Written Comments
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Revenue Sharing Practices

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## Introduction

My name is Fred Reish. I am a shareholder in the law firm of Reish Luftman Reicher & Cohen in Los Angeles, California. My firm specializes in employee benefits and tax matters. I have more than thirty years experience as an employee benefits attorney.

I am here to present my views on revenue sharing practices for participant-directed 401(k) plans. My testimony—which was co-prepared with Stephanie Bennett, an ERISA attorney in my law firm—will address the issues outlined under the heading "Revenue Sharing Practices," in the Working Group's Objectives. More specifically, the testimony will focus on questions 6-9.

My practice concentrates on advising and consulting with clients regarding fiduciary responsibilities for participant-directed plans. My views reflect my extensive experience in this area. That experience includes: representing plan sponsors of all sizes; educating both private and public sector plan sponsors about revenue sharing; representing consultants, investment advisers, and broker-dealers on fiduciary and prohibited transaction matters, including those related to revenue sharing; and representing providers and recordkeepers that receive revenue-sharing related to small, mid-sized and large plans.

## Background

Defined contribution plans, and particularly participant-directed plans, have become America's primary retirement vehicle—for both employers and employees. The responsibilities of the fiduciaries of those plans include the duty to understand plan expenses. In particular, under the Employee Retirement Income Security Act of 1974 ("ERISA"), fiduciaries are charged with:

> A fiduciary shall discharge his duties . . . for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying **reasonable expenses** of administering the plan. . . .[1]
> (Emphasis added.)

In addition, ERISA sections 406(a) and 408(b)(2) prohibit the payment of more than reasonable amounts to parties who are closely related to a plan, that is, to parties in interest.

In order to discharge these duties, plan sponsors must understand all plan fees and expenses to (1) fulfill their responsibilities under ERISA; (2) to evaluate the reasonableness of provider compensation; and (3) to evaluate whether there are any prohibited transactions or other conflicts of interest. These fees and expenses include indirect payments, such as revenue sharing (for example, 12b-1 fees and subtransfer agency, or sub-TA, fees). As explained by the Department of Labor (DOL) in Advisory Opinion 97-15A:

[1] ERISA § 404(a)(1)(A). ERISA section 403(c)(1) similarly provides that "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."

> Under section 404(a)(1) of ERISA, the responsible Plan fiduciaries must act prudently and solely in the interest of the Plan participants and beneficiaries both in deciding whether to enter into, or continue, the above-described arrangement and trustee agreement with Frost [the recipient of revenue sharing payments], and in determining which investment options to utilize or make available to Plan participants or beneficiaries. In this regard, the responsible **Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan to Frost is reasonable**, taking into account the trustee services provided to the Plan as well as any other fees or compensation received by Frost in connection with the investment of Plan assets. In this connection, it is the view of the Department that **the responsible Plan fiduciaries must obtain sufficient information regarding any fees or other compensation that Frost receives with respect to the Plan's investments in each mutual fund** to make an informed decision whether Frost's compensation for services is no more than reasonable. The Plan fiduciaries also must periodically monitor the actions taken by Frost in the performance of its duties, to assure, among other things, that any fee offsets to which the Plan is entitled are correctly calculated and applied. (Both text in brackets and emphasis added.)

In addition, appropriate information regarding plan fees and expenses should be provided to participants so they can make informed decisions about (i) whether or not to participate in the plan and (ii) how to invest. As a result of this two-pronged need for information (first, whether to participate and, then, how to invest), participants need information about plan-level expenses (including market value adjustments and surrender charges where investments are removed at the plan level) and about participant-level expenses (for example, expense ratios, transaction fees, redemption fees, brokerage account charges). In addition, participants need information concerning any restrictions or limitations on the free transferability of their investments, including any charges or other reductions in value.

The practice of revenue sharing—for example, payments from mutual funds and their managers and affiliates to plan providers—is not only common in the industry, it is prevalent. As a result, there is a critical need for guidance.

## Responses to Questions

*What are the current practices as to revenue sharing arrangements, including the basis upon which the revenue-sharing is determined and the methods by which employers utilize the amounts shared?*

Revenue sharing generally refers to a compensation practice in which 401(k) plan investments or their managers (and affiliates) pay money to other plan service providers.[2] For purposes of my testimony I will refer to all investments as mutual funds and I will address three forms of revenue sharing. All three forms have, as their source, the participant's investments in mutual funds. Stated slightly differently, the money for the revenue sharing is extracted from the participants' accounts and thereby reduces their retirement benefits. However, to the extent the charges are reasonable and the revenue sharing pays for services that are properly payable by a plan—and provide commensurate value to the plan and its participants, the charges are offset by equivalent and appropriate value.

The first form, 12b-1 fees, is used for the cost of the sale, or distribution, of investments. The fee is deducted from the assets with the mutual funds and thereby is charged directly to the participants invested in that fund. The fee is ordinarily paid to a broker-dealer as a part of the distribution of the mutual fund. However, for small plans funded with group annuity contracts, it may be paid to a broker-dealer affiliated with the insurance company to subsidize the recordkeeping costs.

The second form, subtransfer agency fees, are also deducted from the mutual funds' assets. A mutual fund must maintain records of its shareholders and may properly pay for that service. Where an intermediary, like a recordkeeper, maintains those records, the mutual fund pays the recordkeeper for that service. The transfer agent fee is typically paid as a fixed fee on a per-participant basis or an asset-based fee, or a combination of both.[3] The transfer agent also provides other shareholder services, such as administration, compliance, communications, and other operational services. (For ease of reference, I refer to the payments for all of these services as subtransfer agency fees, or sub-TA fees.)

The third form is that the investment management firm, or an affiliate, may pay a portion of its management fee to a third party as a form of revenue sharing. The source of this money is the management fee which is charged to the mutual fund by its investment adviser.

Revenue sharing arrangements vary based on the size of the plan. By size, I am referring to the dollar amount of the investments in a plan. The best way to understand the variance in revenue sharing arrangements among plans of different sizes is through examples. (The following ranges for plan sizes are somewhat arbitrary, but generally correct.)

In large plans (by large, I am referring to a plan with $100 million or more in assets), there would not ordinarily be any 12b-1 fees paid to a broker-dealer. In most cases, however, the recordkeeper would receive fees for performing the transfer agent function and other shareholder services. However, sophisticated plan sponsors (which you would expect at this size of plan and

[2] Some may quibble about the precise definition of revenue sharing and whether all of these (and other) forms of payments should be so labeled. However, in the 401(k) community, "revenue sharing" has come to mean payments that are sourced in a plan's investments, and that are paid to other providers without going through the plan. The Department often refers to these as "indirect payments," while plaintiffs' attorneys call them "secret and excessive payments." A feature of these payments is that, while they are sourced in a plan's assets, the payments are "shared" by the plan's providers, often without the knowledge of the plan sponsor and the fiduciaries.

[3] Pozen, Robert C., The Mutual Fund Business. Boston: Houghton Mifflin Company, 2002.

company) often negotiate a fixed fee for the recordkeeping services and the revenue sharing is offset against that fixed cost. If the revenue sharing exceeds that cost, the excess is restored to the participants' accounts at the end of each year. If the revenue sharing is not enough to cover that cost, the plan usually pays the difference, and the participants' benefits are reduced by the amount of that payment (although some employers may absorb those charges).

For mid-market plans (plans with $10 million to $100 million in assets—and particularly the lower half of that range), it is relatively common for plans to hold mutual funds that pay 12b-1 fees to a broker-dealer. For these plans, the recordkeeper also receives revenue sharing fees for performing the transfer agent function and some shareholder services.

For small plans (plans with $10 million or less in assets), the practices vary. For example, for a mutual fund based product (often a single fund family with a limited number of outside investments), the arrangement is similar to that described for mid-market plans, but with additional direct charges to the plan. For an insurance product (*e.g.*, a group annuity contract), both the 12b-1 and subtransfer agent fees are paid to the provider. The insurance company provider retains those amounts to cover the costs of its recordkeeping and other services, and pays the broker through a separate asset charge. The retention of the 12b-1 fees is usually based on the additional services provided to the plans and their participants, that is, those providers often offer a robust set of investments and services to very small plans.

To be complete, I should explain that my descriptions are intended to cover the most common practices. There are exceptions to each of these examples. For example, the higher end of the small plan market has, in recent years, become more competitive and, as a result, is becoming more similar to the mid-market.

In addition, revenue sharing arrangements vary depending on whether the plan sponsor has selected a "bundled" or "unbundled" provider. Plan sponsors that select "bundled" providers receive both administrative and investment services from a single provider. Typically, bundled providers offer proprietary as well as third-party investments. In those cases, the bundled provider will receive revenue sharing from the third-party investments based on a percentage of participant assets invested in those funds. Those fees, along with the management fees (and possibly 12b-1 fees) from the proprietary funds, are used to offset the cost of providing administrative services, such as recordkeeping and compliance. In our experience, some bundled providers "credit" their retirement services division for the proprietary investments held in the plans on their recordkeeping platforms. That crediting may be higher than the rate of revenue sharing paid by third party mutual funds—thus creating an incentive for the retirement services division to "encourage" plan sponsors and fiduciaries to use the proprietary funds, a potential conflict of interest. In effect, that crediting process is the functional equivalent of revenue sharing. As a result, its disclosure should be required so that plan sponsors and fiduciaries can easily compare the revenue sharing and evaluate the conflicts for the competing investments.

*What, if any, guidance should the DOL issue with respect to the obligations of plan sponsors, trustee and other fiduciaries regarding the allocation of revenue sharing payment received by the plan from the service provider?*

Although the DOL has issued three Advisory Opinions that provide insight into its views on revenue sharing,[4] those letters do not address a fundamental question. That question is whether revenue sharing payments are plan assets. As a result, there is a need for guidance on that issue. If revenue sharing amounts are plan assets, those amounts must be held for the "exclusive purpose" of participants and beneficiaries and are subject to the ERISA section 406(b) prohibited transaction provisions. In addition, to the extent providers have control over the management and disposition of those payments, those providers may be fiduciaries.

A recent district court decision highlights this issue. In *Haddock v. Nationwide Financial Services, Inc.,* 419 F.Supp. 156 (D. Conn. 2006), the trustees asserted that Nationwide's contractual agreements with mutual funds and its retention of revenue sharing payments constituted breaches of its fiduciary duties and prohibited transactions under ERISA. The matter came before the court on Nationwide's motion for summary judgment. In considering the motion, the court found that there was no guidance that addresses whether revenue sharing payments are plan assets:

> ERISA provides no explicit definition of "plan assets." No regulation or case law provides a definition of "plan assets" that answers whether fees, arguably received in exchange for services provided, that are paid to an ERISA fiduciary in connection with its fiduciary functions and that may be at the expense of a plan, constitute plan assets.[5] (Internal citations omitted.)

**Since this issue remains unresolved, we recommend that the DOL issue guidance as to whether revenue sharing payments constitute plan assets. In that regard, our opinion is that revenue sharing amounts will not ordinarily be plan assets. This is a matter of great importance and, as such, we recommend that it be the subject of a regulatory project.**

A closely related issue is whether fiduciaries have a responsibility to investigate, or even negotiate, for the return of "excess compensation" ( *i.e.*, revenue sharing) to their plans.

In recent years, as 401(k) plans have increased in size, the costs of operating a plan have generally not grown as rapidly as the increase in plan assets. Since some plan expenses−and particularly investment-related expenses−are calculated as a percentage of plan assets, the revenues of providers (including revenue sharing they receive) have grown to exceed the

[4] DOL Advisory Opinions 97-15, 97-16A and 2003-09A. In Advisory Opinion 97-15A (the Frost Opinion), the DOL determined that a bank serving as the plan trustee ("Frost") could receive mutual fund revenue sharing fees without violating the ERISA prohibited transactions under 406(b)(1) (self-dealing) and 406(b)(3) (anti-kickback) if those payments are passed along to the plan as a direct payment or expense offset. In DOL Advisory Opinion 97-16A (the Aetna Opinion), the DOL advised that a non-fiduciary could retain revenue sharing payments. The Aetna Opinion also pointed out that fiduciaries are required to "*obtain sufficient information regarding any fees or other compensation that [service provider] receives with respect to the Plan's investments in each Unrelated Fund to make an informed decision whether [the service provider's] compensation for services is no more than reasonable."* Finally, in Advisory Opinion 2003-09A (the ABN AMRO Opinion) the DOL determined that a directed trustee without discretion over plan assets can keep revenue sharing payments and explicitly consider the revenues earned on proprietary funds in establishing and re-negotiating the trustee's (and recordkeeping) fees.

[5] *Haddock*, at 167.

reasonable charges of doing business. Sophisticated consultants, plan sponsors and fiduciaries have negotiated for the restoration to the plans of the amounts that exceed the reasonable charges. (To be fair, some providers have adopted a business model of charging a set fee for their services, offsetting all revenue sharing, and restoring excess amounts to the plans.)

Those excess amounts are usually paid into a "suspense," or unallocated, account, which is used to pay plan expenses—with any remaining amounts allocated to the participants. In the industry, these are often referred to as "ERISA accounts."

Undoubtedly, in many cases providers would restore excess amounts of revenue sharing to plans if the fiduciaries investigated and negotiated for that restoration. A reasonable interpretation of the prudent man rule is that fiduciaries must act on the participants' behalf to obtain this "free money" for the plan. (A second alternative for fiduciaries of plans with "excess" revenue sharing is to change to a different share class of mutual funds, thereby reducing the revenue sharing amounts and the expenses being paid by the participants.) However, there is no official guidance on the subject.

Based on our experience, and as a practical matter, at this time the costs for 401(k) plans with less than $5 million in assets are high enough that, relative to the revenue sharing received, there are virtually no opportunities for the recovery of excess revenue sharing. However, for 401(k) plans with between $5 million and $10 million in assets, though, we are beginning to see amounts restored to plans.

**That guidance is needed; it would both educate fiduciaries of the responsibilities and inform them of these opportunities. Therefore, we recommend specific guidance on the duties of fiduciaries for investigating revenue sharing based on their plan's assets.**

A related issue is the allocation of revenue sharing payments received by plans. For purposes of determining how revenue sharing payments should be allocated, we are discussing only those situations in which the revenue sharing payments are deposited into a plan. (For example, a large plan may collect all of the revenue sharing and pay service providers from those amounts. Alternatively, a mid-sized plan might require its recordkeeping to pay all revenue sharing in excess of the negotiated charges into the plan.)

There is no guidance directly on point regarding the allocation of revenue sharing payments; however, two DOL Field Assistance Bulletins (FAB) provide insight into the DOL's approach to allocation methods. While the FABs address other issues–the allocation of plan expenses and settlement fees, that guidance may shed light on the DOL's position on allocation methods for revenue sharing payments. In Field Assistance Bulletin (FAB) 2003-03, the DOL provided guidelines for ERISA fiduciaries regarding the allocation of expenses in a defined contribution plan. The DOL advised that a plan fiduciary must be prudent in making a determination regarding the appropriate method of allocating expenses:

> A plan fiduciary must be prudent in the selection of the method of allocation. Prudence in such instances would, at a minimum, require a process by which the fiduciary weighs the competing

> interests of various classes of the plan's participants and the effects of various allocation methods on those interests. In addition to a deliberative process, a fiduciary's decision must satisfy the 'solely in the interest of participants' standard. In this regard, a method of allocating expenses would not fail to be 'solely in the interest of participants' merely because the selected method disfavors one class of participants, provided that a rational basis exists for the selected method.

Thus, the guidance provides that the fiduciary must engage in a deliberative process in selecting a method of allocating expenses. The FAB acknowledges that the allocation method may differ based on the nature of the expense. Nonetheless, the allocation method must bear a reasonable relationship to the nature of the expense, "On the other hand, if a method of allocation has no reasonable relationship to the services furnished or available to an individual account, a case might be made that the fiduciary breached his fiduciary duties to act prudently and 'solely in the interest of participants' in selecting the allocation method."

For example, the FAB provides that the pro rata method (*i.e.*, allocations made on the relative basis of assets in individual accounts) of allocating expenses among participants would, in most cases, be equitable. However, it is not the only permissible method of allocation of expenses among participants. Another method is the per capita method (*i.e.*, expenses charged equally to each account, without regard to the amount of assets in the individual accounts). Thus, based on the guidance in the FAB, a fiduciary may employ a variety of methods for allocating expenses among plan participants; however, the decision involves analyzing the nature of the expense.

In FAB 2006-1, the DOL provided guidance on the allocation of mutual fund settlement proceeds. If the distribution plan does not contain a method for allocating the proceeds among participants, then the plan administrator must determine a method that relates to the impact of the market timing and late trading activities on the participant accounts. Plan administrators are permitted to weigh the costs to the plan and participant accounts and the ultimate benefit to participants when trying to determine how to allocate settlement proceeds, taking into account matters such as the availability of plan records and the costs of different allocation methodologies. For example, the FAB suggests that it may be permissible to allocate the proceeds to current participants (rather than participants who participated in the plan during the relevant period (*i.e.*, when market timing/late trading occurred). In addition, the FAB acknowledges that in certain situations the amounts involved may be so small that the plan administrator might conclude that determining a method of allocating the amounts and the expense of actually allocating the amounts are not cost-effective and use the amounts to pay plan expenses.

**The DOL and IRS should coordinate such that their rules are consistent on this issue**.

Specifically, the IRS should recognize cost as a factor in allocation methodologies and include a *de minimis* exception, recognizing that there are instances where the cost of allocation outweighs the benefit that is being allocated.

Applying this guidance to the allocation of revenue sharing, fiduciaries responsible for allocating revenue sharing amounts among participant accounts need to be granted flexibility and discretion to determine whether, *e.g.*, a pro-rata allocation is appropriate or whether a more precise calculation can be done in a reasonable and cost-effective manner. While a straight-forward approach of allocating revenue sharing in proportion to account balances may seem to be the most reasonable manner of allocation, when one considers the variety of plans and revenue sharing arrangements, it becomes evident that flexibility is needed to determine the most appropriate manner. By definition, a method of allocation based on all balances at the end of year is not the most precise method, but the cost of doing precise calculations may be prohibitively expensive and administratively burdensome considering the amounts to be allocated. Thus, on balance it would seem that, in most cases, a pro rata allocation based on end of the year account balances is a reasonable method. But, it may not always be appropriate.

Consider, for example, two types of investments that often have the greatest divergence in revenue sharing (particularly for small plans)—stable value investments and an S&P 500 fund. (For example, it is not unheard of for a stable value investment to revenue share as much as 75 to 100 basis points per year, while a low-cost index fund may not revenue share at all.) In that case, if two participants have the same account balances, but one is invested entirely in the stable value vehicle while the other is entirely in the index fund, a pro-rata allocation based on account balances raises obvious issues for fiduciaries considering that one participant bore the entire cost of operating the plan through revenue sharing fees and the other participant did not. While this is an extreme example, the reality is that, for many small and mid-sized plans (and perhaps some large plans), the revenue sharing costs borne by participants for maintaining the plans may vary significantly. While that fact situation may raise fiduciary issues in its own right, our focus is on the prudent and equitable allocation of excess revenue sharing to the participants' accounts. Should it be allocated in proportion to the amounts charged to each participant to generate the revenue sharing? Conceptually, the answer is, yes, it should be. However, practically speaking, that may not be possible—at least at this time (although we are aware of one large plan that is doing exactly that).

**Fiduciaries need guidance on this allocation issue similar to the guidance provided by the referenced Field Assistance Bulletins.**

In recognition of the variety of revenue sharing arrangements, we recommend that any guidance on allocation methods for revenue sharing should build in flexibility and discretion so the fiduciaries may reasonably consider the material factors for determining the most appropriate method of allocation.

Finally, a tangential issue surfaces when considering the proper allocation of revenue sharing payments. That issue is—how long may that money remain in plan before it is allocated? Typically, when revenue sharing amounts are deposited into a plan they are initially placed into an unallocated account, sometimes referred to as a suspense account. Guidance in the form of a Revenue Ruling provides that, in general, money in a defined contribution plan must be allocated

to participants' accounts on an annual basis.[6] As a general statement of the qualification standards under the Internal Revenue Code, amounts held in a defined contribution plan must be allocated to participants' accounts on an annual basis unless there is specific authority allowing the money to be held unallocated beyond that time.[7] Since there is not specific authority for the creation of a suspense account for retaining recaptured revenue sharing payments (or similar revenues), those amounts must be allocated to participant accounts on an annual basis.

**Thus, I recommend that the DOL guidance regarding the allocation of revenue sharing payments be coordinated with the IRS to avoid conflicting guidance between the agencies.**

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

It is our understanding that the DOL is currently pursuing two initiatives to help plan sponsors and fiduciaries obtain information needed to understand and evaluate revenue sharing. We applaud the DOL's project to amend the regulations under ERISA section 408(b)(2) and the revision of Schedule C on the Form 5500 for 2009. We believe those changes will greatly improve the quality of information in the marketplace by, at least partially, transferring the burden of investigation by fiduciaries to a burden of disclosure by providers.

Specifically, the DOL is in the process of revising the regulation under ERISA section 408(b)(2) with respect to the reasonable contract or arrangement prohibited transaction exemption. The DOL has stated that it is considering requiring the following categories of information to be disclosed in order to satisfy the exemption: (i) information the fiduciary needs in order to determine if the contract or arrangement is reasonable; (ii) information regarding conflicts of interest; and (iii) information the plan administrator needs for the annual report.

**We suggest that the DOL coordinate the disclosure and reporting requirements of the proposed Form 5500 revisions and the anticipated 408(b)(2) regulations. That is, the regulation should require the upfront disclosure of fees and expenses, while the Form 5500 should require the after-the-fact reporting of those same fees and expenses.**

Beginning with the 2009 plan year, plan sponsors will have to disclose information regarding revenue sharing in the Form 5500. In particular, a significant change to Schedule C requires reporting of compensation paid by the plan or received by a provider. The Instructions in the DOL proposal state (and we assume the final version will retain those instructions):

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[6] Rev. Rul. 80-155 states that profit-sharing, stock-bonus and pension plans of the money-purchase type (*i.e.*, defined contribution plans) must provide for a valuation of investments held by the trust at least once a year in accordance with a method consistently followed and uniformly applied. In addition, Rev. Rul. 80-155 states that profit-sharing and stock bonus plans must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan.

[7] Note that there is guidance under sections 415 and 4980 of the Code that permit unallocated amounts to be held in a suspense account for forfeitures and amounts transferred from a terminating defined benefit plan to a defined contribution plan.

> For purposes of this Schedule, reportable compensation includes money or any other thing of value (for example, gifts, awards, trips) paid by the plan or received from a source other than the plan or the plan sponsor by a person who is a service provider in connection with that person's position with the plan or services rendered to the plan.

They also provide examples of indirect compensation, including:

> [F]inders' fees, placement fees, commissions on investment products, transaction-based commissions, sub-transfer agency fees, shareholder serving fees, 12b-1 fees, soft-dollar payments, and float income. Also, brokerage commissions or fees (regardless of whether the broker is granted discretion) are reportable whether or not they are capitalized as investment costs.

However, since Schedule C is only required to be filed for large plans, that is, plans with 100 or more participants, the new reporting will not apply to all plans.[8]

**We recommend that the reporting rules in revised Schedule C apply to all plans. That is, the DOL should exercise its authority to require small plans to report information on the 5500 Form identical to that required on the new Schedule C. The burden would fall primarily on providers and little, if any, additional cost would be imposed on small plans. In fact, the disclosed information may enable small plans to lower their costs through negotiation or through changing providers.**

In order for the information regarding revenue sharing fees to be understandable and presented in a manner that allows fiduciaries to evaluate the information, all providers should have to present their fees, expenses, and revenue sharing in the same way. If that information is presented in different ways by different providers, it will be very difficult for plan sponsors to readily compare provider fees (and it may be virtually impossible for smaller, less sophisticated, plan sponsors to do the analysis). In addition, for bundled providers that use internal corporate crediting (where credits are given by the investment management division to an affiliated recordkeeper for the use of proprietary investments), those providers should disclose the crediting (or, alternatively, if the investment manager offers mutual funds through other providers, the highest revenue sharing payment they make should be reported).

**To assist plan sponsors in understanding revenue sharing arrangements, I recommend that the data on expenses be divided into three categories:**

- Investment-related expenses ("investment expenses").

[8] It also applies to plans that have between 80 and 100 participants as of the beginning of the plan year, were large plans in the prior year and elect to file as a large plan even though they have less than 100 participants.

- Recordkeeping and administration expenses, which include communications, compliance, and other services related to the operation of a plan ("administrative expenses").
- Investment consulting, brokerage or advisory services ("advisory expenses").

The first category, investment expenses, covers the costs for the investments. For example, for a mutual fund, it would be the expense ratio of the mutual fund, including the management fee of the advisory firm. However, that data needs to be modified because of the unique characteristics of 401(k) plans. The amount of revenue from the investments that is paid (or credited) to either of the other two categories (administrative and advisory services) should be subtracted from the investment costs. That would include, for example, fees or commissions that are paid to the broker, consultant or adviser. It also includes any subsidy paid for recordkeeping and administration. The resulting "net" number is the true cost of the investments.

The second category, administrative expenses, includes any charges specifically for recordkeeping, administration, compliance, communications, and other operational services, as well as any revenue sharing or other payments received from the investments. Those revenue sharing payments typically include subtransfer agency fees and other shareholder servicing fees.

The third category, advisory services, covers any amounts paid directly by the plan to consultants, advisers, or brokers, as well as any indirect payments (that is, any payments or benefits from any source, but most likely from the investments or companies related to the investments). That includes, for example, finder's fees, 12b-1 fees, "success" bonuses, and so on.

Equipped with this information, plan sponsors and fiduciaries will be in a position to evaluate the services they are receiving in each of the three categories, with the costs properly allocated for purposes of that comparison. While no system is perfect, and this one is not either, the information would be a higher quality than is currently generally available, and would be much more useful to fiduciaries in performing their duties.

*Should the DOL develop a model prototype in this area?*

We do not believe that disclosure of revenue sharing lends itself to a prototype or model. However, the DOL should require that disclosures of revenue sharing payments should be broken out into consistent categories, such that plan sponsors can readily compare revenue sharing among providers. We also recommend that reporting be made, to the greatest possible extent, in actual dollar amounts or, at the least, in reasonably estimated dollar amounts based on the particular plan.

As an additional suggestion, we recommend that the Advisory Council reaffirm its guidance to plan sponsors and fiduciaries included in a 2004 Working Group Report. That guidance is:

> "The Advisory Council makes the following recommendations in an effort to further educate plan sponsors and fiduciaries:

- Plan sponsors should avoid entering transactions with vendors who refuse to disclose the amount and sources of all fees and compensation received in connection with plan.
- Plan sponsors should obtain all information on fees and expenses as well as revenue sharing arrangements with each investment option.
- Plan sponsors should also determine the availability of other mutual funds or share classes within a mutual fund with lower revenue sharing arrangements prior to selecting an investment option.
- Plan sponsors should require vendors to provide annual written statements with respect to all compensation, both direct and indirect, received by the provider in connection with its services to the plan.
- Plan sponsors need to be aware that with asset-based fees, fees can grow just as the size of the asset pool grows, regardless of whether any additional services are provided by the vendor, and as a result, asset-based fees should be monitored periodically.
- Plan sponsors should calculate the total plan costs annually.

Thank you for the opportunity to express my views to the Advisory Council. I would be glad to answer any questions from members of the Advisory Council or from the staff at the Employee Benefits Security Administration of the U.S. Department of Labor.