Testimony Before the ERISA Advisory Council on Employee Welfare and Pension Benefit Plans

Working Group on Fiduciary Responsibilities Update and Revenue Sharing

September 20, 2007

Introduction

Good morning, my name is Michael J. Malone, and I am the founder and managing director of MJM401k. We are a plan consultancy and registered investment advisor located in Phoenix, Arizona. Our sole line of business is assisting plan sponsors and committees with properly discharging not only their fiduciary duties but also a range of other responsibilities inherent in maintaining a 401(k) plan for their employees.

My career in the defined contribution industry began in 1978, the same year that Section 401(k) was added to the Internal Revenue Code. In addition to my current business, for twenty years I owned and operated a plan administration firm that provided qualified plan record keeping and compliance services to small and mid-sized businesses throughout the southwest.

For purposes of context, MJM401k's representative client base falls within what is defined as the small to middle market for 401(k) plans. Most of our clients have plans between several hundred and several thousand participants, with assets ranging from $5 million up to $250 million.

Overview

Let me state at the outset that I am not a moralist when it comes to the "use" of revenue sharing in 401(k) plans. Standing on its own, revenue sharing is not philosophically right or wrong. However, like many things in our business world, it is abused at times by some 401(k) providers and financial advisors.

There are numerous examples of plans properly using revenue sharing payments with the sole interests of their participants at heart, and where these payments have been used to provide good plans to participants at a reasonable price. However, due to its opaque nature, revenue sharing easily can also be used to facilitate the payment from a plan of an unreasonable fee. Suffice it to say that, sadly, I have seen a number of examples where revenue sharing payments have been used in a manner that inappropriately increases revenue to providers and advisors at the expense of plan participants.

Responses to Questions

I was previously provided with the transcripts and testimony from your July 11th meeting, so I am aware that this Council is generally familiar with the structure of revenue sharing and its use based on the provision of some very good illustrations and comments from previous witnesses. My intention this morning is to supplement that testimony by way of a few observations of revenue sharing practices in the medium sized 401(k) plan market, and to address the four questions detailed in the "scope" document. At this juncture, I would also like to gratefully acknowledge Irving Isaacson, a senior consultant in our office, for his substantial contribution in the preparation of this document.

What are the current practices as to revenue sharing arrangements, including the basis on which revenue sharing is determined and the methodology by which employers utilized the amount shared?

In our experience, in the smaller to middle plan market, an *employer's* utilization of revenue sharing is *unconscious*. What I mean by this is that generally, in the absence of an independent consultant, the employer neither knows the amount of revenue sharing generated by the plan, nor understands how it is being applied. Of course there is a revenue sharing methodology, but in a majority of cases, the employer has not been a party to the discussion or decision making as to how that methodology has been applied.

In this market segment, from a plan provider's viewpoint, as well as the financial advisor who is receiving commission-based compensation, a primary objective of the revenue sharing methodology is to bring the plan to a point where there are no *billable fees* assessed to the plan sponsor. The reason for this is to create a solution for the plan that is price-attractive when competing for new business.

This thinking created what we refer to as a 'Solving for X' plan design and pricing culture, where X is the amount of revenue sharing that must be generated in order to pay for the operational and sales compensation requirements of the plan. In this culture, a plan sponsor is led to believe that the plan is "free", and is not aware of either the total cost to plan participants or the amount their broker is receiving as compensation.

Pricing algorithms vary from provider to provider, but a simple overview of this 'Solving for X' pricing methodology is illustrated below:

***Solving for X* - Matching Plan Revenues & Expenses**

Provider Expenses

- Enrollment, education materials & meetings
- Daily Recordkeeping
- Administration & compliance
- Web services & call center
- Trading & execution
- Distributions & reporting
- Sales compensation
- Amortization of fixed costs
- Profit Margin

Expense = $175/participant

Provider Revenues

- Average plan account balance = $43,750
- Average margin required from proprietary investment management and non-proprietary revenue sharing payments = 40 bps (.40%)

Revenue = $175/participant ($43,750 x .40%)

There is certainly nothing inappropriate in terms of the plan provider evaluating the financial profitability of a potential plan client in this manner. The inappropriateness occurs when the plan sponsor is not a party to the discussion where decisions are made as to how the pricing requirements actually get implemented.

A very commonplace example of how the plan sponsor can be left out of important decisions that have fiduciary implications deals with share class selection. In a perfect world (or at least one where all plan expenses are paid by the sponsor), once a given fund has been screened and selected, plan fiduciaries would select in all cases the least-costly available share class for that particular fund. In doing so, the net investment return to the participant is maximized. But by selecting a more expensive share class, the fiduciary (provider, broker, or plan sponsor) has decided that the plan participant will overpay for investment management so that the excess payment can be applied to some other plan cost or service.

This decision is a fiduciary decision, but it is too often one to which the plan sponsor (or committee) is not a participant. It is more often a broker and the plan provider making the recommendation, neither of whom, ironically, assumes any fiduciary responsibility for the recommendation of the fund choices, including the class of share.

And yet, this is a very important decision. In the table below, all share classes of this particular target-date retirement fund have an overall investment management cost of 44 basis points, according to the fund's prospectus. But the total cost to the shareholder/participant can vary quite dramatically depending upon the class of share selected by the plan. There is a greater than 100 bps differential between the most and least expensive class of share. Needless to say, such a difference will have a dramatic impact on the net rate of return to the participant and their eventual retirement account accumulation.

2045 Target Date Retirement Fund A

Share Class	12b-1	Sub-TA	Total Operating Expense
A	25 bps	5 bps	81 bps
R1	100 bps	10 bps	151 bps
R2	75 bps	25 bps	152 bps
R3	50 bps	15 bps	109 bps
R4	25 bps	10 bps	76 bps
R5	0 bps	5 bps	46 bps

The important concluding point to the question raised is that while various revenue methodologies are being employed in the smaller and mid plan markets, they are generally unknown to the plan sponsor. Decisions are often made in the absence of a discussion with the plan sponsor/committee, notwithstanding the fact that these decisions have fiduciary consequences for the plan sponsor/committee.

What, if any guidance, should the DOL issue with respect to the obligation of plan sponsors, trustees, and other fiduciaries regarding the allocation of revenue sharing payments received by a plan from a service provider?

Our firm works closely with a number of small to medium sized plan sponsors to help them properly manage the fiduciary responsibilities they assume in providing a 401(k) plan to their employees. In assisting our clients to fully understand the total cost of their 401(k) plans, our experience with revenue sharing is that it can be a very useful tool with significant benefits for plan participants. However, it must be used correctly. The abuse of revenue sharing occurs when fiduciaries are not aware of or do not understand the revenue sharing agreements pertaining to their plan. In these situations, revenue sharing can lead to unreasonable compensation being paid by plan participants.

As such, our firm feels very strongly that the DOL needs to issue written guidance that demands strict disclosure of all revenue sharing agreements between 401(k) service providers. If 401(k) plans are to fulfill their stated promise of providing adequate retirement income to our nation's workers, it is essential that plan fiduciaries be put on notice that they are legally responsible for controlling the expenses paid by 401(k) plan participants. This guidance should explicitly state that a plan sponsor has a fiduciary responsibility for understanding the revenue sharing within a plan, and that fiduciaries must determine whether or not the compensation being paid to service providers or financial advisors is reasonable.

Specifically, the guidance issued by the DOL should include the following features:

1. Plan fiduciaries should be required to disclose the total amount of plan expenses paid by plan participants to compensate service providers. Plan fiduciaries should also be required to identify the organizations or individuals that received payment from the plan, and the total amount of these payments. Since revenue sharing among service providers will greatly impact who is receiving compensation from the plan, fiduciaries will need to have significant knowledge of these agreements. This disclosure should be made part of the annual Form 5500 filing for the plan, and should also be required to be reported to participants on the Summary Annual Report.
2. Plan fiduciaries should be required to affirmatively select the specific share class of an investment fund that is to be made available to plan participants, and acknowledge that the selection of the share class is a fiduciary act.
3. 401(k) service providers should be required to disclose the following information to plan fiduciaries when they are selecting the investment options that will be made available to participants:
    - The total internal cost of the investment options being considered.
    - A breakdown of how the total internal cost is divided between investment management fees and fees intended to pay for other services.
    - A report showing additional share classes of the same fund that are also available to qualified retirement plans. This report should include the total internal cost of the other share classes, broken down between investment management fees and fees intended to pay for other services.

4. 401(k) service providers should be required to disclose the following information to plan fiduciaries:

   - The total amount of the revenue sharing payments received by the plan during a plan year.
   - An accounting of how these revenue sharing payments were allocated among plan service providers, including all compensation paid to a financial advisor who is receiving commissions from the plan.
   - Any additional compensation paid to financial advisors that is based on the amount of assets in a specific plan, but that does not necessarily come from plan assets. An example of this would be a volume of business bonus based on the total amount of assets that a financial advisor has placed with a specific 401(k) service provider.

   This requirement can be met by showing the receipt and disbursement of the revenue sharing payments on the trust accounting statements for the plan. Alternatively, 401(k) service providers should be allowed to disclose this information to plan fiduciaries as part of a separate accounting that meets the requirements of this guidance.

5. 401(k) service providers who also are investment managers should be required to provide significant detail about the revenue they earn from any fixed accounts or guaranteed investment contracts that are part of an investment line-up for a plan. This information should include the amount of interest arbitrage they earn on these accounts as well as any compensation or revenue sharing paid to financial advisors based on the amount of participant assets invested in these funds. These funds should not be excluded from the general rules applying to disclosure of revenue sharing agreements simply because they do not charge explicit fees.

What guidance could the DOL offer with respect to what a plan sponsor needs to know and what a service provider should be required to provide when they consider a revenue sharing arrangement?

The experience of our firm has been that most of the 401(k) service providers we work with are willing to provide us with the detailed information we need to properly analyze the fees being charged to our clients. The majority of these firms are willing to disclose all fees and revenue sharing agreements pertaining to the plan. In addition, they are usually willing to disclose to us the total amount of revenue they need to operate a specific 401(k) plan. The only exception to our experience is that we have had difficulty obtaining the information we need to properly analyze the fixed accounts and guaranteed investment contracts that many insurance companies make available to 401(k) plans.

However, since the information we require for our due diligence process is usually not disclosed without a specific request, it is our firm's belief that the DOL needs to issue guidance that requires these disclosures. In addition, the DOL needs to provide education to plan sponsors to assist them in better understanding how 401(k) plans are priced and the role that revenue sharing plays in compensating service providers and financial advisors. This educational material should address the following factors:

1. Revenue sharing is made possible because additional fees are built into the internal expense ratios of mutual funds and separate accounts. The additional fees are used to pay for services that are independent of investment management. In other words, a 401(k) plan is overpaying for investment management services when it invests in a fund that pays revenue sharing to other providers.
2. Many 401(k) service providers and financial advisors have found it easier to get paid for their services by recommending the use of investment funds that pay significant amounts of revenue sharing. This is because plan sponsors and fiduciaries have historically not paid close attention to the internal management fees in investment funds, and are many times not even aware of the amount of compensation being paid from the plan. The result is that some 401(k) service providers and financial advisors receive unreasonable compensation for their services.
3. Plan sponsors and fiduciaries must be made aware that there are multiple share classes of many investment funds, and that these different share classes can vary drastically in the amount of internal management fees charged to investors in the fund. Plan sponsors and fiduciaries must be cautioned to review the investment performance of the specific share class being made available to participants, and not the performance of the share class of the fund with the lowest expense ratio.
4. Within a 401(k) plan, the fees paid by participants are used to purchase a wide range of services. However, due to the way that revenue sharing agreements operate, it may appear to the plan sponsor that the only service being purchased is investment management and that the recordkeeping and administration services are being provided for free. Plan sponsors and fiduciaries must be educated that this is not the case, and that it is their responsibility to make certain that the fees being paid for these other services are reasonable.
5. It is important for plan sponsors and fiduciaries to realize that there is nothing magical about revenue sharing. The same result can be achieved by purchasing funds that do not engage in revenue sharing, and adding a "wrap fee" equaling the amount of revenue required to pay for recordkeeping and administrative services. Most small and medium sized plan sponsors do not like this alternative since these fees are more apparent to participants. However, with proper disclosure of revenue sharing agreements to participants, the end result of the two alternatives should be identical.

While understanding revenue sharing agreements is essential for plan sponsors and fiduciaries, it is also important for them to recognize that the selection of plan investments cannot be based solely on this consideration. It is important for plan sponsors and fiduciaries to look at a number of qualitative and quantitative factors when selecting specific funds and a fund should not be chosen merely because it has low investment management fee or it pays a significant amount of revenue sharing.

Take, for example, the two funds listed below. Both are intermediate-term bond funds with the same prospectus objective and both pay a level of revenue sharing, although the revenue sharing paid in each case is different. By subtracting the revenue sharing from the overall operating expense ratio of the fund, we were able to arrive at a conclusion about net investment management cost. Cost is always a predictive performance determinate and that is particularly true in the case of bond funds.

Both of these funds are well known and are top performers against their peers over extended periods of time. Based on price alone, Fund B would be the logical choice, for either a plan sponsor at the menu level or a plan participant for his or her account.

Fund Expense Comparison (Intermediate-term Bond Funds)

	Expense Ratio	Revenue Sharing	Net Investment Mgm't
Fund A	120 bps	40 bps	80 bps
Fund B	68 bps	25 bps	43 bps

But a second tier of evaluation would involve the investment performance of the fund over time. As noted, both perform well, but in this case, Fund A has delivered a greater rate of return for its shareholders than Fund B. Both of the performance amounts are expressed net of investment management fees. This illustration makes the point that, while important, if too much attention is focused myopically on plan expenses and revenue sharing, important issues such as quality and value returned for cost can be lost.

Fund Performance Comparison

Funds/Index/Peer Group	Quarter	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.
Fund A	-0.22	1.44	6.54	4.62	6.35	7.83
Fund B	-1.39	0.23	4.96	3.71	4.52	6.25
LB Aggregate Bond	-0.52	0.98	6.12	3.98	4.48	6.02
Intermediate-term Bond	-0.71	0.73	5.68	3.66	4.32	5.31

Should the DOL develop a model prototype in this area?

We strongly advocate that the DOL develop a model prototype for the disclosure of revenue sharing payments. As noted above, however, it will be a challenge to create a prototype that can be applied across the various business models predominant today in the 401(k) industry. Generally, we would classify plan providers in one of three business model categories:

Non-Investment Management Providers – This category includes firms who provide 401(k) recordkeeping and administrative services, but are completely objective as to what investment funds are used by their clients. These firms usually charge their clients a flat or hourly fee for performing plan related services. However, most of them will accept revenue sharing payments to help offset their fees.

Partial Investment Management Providers – These are organizations where some investment management services are available for purchase, but where there are few (if any) requirements as to the use of proprietary funds other than possibly their money market or stable value fund. Most of these providers charge an asset based fee for their services, which is fully offset by any revenue sharing payments they are able to collect on behalf of the plan.

Investment Management Providers – The providers who use this business model are investment management companies who do not want to provide record keeping or administrative services to plans that do not include a significant number of their proprietary funds in their investment line-up. This is especially the case for small or medium sized plans.

When issuing an RFP for one of our clients, our firm is usually able to fairly easily compare the pricing submitted to us by non-investment manager providers and partial investment management providers. The challenge to us is comparing the pricing submitted to us by the investment management providers, and it is our view that the DOL will face a similar challenge in developing a model prototype for the disclosure of revenue sharing.

The revenue sharing payments made by investment manager providers are more difficult to understand for the following reasons:

1. Since usually there are a large number of proprietary funds being used, the bulk of the revenue sharing payments are being made internally. In other words, the investment management side of the business is reimbursing the administrative service side of the business for some (or all) of their expenses. In this case, it is often hard to pinpoint the cost of the recordkeeping and administrative services being provided to the plan.
2. The revenue sharing payments are usually "baked" into the overall price of the plan, with little or no disclosure to plan sponsors as to the actual amount collected. In this situation, rather than being used to offset a stated fee for recordkeeping or administrative services, the revenue sharing payments are simply retained by the service provider.

Concluding Remarks

In conclusion, I would like to thank the Council for its work in this area. This is, needless to say, an important issue and becoming increasing so as time passes. The work of this Council and the Department of Labor should be both applauded and encouraged. That said, I would issue a word of caution.

I recognize the challenges associated with providing appropriate disclosures and maintaining a sense of balance with regard to plan cost and complexity. However, it is our belief that under the current structure, it would be impossible to craft an appropriate participant level disclosure on revenue sharing and fees that would result in any meaningful behavior modification on the part of the participant. The only predictable outcome of such an exercise is that the cost of the plan would increase.

A number of the changes in last year's Pension Protection Act were properly focused on the fact that given 20 years of empirical 401(k) data, a large percentage of the 401(k) plan participant population (irrespective of education or industry) does not take the time to properly study, assimilate, and analyze all the wonderful information and disclosures that are available to them currently, and then act appropriately in arranging their investment affairs within their 401(k) plan account. Without being too jaded, I would venture to say a participant level disclosure on revenue sharing and fees would be either unread at best or misunderstood at worst.

Since we believe that it is a bridge too far for the participants to be the assigned gatekeepers, the burden in this area must fall upon the shoulders of the plan's fiduciaries. The easiest approach in this area would be for all non-investment related expenses to be paid for by the plan sponsor.

This would ensure that costs would be routinely scrutinized. But such an approach may stifle plan formation, or even force existing plans to terminate, particularly those sponsored by smaller companies. This leaves a set of provider and advisor payment disclosures for plan fiduciaries (sponsors and committees) as a must. In the absence of a qualified independent advisor or consultant, plan fiduciaries rarely understand the economics of their plans under in the current marketplace. Appropriate and comprehensive disclosure requirements would be a helpful tool in this area to change behavior over time.

Thank you.