of additional transparency that is necessary to improve

[40] Adviser Firm on Pensions Is Rebuked, by Mary Williams Walsh, The New York Times, September 21, 2007.

[41] PaineWebber Settles Pension Fund Dispute With Nashville, By Gretchen Morgenson, The New York Times, May 4, 2002. Callan Associates Settlement with San Diego City Employees' Retirement System, Pensions & Investments, December 2006.

[42] The Great Fund Failure, by Neil Weinberg and Emily Lambert, Forbes, September 13, 2003.

competition and protect investors, as well as the magnitude of the related harm. All parties agree that enhanced transparency, whether desirable or not, is inevitable. Defined contribution retirement plan providers not surprisingly insist that less transparency benefits participants (i.e., too much information confuses investors) and that disclosure of the true economics of the arrangements among vendors to plans is irrelevant to participants or plan sponsors.

These arguments fail to acknowledge that if the portion of mutual funds that is diverted for distribution and other forms of price manipulation were fully disclosed to investors, then investors would be able for the first time to make an informed decision as to whether they believed such fees were justified. According to forbes, "The nation's 95 million investors in mutual funds are overwhelmed by the competing claims of 8,300 funds. They often are clueless about how to win at a fund game on which their financial futures depend: Despite clear evidence to the contrary, 84% believe higher fees buy better performance, according to an academic study last year."[43]

With enhanced transparency investors will be able to make an informed decision as to whether they are willing to pay higher fees to help mutual fund advisers' market their funds and build their businesses, as opposed to obtain superior investment performance.

IV. Economic Self-Interest in Defined Contribution Retirement Plans

Providers of services to defined contribution plans reference economic theory in defense of the status quo. They remind us that one of the most fundamental economic principles is that economic agents act in their self-interest. Therefore, if high cost, poor performing mutual funds garner the vast majority of 401k assets this indicates that such funds are

[43] Ibid.

somehow economically rational investment choices that add value to investors. However, such economic analysis is conveniently incomplete.

If it is true that all economic agents act in their self-interest, then fiduciaries (including plan sponsors) and financial services firms providing services to these plans, as well as participants, will act in their own self-interest. The issue then becomes whose economic interests prevail.

While the industry readily references economic theory to defend its actions and justify its arrangements with plans (see discussion of asset-based record-keeping fees below), it is rarely candid in disclosing disincentives and conflicts of interest that exist in the defined contribution retirement plan context. Further, plan sponsors do not disclose to participants where their economic self-interest impacts upon plans.

The result is that participants are generally unaware of the economic self-interest of sponsors and providers and any potential impact upon the plan. Two reported examples, one recent and the other current, clearly illustrate how provider pursuit of economic self- interest harms 401k participants.

As discussed in Forbes in 2003, “Schwab offers 1,700 outside funds without even the $50 charge, through its OneSource supermarket. For the investor who would otherwise have to contend with a blizzard of paperwork from different fund vendors, OneSource is a godsend. Schwab's pitch (like that of Fidelity and others with supermarkets): You pay nothing extra for this convenience. That's true, in the sense that someone getting the Janus Twenty fund via Schwab bears the same 0.83% annual expense ratio as someone buying directly from Janus. But Schwab extracts undisclosed fees from the fund vendors for acting as

middleman, and these fees necessarily put upward pressure on fund expense ratios. Penny-pinching Vanguard refuses to go along."[44]

In other words, Schwab requiring mutual funds to "pay-to-play" on its platform and retaining such revenue sharing payments keeps the fees 401k investors pay higher than if Schwab were to rebate these payments to plans (or if funds were to simply lower their fees). But this scheme is even more damaging.

David Swensen of Yale, referring to the Schwab arrangement stated, "Schwab's fee arrangements serve to restrict investor choice. Consider the consequences of the firm's early 2003 increase in charges to all but the very largest mutual-fund complexes. The increase in fees drove one of the country's finest mutual fund managers- Southeastern Asset Management- to leave Schwab's system. Southeastern characterized Schwab's fee increase as "duplicative and excessive." By eliminating one of the few superior active managers from its list of offerings, Schwab put its interest in profits far ahead of its clients' needs."[45]

Today 401k record-keepers are playing a far more dangerous game, forcing participants (many of whom have already experienced losses amounting to 50% or more) into funds that expose them to greater risk than they chose. As discussed in an editorial in Pensions & Investments, "At a time of extreme market turmoil when defined contribution plan participants are seeking safety to preserve their principal, mutual fund organizations are closing or restricting contributions into their Treasury money market funds, regarded as the ultimate safe investment option… The moves by the mutual fund companies have left DC sponsors with the difficult decision of what to offer in place of the Treasury fund for

[44] Holier Than Whom by Neil Weinberg, Forbes, June 23, 2003.

[45] Unconventional Success, A Fundamental Approach to Personal Investment, David F. Swensen, Free Press 2005.

worried participants… The fund companies are closing or restricting new cash flows into their Treasury money market funds because they fear the funds' yield in the market crisis could fall to levels so low they cannot sustain their fee structure."[46] Given the current market environment it is more likely than not that these short term funds investing in obligations not guaranteed by the U.S. Government will experience principal losses. At such time these mutual fund companies, such Vanguard and Schwab, will deny any responsibility. After all, the participants "chose" to move out of Treasury funds and into riskier investments.

V. The "Informational Advantage"

Plan sponsors and retirement plan service providers negotiate and enter into economic arrangements related to defined contribution retirement plans without the involvement of participants and maintain a significant "informational advantage" over plan participants at all times. Given the demands of the workplace upon participants, to some extent this informational advantage in defined contribution retirement plans is inevitable. "The majority of investors work 40 to 60 hours a week, check off a box and send their money into a black hole," says Representative Richard Baker (R-La.), the chairman of the House subcommittee on capital markets. "With more unsophisticated people involved in this market than ever, we need better disclosure."[47]

Plan sponsors and retirement plan providers, as experts in retirement plan matters use their informational advantage to serve their own economic agendas. The pursuit of economic self-interest by these parties may result in economic harm to participants, both in terms of higher expenses and diminished investment returns.

[46] Lost Horizon by Barry Burr, Pensions & Investments, February 2, 2009.

[47] Ibid.

Participants today generally bear most, if not all, of the costs of defined contribution retirement plans and the trend is clearly toward shifting the entire cost onto participants. Yet participants have least access to information regarding the economics of managing the plans in which they invest. The plan sponsor has greater access to information from providers of services to the plan as a result of its role in sponsoring the plan and, of course, the plan sponsor is knowledgeable regarding its own economic interests.

However, even sponsors do not have access to information regarding all the economic arrangements among the vendors to the plans they sponsor. **Simply put, there are secrets financial services firms are unwilling to share with their clients, even large plan sponsors.** It is well-known throughout the defined contribution industry that in those rare instances where plan sponsors have sought too much information related to these economic arrangements, major record-keepers have balked at providing it. Routinely any incremental disclosure provided by vendors to better-advised larger sponsors (with clout) is subject to draconian confidentiality agreements that ensure the information is not broadly disseminated to sponsors and participants. For example, in a recent 401k fee lawsuit filed against Wal-Mart it was revealed that Wal-Mart contractually agreed to keep confidential and not disclose to participants information regarding total fees paid by the largest defined contribution plan in America (based on number of participants) to its record-keepers.[48]

Like investors in the recent Madoff scandal, plan sponsors have been taught to restrain from probing too deeply into these arrangements and instead be satisfied with industry assurances of fair dealing. For example, plan sponsors do not monitor investment manager compliance with “most favored nation’s” provisions in their contracts with plans by

[48] The Truth About Hidden 401k Fees, Bloomberg Television, June 19, 2008.

contacting other comparable plan clients of the manager to verify that the plan is indeed paying the lowest fee the manager charges. Such information is readily available but sponsors are too polite to engage in such questioning. As a result, plan sponsors almost universally lack complete information related to the economic arrangements with and among vendors to the defined contribution plans they sponsor.

In summary, plan sponsors and service providers together control the flow of information to participants. Information related to the economic self-interest of any or all of these parties is often withheld from participants. As a result of this informational disadvantage, participant investment decision-making is compromised.

VI. Revenue Sharing and Fidelity's "Cap" on Revenue Sharing

Many types of compensation arrangements exist between mutual fund advisers and retirement plan record-keepers. Most, but not all, of these arrangements are committed to writing.

Revenue sharing agreements between mutual fund distributors and record-keeper brokerage affiliates are the most common forms of compensation arrangements. Plans sponsors may or may not be aware of the existence of any revenue sharing or other compensation arrangements between the mutual funds and record-keepers to their plans. To the extent that plan sponsors are aware of these arrangements, it is generally as a result of disclosure by record-keepers.

Different record-keepers have different policies regarding disclosure of revenue sharing and clients of a given record-keeper may be treated differently. Larger, more sophisticated clients may enjoy greater disclosure regarding the record-keeper's receipt of revenue sharing payments. Record-keepers may or may not be entirely truthful in their representations to plan sponsors regarding the nature and amounts of compensation related to any such agreements. Plan sponsors are not

provided by mutual fund advisers or record-keepers with copies of the operative agreements providing for an exchange of all forms of compensation related to their plans. Without the written agreements, i.e., absent transparency, it is impossible for plan sponsors to review these payments and verify the accuracy of the information they have been provided by record-keepers. Plan sponsors cannot be certain that they are receiving all the compensation circulating between the providers related to assets of the plans they sponsor.

However, perhaps the most important information related to the economic arrangements among providers to a plan does not concern the **receipt** of revenue sharing agreements. Rather, the record-keeper may engage in another form of economic manipulation: refusing to accept or **waiver** of its contractual right to revenue sharing payments.

Certain record-keepers with affiliated money management operations and significant market share, most notably Fidelity, have engaged in the practice of "capping" the amount of revenue sharing compensation they permit mutual funds to pay to plans using their record-keeping platform. In other words, if an adviser wishes to have its mutual funds offered on the Fidelity record-keeping platform, the adviser must agree not to pay or rebate more than 35 basis points related to its equity funds or 25 basis points related to its fixed income funds to retirement plan clients of Fidelity. When Fidelity implemented this policy, advisers who had contractually agreed to pay Fidelity more than these amounts were informed by letter that Fidelity would no longer accept any contractually agreed upon amounts in excess of the cap it had established.

Fidelity's waiver of its right to these contractually agreed upon revenue sharing amounts, resulted in significant loss of revenue sharing payments by its retirement plan record-keeping clients, assuming all such amounts paid to Fidelity would have, in turn, been rebated by Fidelity to its record-keeping clients. Given the significant market share Fidelity's defined contribution plan record-keeping operation enjoys

(Fidelity is the largest), this policy had the effect of significantly altering the economics of retirement plans by artificially raising net investment advisory fees. Why did Fidelity take this action? By limiting the compensation or rebates non-proprietary mutual funds were permitted to pay, Fidelity's own proprietary mutual funds that offered comparable (non-competitive) revenue sharing could still compete in terms of fees. Plan sponsors and participants did not benefit in any manner from this policy that was implemented solely to further Fidelity's economic self-interest. Not surprising, neither sponsors nor participants were told of the economic effects of this policy.

In a truly competitive environment, with the requisite transparency, Fidelity's policy of capping revenue sharing would have had economic consequences. The fact that it did not reveals that in the retirement plan industry price manipulation is not readily apparent. Recently, as a result of inquiries from reporters at forbes, Fidelity publicly announced that it was abandoning its policy of capping revenue sharing from non-proprietary funds.

"After repeated inquiries by FORBES, Fidelity Investments has reversed its fiat that rival mutual funds limit the price breaks they give to get into 401(k) retirement plans Fidelity administers for corporations. The discounts--technically rebates of expenses that might equal 1% of assets--often topped 60 basis points and in effect go straight to investors. For competitive reasons Fidelity would have to match the hefty cuts to get business for its own funds line. In 2004 Fidelity ordered the discounts be cut in half--"to level the playing field," it explained. But amid public criticism of high 401(k) fees, rivals screamed price-fixing. A Fido flack said the new move was long in the works." [49]

[49] Fighting For you Dear Reader, by Michael Maiello, Forbes, October 13, 2008.

In other words, faced with public exposure of the price-fixing, i.e. transparency in the marketplace for its record-keeping services, Fidelity relented. But for 4 years the revenue sharing cap imposed by Fidelity's enabled the firm to offer its funds that were not competitive in terms of fees to defined contribution plans.

Recently it has been disclosed that regulators have for years been investigating price-fixing in another supposedly competitive marketplace, municipal bond underwriting.[50] As is often the case, participants in an apparently competitive marketplace have been victimized by collusion between firms and manipulation of pricing. Lack of transparency has allowed this to happen.

VII. Provider Preference for "Bundled" Record-keeper Arrangements

The manner in which plan sponsors structure their arrangements with 401k record-keepers may enhance or reduce transparency. In a "bundled" arrangement, a single provider offers a single point of contact for all services – recordkeeping, investment management, trustee services and investor education. The "bundled" services arrangement provides the greatest profit potential for record-keepers and allows for the greatest manipulation related to the components of the expenses of the plan. For example, the expense of any service related to the plan can be manipulated downward or even eliminated provided the lost revenue is recouped elsewhere.

The greater the opportunity for manipulation of the pricing, the greater the "informational advantage" the vendors enjoy and the more difficult it is for sponsors and participants to evaluate fees and services, as well as compare competing proposals. As a result, such arrangements are preferred by record-keepers, consultants, mutual fund managers and

[50] Nationwide Inquiry On Bids For Municipal Bond, by Mary Williams Walsh, January 8, 2009.

other providers of services to retirement plans who share in the fees participants pay. The 2005/2006 Deloitte Consulting survey reports that bundled structures are used by 75% of plans and that plans with assets greater than $1 billion are more likely to choose the unbundled structure.[51] This is not surprising and reflects the fact that the informational advantage providers enjoy is less significant in the larger plan marketplace. Nevertheless, the advantage rarely disappears as even the largest plans either are unable or unwilling (like Madoff's investors) to demand the requisite level of transparency.

Historically, record-keepers have sought to contractually obligate plan sponsors to select some of or only their affiliated funds as investment options. More recently, as a result of regulatory concerns, record-keepers have backed-away from seeking such overt contractual provisions. Today record-keepers seek to informally persuade (rather than require in writing) use of their proprietary funds and, failing that, to require non-proprietary funds to pay revenue sharing comparable to the net investment advisory fees they earn from their proprietary funds. Record-keepers today even in an "open architecture" or unbundled environment, instead negotiate revenue sharing payments from all or virtually all of the investment providers involved. "Open architecture" simply means that any mutual fund that is willing to pay-to-play will be permitted to offer its shares on the record-keeper's platform as an option for defined contribution plan clients.

VIII. Record-keeper Preference for Asset-Based Compensation

Record-keepers advise define contribution plan sponsors that an arrangement in which administrative services are provided in exchange for asset-based fees charged in connection with a 401k plan's investment options (as opposed to fixed per participant or per transaction fees) offers advantages to the plan and its participants

[51] Deloitte Consulting, Annual 401(k) Benchmarking Survey: 2005/2006 Edition.

including aligning the interests of participants, providers and plan sponsors around the goals of asset growth and wealth accumulation. An asset-based fee arrangement, sponsors are told, provides an incentive for the record-keeper to develop programs designed to increase participation rates and deferral elections, both of which are important metrics in determining the success of a retirement plan, thereby furthering the sponsor's goal of ensuring employee retirement readiness.

This economic theorizing conveniently only goes so far and stops short of acknowledging any downside to asset-based recordkeeping fees arrangements. If the record-keeper were solely concerned with participants' accounts balance, it could reduce or eliminate its fee. The record-keeper does not do so because the record-keeper is first and foremost motivated by its own economic self-interest.

A corollary to the theory advanced by the industry that economic arrangements between plans and providers impact upon the success of retirement plans is that plans may suffer or fail if economic arrangements with providers involve improper incentives or conflicting economic interests. In other words, improper incentives may provide an economic explanation for poor plan results.

An arrangement in which a 401k plan's administrative service provider is compensated through asset-based investment fees poses significant dangers to the plan and its participants. First, under such an arrangement the record-keeper will likely experience a windfall in the likely event that assets under management grow through contributions and market appreciation over time – neither of which the record-keeper is responsible for. The industry's defense to this inevitable windfall appears to be that under an asset-based fee arrangement, depending upon market and asset growth, the record-keeper may not recover compensation equivalent to the market value of its services until many years into the relationship. In other words, any windfall in later years

only compensates the record-keeper for failure to receive market value for its services in early years. Record-keepers submit that they are entitled to recover costs related to transitioning a plan from another provider.

It is debatable whether a for-profit enterprise (record-keeper) should be entitled to a windfall in order to recover the costs related to the origination of a new revenue stream (the plan) from plan participants. But there is a far greater windfall record-keepers enjoy which is not revealed to plan sponsors or credited to plans.

It is well-known throughout the retirement plan industry that the richest source of revenue for record-keepers related to 401k plans relates to when employees leave plans either through termination of employment or upon retirement. At such time, record-keepers aggressively solicit these individuals to convert their plan assets into retail IRA accounts. Not surprising, the majority of former employees and retirees withdraw their assets from company 401k plans upon departure from active employment. This is a windfall for record-keepers because retail IRA products have higher fees and such investors typically stay in the retail IRS product. The record-keeper reaps these higher retail fees for the rest of the participants' lives. Not only do record-keepers not credit plans with the rich fees they collect related to this termination or retirement process, record-keepers actually charge additional fees to plans for "guidance" to participants nearing retirement "for the purpose of developing a comprehensive retirement plan." Such "guidance" in reality represents a rich selling opportunity for the affiliated asset manager. To add insult to injury, record-keepers charge participants for being converted to retail customers when there are stockbrokers and investment managers who would willingly pay for the opportunity to pitch their products to such a rich prospect base.

Record-keepers also maintain that in the typical asset-based fee arrangement, the record-keeper (like the investment managers) bears

the revenue risk associated with any adjustment in the financial markets, collecting less revenue during the periods of declining markets performance and negative net cash flows. This, of course, assumes that record-keepers do not seek to increase their fees during severe, prolonged market downturns, such as we are experiencing today. Since equity markets are generally considered to outperform fixed income, where an asset-based fee is involved, it would be in the record-keeper's economic self-interest to steer investors into equities or, in essence, gamble participant monies to increase its assets under management based fee. Actively managed equity funds would benefit the economic interest of the record-keeper most since these funds have higher fees that permit greater revenue sharing.

IX. Providers Promote Active Management

High cost actively managed mutual funds are pervasive in the defined contribution context. According to the ICI, 88% of 401k plan assets invested in mutual funds were invested in stock funds at year end 2007.[52] Since the average total expense ratio incurred by 401k investors in stock funds was 74 basis points[53] clearly these assets were primarily invested in actively managed equity funds. What is the explanation for this seemingly overwhelming preference for actively managed funds?

The mutual fund industry maintains that the strong demand for actively managed products in defined contribution plans demonstrates that investors value active management. Further, the industry notes that plan **fiduciaries** overwhelmingly choose to include actively managed funds in their plans. According to the industry, these consumers evaluate the attributes of available products and act in their self-interest

[52] The Economics of Providing 401k Plans: Services, Fees and Expenses, 2007, Investment Company Institute, Research Fundamentals, December 2008, Vol. 17, No. 5.

[53] Ibid.

by selecting the best basket of attributes given their individual preferences.

At the outset it is important to remember that providers create the investment products 401k sponsors and investors choose between. According to David Swensen of Yale, "Defined contribution menus reflect the investment products promoted by the mutual fund industry."[54] In addition, providers seek to control or limit (contractually or otherwise) the investment products sponsors and participants are permitted to choose between.

Virtually all retirement plan providers limit the universe of funds from which sponsors may choose investment options for participants. The justification for such limitations is generally that the provider has undertaken some value-added due diligence with respect to the investment menu. Sponsors and participants are told that only funds that meet the rigorous standards the provider has established are eligible for inclusion on the menu. These statements imply a level of fiduciary involvement. Rather than disclose that the investment menu is limited to proprietary or affiliated funds and funds that have agreed to pay compensation to the platform provider (i.e. that the limitation serves the economic interests of the provider), providers imply the limitation is founded upon fiduciary concerns, i.e., the best interests of the plan. With clever marketing, blatant self-interest is converted into illusory fiduciary protection for the client.

Providers of services to smaller plans (usually under $10 million in assets) are most likely to impose and rigorously enforce such limitations.

[54] Unconventional Success, A Fundamental Approach to Personal Investment, David F. Swensen, Free Press 2005.

Since over 92% of plans have less than $5 million in assets[55], the reality is that **providers almost always limit or control the investment options 401k participants are forced to choose between. Plan sponsors rarely control which funds are available to them and participants never do.[56] Again, providers use this "control" to serve their own economic interests.** Therefore, if investors choose poorly from the restricted menus providers offer, the industry cannot deny a substantial role in this outcome.

Since actively managed retail mutual funds, particularly equity funds have the highest fees (which can be divided among providers) it is clearly in the economic self-interest of the providers of investment services to plans (investment consultants, record-keepers, investment managers and brokers) that such funds dominate the investment line-up of defined contribution retirement plans and attract significant assets.

However, the dominance of actively managed funds in retirement plans would not be possible without convincing participants that active management will outperform passive management. Investors must be convinced (and as mentioned earlier 84% are) that higher fees will result in superior performance.

There are a variety of devices the mutual fund industry has employed over the years to support demand for high cost products that consistently underperform. Clearly, richly compensating all intermediaries involved in the distribution process related to high cost actively managed products and advertising have been key elements.

[55] Private Pension Plan Bulletin, Abstract of 2006 Form 5500 Annual Report, U.S. Department of Labor Employee Benefit Security Administration, December 2006.

[56] One possible exception is where a brokerage "window" exists. However, such windows raise additional fiduciary concerns. The decision whether to offer a window rests with the sponsor, not the participants.

However, manipulation of the performance reported to investors is another pervasive factor.

Finance scholar Berk Sensoy's recent study shows that 31% of U.S. stock funds pick a benchmark that doesn't closely reflect what they own – but does make it easier to beat "the market."[57] In other words, mutual fund money managers package mutual fund product in such a way as to make it appealing despite its high cost by making it appear that performance is superior. Other non-mutual fund providers to plans such as investment consultants, record-keepers and brokers are beneficiaries of this ruse by sharing in the hefty fees related to the actively managed product. Could these providers use their voices to raise participant awareness of the likelihood that higher cost, actively managed funds will underperform? Of course they could but that would not be in their economic self-interest.

Finally, providers must convince sponsors that offering primarily actively managed funds is in their best interests. Here the sales pitch is slightly different. While potential outperformance against a passive benchmark is a factor, active management is in the plan sponsor's best interest because higher expense ratios shared with record-keepers decreases the necessity of explicit fees charged to participants for administration. Record-keepers recommend plan sponsors include actively managed funds which pay substantial revenue sharing (to them) as a means of achieving administration "for free" and advise against use of passive managed funds which do not pay revenue sharing. Participants, who are at an "informational disadvantage," are led to believe that where there is no explicit fee for administration, the employer is paying the costs of administering the plan. By eliminating explicit fees for plan administration the plan sponsor is less likely to feel compelled (by employees) to pay the administrative costs.

[57] Berk Sensoy, Performance Evaluation and Self-Designated Benchmark Indexes in the Mutual Fund Industry," January 31, 2008.

In summary, It is not surprising then that most plans offer few, if any passively managed funds and, where offered, passively managed funds rarely attract the level of assets actively managed funds enjoy. (The bad news is that passively managed funds still only account for a minority of 401k assets; the good news is that despite formidable industry opposition the growth of these funds is exponentially greater than active funds.)

Given the substantial economic interests of providers and plan sponsors in promoting actively managed funds, it would be irresponsible to conclude that the pervasiveness of actively managed funds in defined contribution plans necessarily means participants freely choose actively managed funds based upon value. Lack of transparency, manipulation of plan expense and investment performance (against appropriate benchmarks) information must be considered. Also, as mentioned below, plan design may influence participant selection of actively managed funds.

X. Provider Preference for Expansive Investment Options

Providers of services to 401k plans maintain that more options or more choice is a net positive for participants in plans. While increased choice can be beneficial in many circumstances, it is ill-advised in the retirement plan context when an expertise is required of participants (which they do not possess) and where transparency is lacking. Research on trends in 401k plan offerings reveals that too much choice not only lowers participation rates[58] but also hurts performance because costs increase.

A recent study by Brown and Weisbennem confirms that pension plan design, including the number of investment options offered within a

[58] How Much Choice Is Too Much?: Contributions To Retirement Plans, Iyengar, Sheena, Wei Jiang, Gur Huberman, Pension Research Council, 2003.

plan, can influence participant behavior. The authors found that the recent, rapid increase in the average number of options provided by 401(k) plans has influenced overall portfolio allocations in those plans. "First, consistent with the rapid growth in the number of retail mutual funds over the past 15 years, we find a similar rapid rise in the number of investment options offered by 401(k) plans. For example, from 1993-2002, the median number of funds offered as investment options by 401(k) plans in our sample rose from 5 to 13 (similarly, the mean rose from 5.1 to 13.9). Second, we find that equity funds, primarily actively managed equity funds, account for nearly two-thirds of the new funds being added during the latter part of this period. Third, we show that the increase in the share of funds that are actively managed equity funds has led to an increase in the share of assets invested in these actively managed funds. Fourth, we provide evidence that the average return to these actively managed funds, particularly after accounting for their higher expense ratios, are on average inferior to those of passively managed equity funds. Indeed, we find that there is a significant positive relation between the number of investment options offered by a plan and the average expenses paid by plan participants. Similarly, there is a significant negative relation between the number of options offered and the firm-wide average return on equity funds in the plan. An implication of these findings is that the increase in the number of plan options may lead to lower average investment returns, and potentially lower retirement wealth, as individuals place a larger share of their portfolio in actively managed funds with higher expenses and lower net returns."[59]

[59] 401(k) Investment Options, Portfolio Choice and Retirement Wealth by Jeffrey R. Brown and Scott J. Weisbennerm, Prepared for the NBER Retirement Research Center, December 2005.

On the other hand, increasing the number of investment options offered within plans is clearly in the economic self-interest of providers and sponsors. As plan assets are distributed among a greater number of mutual fund options, it becomes less likely lower cost alternatives, such as commingled and separate accounts, will be feasible. Mutual fund advisers prosper when plans are steered into higher cost (retail) funds but opportunities for revenue sharing and other financial arrangements between other providers of services to defined contribution plans are also enhanced.

Recommendations of multiple strategies within asset classes (e.g. large cap value and growth) and sector funds are common industry devices to increase the number of funds, benefitting plan service providers and sponsors. However, it is the rare investor who is capable of differentiating between alternative strategies within an asset class. While participants may be aware of the latest hot sector fund, such funds do not represent a prudent, diversified investment.

In recent years 401k service providers have promoted use of “model” or “pre-mixed” portfolios. Supposedly these products are designed to make diversified investing easier for participants by providing a selection of pre-mixed models based participant preferences, such as conservative, moderate and aggressive. Indeed, these were the precursor to target-date funds which have been aggressively marketed as Qualified Default Investment Alternatives since 2007.

Many mutual fund families pay certain types of revenue sharing to intermediaries based not on a percent of assets but per participant fund account. If funds that pay such revenue sharing are used in model portfolios to build broadly diversified allocations across more funds than the typical participant would select, the intermediary will benefit from enhanced revenue sharing. Of course, this is exactly what happens.

Since this extra per participant account revenue sharing is not customarily disclosed and shared with the plan, using model portfolios in this manner generates an additional indirect cost of servicing the plan. Remarkably, “model portfolios” where intermediaries are paid revenue sharing on this basis can result in investment managers paying the majority of their investment-related fees to intermediaries for marketing and dramatically increasing the expenses of plans.

The increasingly popular 3-Tiered investment options structure used by larger plans, which includes numerous target date funds, also serves to ensure that lower cost investment vehicles are not utilized.

In summary, the rapid rise in the number of actively managed investment options offered in 401k plans (which participants do not control) may have benefitted sponsors and providers, but has been harmful to participants. There has been no disclosure that increasing the number of options increases the costs of plans and benefits providers at the expense of participants.

XI. Employer Stock Investment Option

In another example of economic self-interest in the retirement plan context, plan sponsors routinely include employer stock as an investment option in their 401k plans. The stated justification for the option is that it “aligns the economic interests of employees with the employer.” Experts such as investment consultants rarely object to the inclusion of company stock within plans (regardless of the stock’s performance), and custodians recommend unitizing the company stock fund (which they will manage for a small asset-based fee plus brokerage commissions). Since employees are already dependent upon their employer for living wages, furthering the economic dependency of the employee upon the employer by offering company stock in the plan is

not defensible from a diversification perspective. The disastrous consequences of including employer stock in defined contribution plans can be seen in the Enron, Worldcom and later U.S. Airways and United bankruptcies. Billions in plan assets were lost.[60]

While it is not in the best interests of the participant, inclusion of company stock is clearly in the economic interest of the employer. As in the case of actively managed funds, it would be irresponsible to attribute the pervasiveness of company stock in defined contribution plans to participants valuing company stock; rather, plan sponsor economic self-interest is responsible for the presence of the option in the first place and contributes to the high level of assets within the option over time.

XII. Conclusion

An analysis of economic self-interest related to the providers of services to defined contribution retirement plans and plan sponsors reveals that many of the problematic investment options, business practices and arrangements within plans can be readily explained as benefitting all parties except participants.

The "informational advantage" that sponsors and providers enjoy over participants permits this state of affairs to endure. While the impact of economic self-interest and the informational advantage on defined contribution plans may seem remote, it is real. Recent studies confirm that plan design (almost always controlled by providers), does matter and can influence participant behavior and investment returns. In short, industry practices have played a significant role in creating the defined contribution retirement plan crisis the nation faces today.

[60] The Enron Problem by Martine Costello, CNN/Money, January 29, 2002.

In order to improve participant behavior and investment results, disclosure of all economic agendas at play, at a minimum, must be compelled. Absent a regulatory overhaul of defined contribution plans, increased transparency is the sole tool available to reduce the costs and improve the performance of these plans. While not a perfect cure, "sunshine" remains a powerful disinfectant.

About Benchmark Financial Services, Inc.

Edward Siedle is President of Benchmark Financial Services, Inc., a boutique consulting firm located in Ocean Ridge, Florida that has investigates money management abuses primarily on behalf of pensions. The firm has pioneered the field of forensic investigations of pension investment management and has been responsible for investigations worldwide involving in excess of $1 trillion in assets.

Siedle has been referred to in the media as the, "Sam Spade of money management" and "the nation's most vocal critic of abuses in the money management industry." In 2002, he published The Siedle Directory of Securities Dealers which provided institutional investors with the criminal and disciplinary histories of the nation's brokerages. The findings of the Directory were reported in publications ranging from Fortune to The New York Law Journal. In 2003, he published "Examining Active Investment Advisory Fees," a survey of the "actual" fees paid by 100 pensions. The survey has been used by many of the nation's largest money managers in pricing their services.

He began his career as an attorney adviser in finance with the SEC's Division of Investment Management, the Division which regulates mutual funds and money managers and later served as Legal Counsel and Director of Compliance to one of the largest international mutual fund families. Since 1989, his firms have offered specialized services to pensions.

Siedle testified before the Senate Banking Committee regarding the mutual fund scandals and the Louisiana State Legislature regarding pension consultant conflicts of interest. Articles about him have appeared in publications including Time, BusinessWeek, Associated Press, Wall Street Journal, The New York Times, Barron's, and USA Today. He widely lectures and has appeared on CNBC, Wall Street Week, and Bloomberg News. He recently appeared in a Bloomberg News special on "Hidden 401k Fees" which received Bloomberg's first Emmy Award.