

# Uncovering and Understanding Hidden Fees in Qualified Retirement Plans

*"Revenue sharing is the 'big secret' of the retirement industry. This practice has created an environment that makes it hard for employers and employees to understand the true cost of their retirement services. Gross inequities can exist for both plan sponsors and participants."*<sup>1</sup> Financial Executive's International Research Foundation

*"Millions of 401(k) participants and thousands of sponsors, particularly in small- and medium-sized plans, are adversely affected by a form of revenue sharing instituted by service providers to reduce the above-line costs of plan administration."*<sup>2</sup> Institute of Management and Administration - DC Plan Investing, 9/25/01

## INTRODUCTION

Modern fee structures, as they relate to qualified retirement plans, are a relatively new phenomena, having been developed over the last thirty years. This paper will explore the five specific types of fees that are frequently considered to be "hidden" because of their difficulty in being recognized, quantified and monitored. It will also address their historical genesis and development, significance to a retirement plan's overall operational structure, fiduciary responsibilities, and their ultimate impact on the participant's financial future.

A historical exploration of the development of the current fee environment yields a significant amount of interesting insight and perspective. Potentially, the most important and sobering revelation is that neither the retirement industry alone, nor the media alone, will ever be able to root out the problem. Not even legislation will solve it. In the author's opinion, this problem will never be solved as long as we operate under the existing defined contribution paradigm. The legitimacy of this bold assertion, as startling as it may sound, rests upon the hypothesis that the current fee culture is symbiotic with the record keeping industry as a whole, and that only by changing the way participant records are kept can these fees be flushed out and ultimately eliminated - to the participant's ultimate benefit. This will prove far more complicated than anyone can conceive, as there are powerful forces at play that we cannot fully comprehend. Only courageous fiduciaries will be able to change the powerful currents, but change them they must if they are to calm the raging storm.

In the mid-to-late 1970's, several independent elements combined (technology, creation of the IRA and the 401(k), added investment ease through mutual funds, access to information etc.), which forced the mutual fund and brokerage industries to react in such a way that caused them to overlook critical fundamentals of creating systems to help participants replace income at retirement. In other words, the retirement plan industry created a culture that valued new asset deposits over participant welfare. Viewing in hindsight all that has transpired collectively, overlooking these fundamentals appears to be the foundation for today's retirement savings chaos and hidden fee crisis.

## PREMISES OF PAPER

1. The hidden fee problem is the result of a fundamentally errant approach to plan management
2. These flaws are the result of mingling of ERISA and non-ERISA defined contribution ("individual account plans") operational philosophies, beginning in the mid-to-late 1970's
3. Mingling ERISA and non-ERISA philosophies has caused the industry and the public to overlook the purpose of ERISA governed plans, which is to replace participant income at retirement
4. Overlooking the principle of income replacement was a significant and fundamental ERISA industry lapse that created an environment of emotional participant investing by effectively forcing non-fiduciary, less-than-novice individuals to invest their retirement funds with marginal help from others. In other words, allowing participants to direct trust assets that would otherwise be subject to, and managed by, prudent and skilled investment experts was a mistake, yet all hidden fees pivot around and interplay exclusively in this environment.

5. This mingled hybrid philosophy also allowed an environment for yield disparity<sup>3</sup> to flourish placing millions of unwary plan participants in the proverbial "harms way."
6. There is an inherent conflict between protecting participants and their beneficiaries, and protecting established systems and associated revenue. The existing goal within the industry is to protect itself, not the participants - a fundamental violation of ERISA's exclusive benefit concept.
7. In an effort to protect its interest, the industry created word games and a philosophical spin to define "disclosure," leading fiduciaries to believe they acted responsibly in authorizing certain transactions, platforms, approaches etc. Instead of disclosure meaning possession of facts coupled with understanding, it has evolved to mean legalese or rarely understood, therefore seldom-read prospectuses.
8. This "self-protection" is why the fees are hidden. Hidden fees pay for services that cannot be justified when viewed from a prudent, ERISA perspective, Sadly, it appears that the industry has had to obscure the economics of the hidden fee structures and strategies to survive.
9. To correct the problem of hidden fees, the industry as a whole must submit to sweeping changes that would completely change the face of how defined contribution plans are administered and handled. Sub-industries that support the errant culture must disappear. Brokerage firms who receive revenue sharing commissions as their sole source of income for selling qualified plans due to their being restricted in the type of revenue they can receive, and because they operate under the "suitability standard" versus the "fiduciary standard." Correcting the hidden fee problem might require barring non-fiduciaries from doing business in a fiduciary governed industry. Only fee-based professional fiduciaries would then remain, and they would manage portfolios for the exclusive benefit of the participant -- thereby rendering participant directed accounts extinct -- except in certain circumstances where ERISA exemptions exist.
10. Plan sponsors, collectively, will save hundreds of millions of dollars once enrollment meetings, participant education, printed materials, Internet account access technology, participant investment advice and all other errant services are no longer needed. On average, participants cannot, and will never, out perform professional prudent fiduciaries, and the retirement plan industry dishonors the financial future of America's workforce by convincing them that they can.
11. Without these sweeping changes, participant account balances will continue to groan under the strain of industry fabricated fees for its own benefit, not the participants.

## THE HEART OF THE MATTER

Specific fees that are considered to be "hidden" are:

- Soft dollar "excess commissions" paid to brokerages pursuant to Securities Exchange Commission ("SEC") rule 28(e)
- Sub-shareholder (participant) servicing fees - called "sub-transfer agent fees"
- Account distribution (sales) based 12(b)-1 fees
- Account servicing based 12(b)-1 fees
- Unitized variable annuity wrap fees

While 12(b)-1 and wrap fees are "disclosed," they are considered to be hidden because plan sponsors and lay trustees do not fully understand what they are, why they are being assessed, whether or not they are justified, and what to do about them if they exist. The author will address these fees in greater detail later in this paper.

## CRITICAL QUESTIONS

The development of these fees directly relates to the connection between the proliferation of individual account plans (IRAs, 401(k) etc.) and the growth of mutual fund industry. Significant questions surround the above fees, not only because they are difficult to quantify for fiduciary due diligence and monitoring purposes, but also because they exist for reasons other than for providing valuable benefits for the exclusive benefit of plan participants and beneficiaries. Relevant questions to this dialog include:

- Why are these fees relatively new? (i.e., Why did they not exist prior to ERISA?)
- What services justify these fees?
- Has the "justification" yielded material results for participants and beneficiaries?
- Why has the retirement plan industry endeavored to obscure these fees?
- If these fees are truly justified and legitimate, shouldn't they be stated on an invoice or statement? In other words, why are they "hidden?"
- Were services were "fabricated," and sold as valuable, in order to capture these fees?

In short, the question fiduciaries should be asking is, "Do these fees exist to pay for reasonable, legitimate and valuable services to participants of qualified retirement plans, or do they exist to support an errant industry whose sole purpose is to feed its supposed errant needs?" These and other tough questions are important for plan sponsors, attorneys, and

fiduciary practitioners to be asking themselves and their service providers.

## HISTORICAL DEVELOPMENTS OF MODERN QUALIFIED PLAN FEE STRUCTURES

Prior to ERISA, fees associated with managing qualified retirement plans were clearly stated and relatively simple to monitor. There are two primary reasons for this.

**First**, most qualified plan assets were professionally managed portfolios consisting of individual securities, real property and other marketable investments. Not only did very few individual accounts exist prior to ERISA, there was no opportunity for "shaving"<sup>4</sup> a little off the top of each individual investment (such as what happens with mutual funds and other similar investment vehicles today) to pay service providers was simply not practical or possible.

Investment portfolio managers would receive compensation directly from the plan sponsor, or they would be paid from available cash in the trust. Record keeping was done on a pooled aggregate basis (vs. a daily valued share/unit basis), which allowed fees to be easily reported and journaled to the income statement's gain/loss account. Further, all brokerage firms received fixed commissions for buying and selling underlying assets in the trust. Therefore, all compensation paid to service providers and brokers was up front and clearly stated.

**Second**, participants did not "choose" from a menu of funds, rather they received "allocations" of contributions and investment earnings to their account. This account was the same for all participants under the plan, and was professionally managed. Record keeping was simple. No investment education meetings were needed. No investment election forms to track and manage were required. Expensive voice response systems or online account access were not needed. Expensive "trading platforms" integrated with daily recordkeeping systems were not needed. In short, the operational environment was relatively simple and costs were low (and known).

### 1974 - Creation of IRA is genesis of modern fee environment

The genesis of the modern day fee environment was, ironically 1974, the year the Employee Retirement Income Securities Act (ERISA) was enacted. ERISA created the Individual Retirement Account for individuals who did not have the privilege of participating in employer-sponsored plans.

**Practice Note:** Notwithstanding IRA's having been created by ERISA, they are not subject to ERISA's rigorous fiduciary and reporting requirements the way qualified plans (plans governed by code § 401(a)). As 401(a) individual account plans (401(k), profit sharing etc.) began to proliferate, no care was taken by the industry to ensure service providers recognized and developed their operational infrastructure to accommodate the inherent differences between IRA's and qualified plans under § 401(a). In other words, 401(k) plans "piggy backed" upon established IRA mainframe platforms, and took on the characteristics of the non-ERISA governed IRA. Failure to separate the way these entirely different plans were sold, implemented, operated etc., created dilemma within the retirement plan industry that has yet to be adequately recognized, addressed or solved. The dilemma involves the disconnect and blurring of proper strategies, standards and governance between those entities (service providers) who are subject to the "fiduciary standard"<sup>5</sup> compared to those who are subject to the "suitability standard"<sup>6</sup>, In other words, the operational platform required to sustain a successful IRA industry effectively duplicated their platform to support the growing 401(k) and other individual account plan phenomenon without thought for whether the IRA platform would be appropriate for an ERISA governed plan. Failure to consider this subtle difference resulted in the creation of abusive, misleading, and falsely justified fees (and lower rates of return due caused by the embrace of an IRA like investment culture within 401(k) plans - i.e. the supposed need of participants to personally direct plan investments **to their own** financial detriment<sup>7</sup>) in §401(a) individual account plans that are subject to the rigorous ERISA reporting and compliance regulations. This dilemma will be discussed in greater detail later in this paper.

At that time, an individual could invest up to \$1,500 (not to exceed 15% of their earnings) each year, receive a tax deduction for this investment, and also receive tax-favored treatment on the earnings thereon.<sup>8</sup> The creation of IRA brought about a completely new paradigm and environment within the brokerage and mutual fund industry. This new environment is best described by Fredman and Wiles: "[A] generation ago, mutual funds were like the earliest mammals - small, vulnerable creatures that scurried about the undergrowth of the investment landscape. Since then, of course, funds have evolved into financial giants with heavy footsteps that reverberate throughout the stock and bond jungles."<sup>9</sup> By making the IRA the preferred venue for the average American's savings, the brokerage industry could capitalize on a new source of continuous deposits. A mere one million IRA deposits per year of \$1,000 or more would equate to at least a billion dollars of new annual investment inflow. Internalizing this fact, mutual fund companies scrambled to position

themselves as the preferred recipient of these billions. In order for mutual funds to uniquely position themselves with brokerage firms, who had distribution venues through their sales forces, they needed to give the brokerage something in return: their trade execution business. By placing their trades with a given brokerage firm, they obtained preferred access to the brokerage firm's sales force. This proved to be a coup for both the mutual fund industry and the brokerage industry. Billions of new deposits began to flow into mutual funds through the sales efforts of brokers, making mutual funds the staple investment of the investing-for-retirement public. However, it was not until 1981 with the passage of the Economic Recovery Tax Act of 1981 (ERTA '81) did the floodgates fully open, making IRA's universally available in for any person with earned income to make a tax deductible investment of \$2,000 (up to 100% of income).

### 1978 - The 401(k) Effect

In 1978, the Revenue Act was passed, later being sanctioned by the IRS in 1981 that created the 401(k) as we know it today. With IRA mainframe platforms already in place, brokerage firms were ready to take a billion dollar flow of new IRA deposits to mutual funds, to hundreds of billions in 401(k) plans in a matter of years, and over a trillion<sup>10</sup> in a matter of a few decades. Competition for 401(k) dollars became fierce, and in order to compete, new "bells and whistles" were created to entice plan sponsors to choose one vendor's 401(k) platform over another. These bells and whistles were costly, and additional revenues were required to support a broker or vendor's ability to grow and compete. The demand for additional revenues forced providers to construct ways to capture new forms of fees by legitimizing the new bell-and-whistle services, which would in turn justify the added fees. The modern fee structure began to take form.

With 401(k) and IRA gaining popularity and associated momentum (and subsequently other individual account plans such as 457, 403(b) etc.), both new and existing companies were needed, including brokerages, third party administrators, in-house mutual fund administration (bundled operations) consultants, etc. to service the bulging demand, and strategies were crafted to pay for these services. In the early 1990's, the common "pitch" was "give us your assets, and we'll throw in administration services for free." By the time this "pitch" was common-place in the industry, the additional fees had been conceived, investigated, implemented and tested - successfully. However, a fundamental flaw existed. IRA's deposits belonged to, and came from, the individual. 401(k) contributions were employer contributions made to the trust pursuant to a cash or deferred election (CODA), yet 401(k) investments would be handled as though they were IRAs, and since IRA's are not subject to ERISA's prudence requirements, a subtle conflict with ERISA was created. This is a problem because elective deferral CODA employer contributions are and were subject to the same fiduciary requirements that apply to traditional pension plans. Since hidden fees do not exist in defined benefit portfolios, per se, they should not exist in defined contribution plans either. Requiring participants to direct their own investments creates the environment for (potentially) exclusive benefit violating hidden fees to exist.

### **THE ADVENT OF HIDDEN FEES**

Shortly after the creation of the IRA, but before the creation of the 401(k) as we know it, an interesting change occurred within the brokerage and mutual fund industry. As part of the Securities Acts Amendments of May 1975 (SAA '75), fixed commission rates on the buy or sell of securities through brokerage firms were eliminated. The significance of the elimination of fixed commission rates would prove to be one of several core issues of debate regarding fees in retirement plans. This would ultimately allow brokerage firms to charge an "excess" commission, thereby creating "at play" revenue, which is commonly referred to as "soft dollar" revenue. With hundreds of billions of securities trades each, the revenue made available by SAA '75 would forever change the mutual fund and retirement plan industry. These soft dollars, coupled with the urgent need to compete and the creation of the 12(b)-1 in 1980, created the "perfect fee storm," which until now has existed with little or no notice of Federal regulators or the general public.

### **Hidden Fee Type 1 - SEC 28(e) Soft Dollars**

**Prior to ERISA**, mutual funds used the "excess" commission on a securities transaction to buy additional goods or services from their chosen brokerage firm. For example, if a trade costs 3.5 cents per share (trade execution, clearance and settlement)<sup>11</sup>, and the brokerage fixed commission was 5 cents per share, the excess 1.5 cents could either be used to purchase additional goods or services from the broker that directly benefited the account holder, or be credited back to their rightful owners, the account holders. Excess brokerage commissions (hereafter called soft dollars) were handled the same way for IRAs and qualified plans.

**After ERISA**, the practice of using such soft dollars in IRAs would remain the same, but with respect to participants and beneficiaries within a qualified plan, a conflict clearly existed with the traditional use of soft dollars and ERISA sections 403(c)(1), 404(a)(1), 406(a)(1)(D), 406(b)(1) and 406(b)(3).

- ERISA 403(c)(1) states that the assets of a plan shall never inure to the benefit of any employer and shall be held for the *exclusive* purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan.

*Significance: Using soft dollars for purposes other than for the exclusive purpose of providing benefits to participants and beneficiaries and paying operational costs of the plan itself is a fiduciary breach.*

- ERISA 404(a)(1) states that a fiduciary must act prudently and *solely* in the interest of the participants and beneficiaries.

*Significance: Using soft dollars to buy loyalty of brokerage firms, consultants or other parties-in-interest to the plan is a fiduciary breach.*

- ERISA 406(a)(1)(D) states that a fiduciary *shall not* transfer to, or use by or for the benefit of a party-in-interest, of any assets of an *ERISA governed* plan

*Significance: Use of soft dollars could effectively be a transfer to a party-in-interest, thereby creating a fiduciary breach.*

As a result of the Securities Acts Amendments of 1975, Section 28(e) was added to the Securities Exchange Act of 1934. With fixed commission rates no longer the law, Section 28(e) created a safe harbor for brokerage firms who exercise *no investment discretion* as defined under Section 3(a)(35) of the 1934 Act (e.g. acting under "Suitability" standard vs. "Fiduciary" standard) to be able to charge a mutual fund a commission that was "more" than what it costs to actually execute, clear and settle a securities buy or sell *without violating the law or fiduciary duties*. This excess commission could be used to purchase "additional" services from the brokerage firm in the form of presumably valuable investment research. In order to receive protection under the safe harbor, the mutual fund must act in good faith to ensure the excess commission was "reasonable in relation to the value of brokerage and research services provided by the broker-dealer."<sup>12</sup>

#### Lack of Regulatory Oversight and Illegal Use of Soft Dollars

Failing to deal with soft dollar abuses, the Securities and Exchange Commission was effectively compelled to address the issue on June 18, 2003 before the Congressional Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, shortly after H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003" was presented to the House of Representatives by Chairman Baker, Ranking Member Kanjorski and other members of the Subcommittee. According to the testimony of Paul F. Roye, Director, Division of Investment Management of the SEC, the Mutual Funds Integrity and Fee Transparency Act would:

- Provide investors with disclosures about "estimated" operating expenses incurred by shareholders, soft dollar arrangements, portfolio transaction costs, sales load break points, directed brokerage and revenue sharing arrangements.
- Provide investors with disclosure of information on how fund portfolio managers are compensated.
- Require fund advisers to submit annual reports to fund directors on directed brokerage and soft dollar arrangements, as well as revenue sharing.
- Recognize fiduciary responsibility and obligations of fund directors to supervise these activities and assure that they are in the best interest of the fund and its shareholders.
- Require the SEC to conduct a study of soft dollar arrangement to assess conflicts of interest raised by these arrangements, and examine whether the statutory safe harbor is section 28(e) of the Securities Exchange Act of 1934 should be reconsidered or modified.

While it is commendable that the SEC has decided to act on this issue, 17 years earlier the U.S. Department of Labor issued ERISA Technical Release 86-1 that notified the public of this very issue. The nature of ETR 86-1 was to "reflect the views of the Pension and Welfare Benefits Administration (PWBA) with regard to 'soft dollar' and directed commission arrangements pursuant to its responsibility to administer and enforce the provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA)."

An excerpt from ETR 86-1 states:

"It has come to the attention of PWBA that ERISA fiduciaries may be involved in several types of 'soft-dollar' and directed commission arrangements which do not qualify for the 'safe harbor' provided by Section 28(e) of the 1934 Act. In some instances, investment managers direct a portion of a plan's securities trades through specific broker-dealers, who then apply a percentage of the brokerage commissions to pay for travel, hotel rooms and other goods and services for such investment managers which do not qualify as research with the meaning of Section 28(e). In other instances, plan sponsors who do not exercise investment discretion with respect to a plan direct the plan's securities trades to one or more broker-dealers in return for research, performance evaluation, and other administrative services or discounted commissions. The Commission (SEC) has indicated that the safe harbor of Section 28(e) is not available for directed brokerage transactions."<sup>13</sup>

Subsequent SEC investigations<sup>14</sup> have shown that illegal "28(e)" revenues have been used by consultants to make certain services available to mutual funds such as access to:

- Conferences and other similar group meetings where the consultant invites both the "client" (i.e. a 401(k) plan sponsor/trustees) and the mutual funds who want to sell their funds to the "client" of the consultant. In other words, the mutual fund pays the consultant a significant amount of money to be invited to meetings where the consultant's clients will be in attendance.
- Sales and marketing support to the mutual fund's staff.
- "Objectively looking" performance reports that paint the mutual fund in the best light, and facilitate the sale of that fund to clients of the consultant.
- Other "image enhancement" or "sales facilitation" services.
- Loyalty of consultant or brokerage firm.

**Practice Note:** Illegal 28(e) revenue practices hurt plan participants and their beneficiaries, and violate ERISA Sections 403(c)(1), 404(a)(1) and 406(a)(1)(D). Fiduciaries must know whether these activities are going on within their plans to protect the participants and themselves from harm. Illegal 28(e) soft dollars are the most difficult fee to uncover; therefore it is incumbent upon fiduciaries to investigate this issue thoroughly, asking relevant clear and concise questions to brokerage firms, consultants and the mutual funds themselves. It may require an independent fiduciary audit to ultimately uncover such activities. If illegal 28(e) soft dollars are found to exist within your plan, consult with legal counsel immediately.

**Practice Tip:** Questions to ask your consultant, investment advisor and/or broker:

1. Do you receive benefits from 28(e) soft dollars from mutual funds within our plan?
2. If yes, what exact benefits do you/have you received?
3. Exactly how many 28(e) soft dollars are attributed to our plan?

## Hidden Fee Type 2 - Sub-Transfer Agent Fees

"Nothing is less productive than to make more efficient what should not be done at all" - Peter Drucker.

Blindly accommodating the insistence of the mutual fund and brokerage industry that ERISA governed 401(k) plans should be handled in the same manner as non-ERISA IRA's rather than adhering to a more traditional, prudent, ERISA based platform (failing to accommodate would require the fund industry to forsake established operational systems), was a mistake. With the facts of how hidden fees have come to be, it is very reasonable to question whether participant directed accounts should exist at all, yet billions are spent trying to make the process more efficient.

The issue of hidden fees is directly related the ability for a participant to direct their own investments within the plan, and hence are tied to the record keeping systems that enable participants to do so. The statistical data reveals that the philosophical error of requiring participant direction within ERISA governed plans has been devastating to the individual participant in the form of yield disparity<sup>15</sup>, account value attrition through gaming<sup>16</sup>, playing to the ego and emotion of the individual participant<sup>17</sup>, the increase in paperwork, increase in systems to handle the records and transactions.<sup>18</sup>

As explained previously in this paper, originally 401(k) and other individual account plans effectively "piggy backed" upon the existing mainframe IRA infrastructure that existed within the brokerage industry. To account for 401(k) participant accounts, brokerage or mutual fund companies would maintain a separate account for each individual participant - and this proved to be quite costly - especially as larger companies began to adopt 401(k) plans. Instead of re-thinking whether or not the IRA philosophy of participant directed funds (compared to the traditional prudently managed portfolio approach used in traditional defined benefit and money purchase pension plans) was "correct" with respect to ERISA, brokerages and mutual fund companies added additional clay to the sculpture.

The problem of hidden fees was soon to be perpetuated and exacerbated by sub-contracting the accounting of participant "shares" to third parties called "sub-transfer agents."

A transfer agent is usually a bank or trust company (or the mutual fund itself) that executes, clears and settles a security buy or sell order, and maintains shareholder records (i.e. accounts for "title" of the ownership of the shares). When certain functions of the transfer agent are sub-contracted to a third party, that third party becomes a "sub-transfer agent." Within

the context of this paper, a sub-transfer agent would be one of the following entities:

1. A third party administrator.
2. A bank or trust company performing recordkeeping services.
3. Some other entity tracking the number of shares held for the benefit of a specific participant within an individual account plan.

Payment to these parties for this sub-contracted service has come to be known as "sub-transfer agent fees." Sub-transfer agent fees exist solely due to support the participant directed account culture.

Sub-transfer agent fees are generally paid as a flat dollar per-participant per fund. For example, many funds will pay a third party administrator \$10 per participant per fund. Other funds will pay a percentage of assets - such as 5 to 10 basis points. However, some funds pay up to \$22 per participant per fund or 35 basis points.<sup>19</sup>

The problem with sub-transfer agent fees is not "how much" is being paid to service provider. The problem is knowing "who" is receiving the payment, and whether or not the payment fairly represents the value of the service being rendered." The Department of Labor has made it very clear that a plan sponsor must understand the value and associated compensation of each individual servicing company thereby making the cost of the parts more important than the cost of the whole.<sup>20</sup>

In the mid-1980's, the budding third party administration industry developed balance forward accounting software that ran on micro-processors, which for the most part, was affordable enough for even the smallest, developing company. Existing larger firms had developed proprietary mainframe systems that were robust enough to provide sub-accounting for multiple fund accounts (i.e. a menu of funds within a participant account as compared to a single professionally managed account). Shifting the accounting of each individual, and that individual's fund choices, to a third party, allowed the mutual fund to maintain a more streamlined and affordable omnibus account. In other words, the mutual fund was able to streamline their operation by maintaining a single account in the name of the trust, and feed aggregate transaction data to a sub-transfer agent for sub-accounting processing.

Sub-transfer agents, burdened by the strain felt for bearing the sub-accounting responsibility of an ever increasing number of funds offered within plans, handling participant transfers between funds within the plan, providing mediums for participants to access their accounts over the telephone or the Internet menu and the need for more sophisticated technology to more efficiently handle such an unprecedented environment, began to demand additional fees for their services.

These sub-accounting software platforms have evolved to the point where they can link to virtually any brokerage, mutual fund or trading/clearing platform, and by so linking, enable their users (the firm) to capture sub-transfer agent dollars from the participating mutual funds. An estimated 100 million shareholder accounts exist at this writing, or approximately 40 percent of all mutual funds, are in sub accounts at financial or record keeping intermediaries.<sup>21</sup> Approximately \$2 billion dollars per year is paid to third parties for sub-accounting services.<sup>22</sup>

Potential costly and ERISA violating problems with omnibus accounts with underlying participant directed sub-accounts.

- Only the omnibus account is subject to the oversight and review of the fund's board of directors.<sup>23</sup>
- Investment company compliance personnel cannot monitor the transactions occurring at the sub-account level, because the shareholder information is not disclosed to them - only information on the omnibus account itself.
- The emergence of omnibus accounts - coupled with participant direction - has provided an environment where the receipt of sub-transfer agent revenue can be hidden from plan sponsors. It is this same environment that provided a scenario where unscrupulous traders could hide late trading and market timing abuses.
- The omnibus structure obscures who is trading within a fund, and how often a particular shareholder may be trading. In other words, without sub-account transparency, the mutual fund compliance department cannot prove or disprove rapid-fire traders are using their access to mutual fund trading via the Internet for their own gain, hurting long-term investors.<sup>24</sup>

Proposed SEC rule 22c-2 demands transparency of these fees, so investment companies can see what is happening at the sub-accounting level - e.g. the participant level.

This error in philosophy of trying to make something more efficient that should not be done at all has come back to haunt the industry - in more than one way. Record keeping costs continue to increase, transaction errors are rampant and poor participation and overall account performance are now hallmarks of the philosophy. The SEC believes that developing tools to provide this capture information will cost \$1 billion a year for at least 3 years, and hundreds of millions annually after that to monitor it.<sup>25</sup>

## Significance of Sub-Transfer Agent Fees

- Sub-transfer agent fees are revenues "at play," meaning they can be paid to third parties for sub-accounting practices. They could also be "captured" and credited back to the trust for the benefit of the participants.
- Plan sponsors may be limited in the number or types of funds they have access to due to restrictions placed on a fund that does not pay sub-transfer agent fees, thereby impeding the fiduciaries ability to select the fund they deem in their best judgment are appropriate for the participants in the plan.
- At play dollars belong to the participant, and therefore fall under the jurisdiction of the named fiduciaries of the plan.
- If the named fiduciaries do not know that a third party is receiving these Sub-TA fees, they cannot monitor them, evaluate the worthiness of the compensation in view of services rendered, and take action as needed.
- In many cases, Sub-TA fees are being paid to third parties without the knowledge of the trustees - in addition to hard dollar amounts (invoiced to plan or plan sponsor by third party), effectively enriching the third party for unearned services. This is a violation of the exclusive benefit rule, as plan assets are being used for purposes other than to provide benefits to participants or to pay reasonable fees (which the plan sponsor or fiduciaries have agreed pursuant to the hard dollar billing - but not more)
- Some third parties construct their fee schedule around revenue sharing, stating that these fees will offset billed amounts, and they do show the offset against billable amounts on invoices.

**Practice Tip:** Questions to ask your consultant, third party administrator, mutual fund company, investment advisor and/or broker:

1. Do you or any other entity receive sub-transfer agent revenue?
2. If yes, is this revenue offset directly against stated costs as described in a service agreement?
3. Do invoices reflect the offset against what otherwise would be fees paid directly by the employer via invoice?

## **Hidden Fee Types 3 and 4 - Account Distribution (Sales) Based 12(b)-1**

Two types of 12(b)-1 fees:

1. Sales commission 12(b)-1 - paid to a registered representative for selling mutual funds for an individual or within a plan.
2. Servicing 12(b)-1 - paid to a person or entity who services an account after the sale.

SEC Rule 12(b)-1 was enacted in 1980. It is partially responsible for the proliferation of mutual funds in individual account plans. Again, referring to the mutual fund relationship with the distribution medium (sales force) of the brokerage firm, it creates a conflict of interest between the brokerage firm and the mutual fund - thereby rendering them unable to devote their loyalties to the plan participants. It permits mutual funds to increase their internal fund expense ratio by up to 1% in aggregate. For example, .5% could be paid as a sales 12(b)-1, and .5% could be paid as a servicing 12(b)-1, so long as the sum of the two does not exceed 1%. It is common to refer to both sales and serving revenue as "12(b)-1" fees, not differentiating between the two. More than half of all mutual funds have a 12(b)-1 feature.<sup>26</sup> These fees are disclosed in the prospectus, but very few plan sponsors understand what significance they have to the them, the participants, and the trustees.

Fiduciary audits performed by the author have discovered plans with otherwise high quality mutual funds with high 12(b)-1 fees. The same mutual fund could have been procured with no 12(b)-1, or at a minimum, a lower 12(b)-1 fee. This again points out the conflict between the suitability standard and the fiduciary standard. Non-fiduciary sales people carefully place products with high commissions unbeknownst to the plan sponsor or trustees, where an acting Registered Investment Advisor fiduciary would be obligated to disclose fees in writing, invoice the plan sponsor or plan for those stated fees, and credit any 12(b)-1 fees back to the trust. The clear difference shows the crisis that exists in the industry. Plan sponsors don't know there is a difference. Mutual funds are mutual funds to them.

Another seldomly considered 12(b)-1 issue is that of unfair subsidy disparity. Fee subsidy disparity is often referred to by the fiduciary community as the "Hidden Tax" is paid from participants with large account balances. Therefore, if the average 12(b)-1 fee is 35 basis points, participants with balances over \$40,000 can be viewed as subsidizing the other participants.<sup>27</sup>

**Practice Tip:** Questions to ask your consultant, company, investment advisor and/or broker:

1. Are you acting under a suitability or a fiduciary standard? In other words, are you a non-fiduciary registered representative or are you a fiduciary registered investment advisor?
2. If you are a registered representative, are you receiving 12(b)-1 fees?
3. If yes, what is the annual value of the 12(b)-1 gross revenue you receive? Obtain this information in writing. Compare with original information received at time trustees proceeded with these particular investments.
4. Can our same funds be purchased for a different share class with a lower 12(b)-1 fee?
5. Were our assets placed in this particular share class for a reason?
6. If yes, please explain. Was it because this share class paid higher 12(b)-1 fees?
7. If yes, has this caused us to breach our fiduciary duty for failing to properly investigate and pay only those fees that were appropriate and reasonable?
8. Are we in continued fiduciary jeopardy by allowing a non-fiduciary sales person guide us with respect to fiduciary decisions?

### Hidden Fee Type 5 - Variable Annuity Wrap Fees

A variable annuity is an investment contract between a plan and an insurance company where (normally) a series of ongoing deposits are made to accumulate resources sufficient to pay a future benefit. Variable Annuities can be sold by insurance agents who have little or no formal investment or fiduciary training. Variable Annuities are a separate vehicle that invests in mutual funds - it is not a mutual fund in and of itself. Variable annuities offer a variety of investment options that are typically mutual funds that invest in stocks, bonds and cash. Gains on Variable Annuities are tax-deferred. A fee is associated with obtaining this tax-deferred benefit (the insurance component - which provides the tax deferral). Therefore, one must ask whether or not putting a variable annuity in an ERISA governed vehicle is necessary or wise. In other words, you could buy a lower cost mutual fund using the inherent benefits of a 401(k) and still get the deferral of tax. Paying the insurance company for the tax deferral might be a waste of money. Variable Annuities generally have higher expenses than comparable mutual funds, and these fees are assessed in such a way where each component service is "wrapped up" into one aggregate fee. Accordingly, this aggregate fee is called a "wrap" fee.

The wrap fee hides individual component fees and services, which are:

- **Investment Management:** Fund management fees of the mutual fund that is contained within the variable annuity.<sup>28</sup>
- **Surrender Charges:** If withdrawals are made from a variable annuity within a certain period of time after units are purchased within the annuity, the insurance company will assess a surrender charge. The charge is used to reimburse the insurance company for the commission payments they paid to a broker or insurance agent upfront. The surrender charge usually starts out higher, and decreases over the length of the surrender period.<sup>29</sup>
- **Mortality and Expense risk charge:** This charge is equal to a percentage of the account value, typically 1.25% per year over the investment management fees - but could be more or less depending on who is purchasing the annuity.<sup>30</sup>
- **Administrative Fees:** The insurer may deduct charges to cover record-keeping and other administrative expenses. It is common to see fees of \$25, \$30 per year or a percentage of each participant's account value, typically in the range of 15% per year.<sup>31</sup>
- **Fees and Charges for Other Features:** Stepped up death benefit, a guaranteed minimum income benefit, long-term care insurance etc. These fees are stated in the annuity contract, and are actuarially computed based on age, health etc., and hence differ from participant to participant.<sup>32</sup>
- **Bonus Credits:** Some insurance companies offer something called "bonus credits." A bonus credit contract states that the insurer will credit back to your account a percentage of each purchase - e.g. 3% of each deposit. These types of accounts often have higher expenses, and these expenses can be larger than the credit you receive. Bonus credits are generally "purchased" with *higher surrender charges, longer surrender periods, higher mortality and expense risk charges*.<sup>33</sup>

404(c) attempted to reconcile fiduciary and non-fiduciary operations.

On October 13, 1992, the Department of Labor recognized the conflict between fiduciary duty and the culture of individual account plan sales being driven by non-fiduciaries. The Department of Labor attempted to bridge the gap between non-fiduciary behaviors in fiduciary governed plans by issuing DOL regulation §2550.404c, and this regulation was subsequently sold to the public (by the retirement plan industry) as a fiduciary protection tool. 404(c) successfully convinced fiduciaries of the reality of potential liability that could be caused by the non-prudent, non-traditional,

non-ERISA "IRA type" participant direction culture that was rapidly becoming the standard in all 401(k) plans. However, 404(c) may have actually created a false sense of security with most 401(k) trustees and other fiduciaries. The effort to educate participants with respect to their duties is honorable, yet such efforts have not yielded positive results for the participant and have had greatly increased the plan sponsor's burden to pay for and manage these efforts. Obtaining protection under 404(c) requires full compliance - a costly all or nothing effort. All of the plans audited by the author have not complied fully with 404(c), rendering all efforts vain - with respect to their original intent - which was to protect the fiduciary. This well intended band-aid further reveals the flaw in the system and culture. Fiduciaries who try to protect themselves will fail. Fiduciaries who protect participants will succeed, which is the true intent of ERISA.

## CONCLUSION

Participant directed accounts are the source of the problem. It is basic cause and effect. In other words, a wet street does not create rain, rain creates the wet street.<sup>34</sup> To eliminate hidden fees, the participant directed IRA culture must be rooted out of all ERISA governed plans. Failure to treat all plans subject to IRC §401(a), and hence subject to ERISA's fiduciary standard, the same way has now placed some 401(k) service providers and fiduciaries in the cross hairs of the Securities and Exchange Commission, the Department of Labor and State Attorneys General<sup>35</sup> for violations of the exclusive benefit and other fiduciary rules. Most fiduciaries have not made the connection that the fee problem begins deep inside the operational structure of the industry, and until this fact is universally internalized, the problem will remain within 401(k) plans.

Some legal experts and other expert fiduciaries<sup>36</sup> have concluded that modern individual account plan services were sold to plan sponsors as a "need" to justify the platform that would in turn justify additional fees. Statistics not only show that these new costs are putting a heavy strain on participant accounts, participant direction itself has proven to be a costly failure - hurting millions of future retirees.<sup>37</sup>

It is the fiduciary's solemn duty to prevent the use of plan assets for any other purpose than for the exclusive benefit of participants and beneficiaries or for paying reasonable administrative fees.

Until the problem (vs symptoms) is dealt with, full disclosure must be demanded more rigorously. Full disclosure with respect to fees **must** mean:

- a. The fiduciaries have been told everything about the services, fees and expenses of the plan in **writing**.
- b. The fiduciaries **understand** the significance of what was disclosed in writing. In other words, the disclosure is made verbally and in writing - AND a dialog is entered into that is logged in fiduciary minutes that confirm that understanding and comprehension was the primary objective of the disclosure.
- c. Until fiduciaries have in their possession **information sufficient to analyze and comprehend**, there is not full disclosure.

Soft dollars, sub-transfer agent fees and revenue sharing obscure a fiduciary's ability to act prudently, with knowledge and understanding, which can materially affect the quality of a participant's future. Hidden fees, in some cases, are an illegal transfer of plan assets to a party-in-interest, violating the exclusive benefit rule. Further, the way hidden fees are structured and ultimately collected can in fact impede a fiduciary's ability to select the investment strategy that is best for the participants within a plan. Fiduciaries must demand clarity and full disclosure with all fees, even those that the broker or consultant may not be aware of themselves. Fiduciaries should consider the history of how hidden fees came to be, and consider the merits of a traditional ERISA fiduciary approach, with the assistance of fiduciary service providers. Until the problem is corrected at its source, which it in reality may never be, will ensure all fees are known and easily monitored.

## FOOTNOTES

1. Hutcheson/Lansing/Meigs - Institute of Management and Administration ("IOMA) November 10, 2003 Audio Conference.
2. Ibid
3. Hamilton/Burns - "Reinventing Retirement Income in America," National Center for Policy Analysis. [www.ncpa.org/pub/st/st248](http://www.ncpa.org/pub/st/st248)
4. Statement by Senate Governmental Affairs Subcommittee on Financial Management, The Budget, and International Security. November 3, 2003, Senator Peter G. Fitzgerald (R- IL) stated, ""The mutual fund industry is now the world's largest skimming operation -- a \$7 million trough from which fund managers, brokers, and other insiders are steadily siphoning off an excessive slice of the nation's household, college, and retirement savings."
5. ERISA §404(a)(1), 29 U.S.C. §1404(a)(1)
6. NASD suitability requirement - Securities and Exchange Commission ("SEC" Rule 405 - Suitability or as we called it "Know Your Client Rule") is intended to ensure practitioners broadly understand client's objectives with their money in each of their accounts. It is not a fiduciary standard.
7. Statement of John C. Bogle to Senatorial Committee on Banking, Housing and Urban Affairs, February 26, 2004. Page 19. During the past 20 years, the S&P 500 earned approximately 13%. Over the same period, the average equity fund earned an annual return of 10.3%, while the average fund investor (i.e. participant) earned just 3%. The common denominator is participant direction of account vs. prudent professional direction of trust.
8. Jane G. Gravelle, Report for Congress. March 11, 2003. Individual Retirement Accounts (IRAs): Issues and Proposed Expansion.

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9. Fredman/Wiles: How Mutual Funds Work, Chapter 25. New York Institute of Finance 1998
10. Investment Company Institute, 2004 Mutual Fund Fact Book.
11. Technical Bulletin. U.S. Department of Labor May 22, 1986. ERISA Technical Release 86-1
12. Ibid
13. Ibid
14. SEC investigation of pay-to-play schemes. Center for fiduciary studies commentary see <http://www.fi360.com/press/pdfs/paytoplay.pdf>
15. Hamilton/Burns - "Reinventing Retirement Income in America," National Center for Policy Analysis. [www.ncpa.org/pub/st/st248](http://www.ncpa.org/pub/st/st248)
16. Employee Benefit News, March 2001, "Individually Directed Accounts are a Dumb Idea"
17. Emotional investing. <http://www.sap-img.com/stock-market-investment/emotional-investing-hurts.htm>.  
<http://www.advancedfutures.com/cbot/3.asp>. (This second article deals with those individuals who are actively buying individual securities. This is not the same as trading mutual funds within a closed fund menu, however the author believes that "investment trader" emotion exists in both, and cannot be materially distinguished by investors, albeit different types of investments being traded. In other words, trading individual securities or mutual funds themselves can create the same anxiety and emotion with respective investors.)
18. The leader in participant directed accounting software technology generated \$2.9 Billion in revenue during 2003, up \$2.5 billion in the last ten years alone. <http://www.sec.gov/Archives/edgar/data/789388/0001036050-99-000693.txt> <http://www.sungard.com/investors/q104factsheet.pdf>
19. Hutcheson/Lansing/Meigs - Institute of Management and Administration ("IOMA) November 10, 2003 Audio Conference
20. The Department of Labors booklet "A Look at 401(k) Plan Fees" [http://www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html)
21. Ibid
22. Ibid
23. The omnibus account problem: You can't monitor what you can't see. James J. Dolan, President and CEO, Access Data Corporation.
24. Ibid
25. Ibid
26. Institute of Business and Finance. Fredman and Wiles. How mutual funds work, page 369
27. Hutcheson/Lansing/Meigs - Institute of Management and Administration ("IOMA) November 10, 2003 Audio Conference
28. SEC variable annuities: What you should know. <http://www.sec.gov/investor/pubs/varanntty.htm>
29. Ibid
30. Ibid
31. Ibid
32. Ibid
33. Ibid
34. Brooks Hamilton, Attorney-at-Law 2004
35. <http://www.oag.state.ny.us/investors/investors.html>, <http://googleppc.stockbroker-fraud.com/news.htm>
36. Hamilton/Burns - "Reinventing Retirement Income in America," National Center for Policy Analysis. [www.ncpa.org/pub/st/st248](http://www.ncpa.org/pub/st/st248)
37. Statement of John C. Bogle to Senatorial Committee on Banking, Housing and Urban Affairs, February 26, 2004.

Two other articles dealing with this issue are: [Uncovering Hidden 401k Fees](#) and [New Tools Help Plan Sponsors Fulfill Fiduciary Duty](#)

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