



# INVESTMENT COMPANY INSTITUTE

MATTHEW P. FINK  
PRESIDENT

November 13, 1997

RECEIVED  
073963  
97 NOV 13 PM 5:17  
OFFICE OF THE CHAIRMAN

The Honorable  
Arthur J. Levitt, Jr.  
Chairman  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W., Room 6010  
Washington, DC 20549

Dear Arthur:

At your request, I have conducted an informal mail survey of the members of the Institute's Board of Governors regarding circuit breakers. We have collected responses from 21 of our Governors. The following is a summary of the responses:

- As to the first question as to whether circuit breakers should be eliminated, modified or kept unchanged: 9 favor elimination; 11 favor modification; and 2 favor keeping them unchanged.
- As to the type of modification: 17 favor basing circuit breakers on a percentage of the market rather than a fixed number of points; 6 would have a 15% test; and 5 would have a 10% test. Seven respondents said the percentage should be converted into a fixed number of points quarterly; 6 preferred daily; and 3 favored an annual adjustment. (Respondents who favored eliminating the circuit breakers also answered this question.)
- We also asked if circuit breakers should be based on a broader index than the Dow Jones Industrial Average: 9 favor using the S&P 500; and 2 favor using the NYSE Composite.
- Five respondents stated that markets should re-open for one-half hour if a trading halt extends beyond the normal close; several others favored other approaches to this issue (e.g., not closing if the trading halt would extend beyond the close).
- Responses to other questions were too scattered to be useful.

I hope that this information, although *ad hoc* and informal, is useful to you.

I am also enclosing a copy of the testimony that I delivered yesterday at a Department of Labor hearing on 401(k) fees.

All best regards,

Enclosure

**STATEMENT OF**  
**MATTHEW P. FINK**  
**INVESTMENT COMPANY INSTITUTE**

**ON**

**401(K) PLAN EXPENSES**

**BEFORE THE PENSION AND WELFARE BENEFITS ADMINISTRATION**

**DEPARTMENT OF LABOR**

**NOVEMBER 12, 1997**

Good morning. My name is Matthew Fink, President of the Investment Company Institute, the national association of the mutual fund industry. I appreciate the opportunity to testify at this public hearing regarding the nature and availability of disclosure concerning section 401(k) plan fees. The mutual fund industry has long been a proponent of full disclosure to investors, including, in particular, disclosure regarding all fees and expenses. Accordingly, we support the Department's consideration of this issue and offer our assistance in working with the Department as it continues to study it.

My testimony today will address the following points. First, the growth of defined contribution plans generally, and 401(k) plans in particular, has been a positive development for millions of employees. Second, plan sponsors are under a fiduciary duty to consider the costs that plan participants will bear in 401(k) plans. The highly competitive nature of the 401(k) market provides strong evidence that sponsors do, in fact, take these costs into account. Third, participants are entitled to receive full disclosure about the costs and expenses they will bear. Mutual funds provide information about their fees and expenses in a standardized and straightforward manner in their prospectuses required by the federal securities laws. The Department may wish to consider imposing similar requirements on providers of other investment options, as well as with regard to plan-level fees.

#### **A. The Shift To Defined Contribution Plans**

The shift from defined benefit to defined contribution plans perhaps is the most significant pension development since ERISA was enacted in 1974. Defined contribution plans, particularly participant-directed 401(k) plans, have grown steadily, and this growth is

particularly notable among small employers.<sup>1</sup> A recent Merrill Lynch survey found the 401(k) plan to be the most popular type of retirement savings vehicle among both employers and employees.<sup>2</sup> The vast majority of these plans now permit employees to direct investments.<sup>3</sup>

Participant-directed 401(k) plans have many characteristics that are attractive to employees. First, individual account-based plans provide a visible, easy-to-understand benefit, rather than a projection based on complicated factors and formulas, as is the case with defined benefit plans. Second, employees like the control associated with self-direction. Third, many employees prefer the immediate tax advantage of salary reduction to the projected benefit promise of defined benefit plans. Fourth, the increased portability and the even benefit accrual rate of the plan benefit is well-suited to a mobile workforce.<sup>4</sup> Indeed, taking these factors together, 401(k) plans may offer better benefits and less risk to employees than defined benefit plans.<sup>5</sup>

---

<sup>1</sup> From 1975 to 1993, the number of participants in defined contribution plans nearly quadrupled from 12 million to 44 million. The number of plans tripled. Between 1984 and 1993 the number of 401(k) plans increased from 17,000 to 155,000, or from 4% to 25% of all DC plans. See Olson, K. and VanDerhei, J., *Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where Are We and Where Are We Going?*, Employee Benefit Research Institute Issue Brief No. 190 (October 1997).

<sup>2</sup> *8th Annual Merrill Lynch Retirement and Financial Planning Survey of Employers*, Merrill Lynch (1997).

<sup>3</sup> A Profit Sharing/401(k) Council of America survey found that 93% of 401(k) plans permit employees to direct their own contributions and 77% permit them to direct employer contributions. *PSCA 40th Survey: Participant Balances Top \$75K and Counting*, DC Plan Investing, KOMA, October 14, 1997.

<sup>4</sup> Job tenure averages under five years. *The Changing World of Work and Employee Benefits*, Employee Benefit Research Institute, Issue Brief No. 172 (April 1996).

<sup>5</sup> Samwick, A. and Skinner, J. *How Will Defined Contribution Plans Affect Retirement Income?* NBER, June, 1995.

Mutual funds serve as a popular investment medium for defined contribution plans, including section 401(k) plans. According to 1996 Institute estimates, approximately \$557 billion of defined contribution plan assets were invested in mutual funds. It is important to note, however, that mutual funds constitute only about one-third of all defined contribution plan assets. The majority of plan assets are invested in other investment media, including guaranteed investment contracts, insurance company separate accounts, bank collective funds and employer stock. Many mutual fund affiliates also provide plan and participant services, as do insurance companies, banks, plan consultants and third-party administrators.

#### **B. Employer Role and Responsibilities**

The employer, in its role as a plan fiduciary, is responsible for prudently selecting and monitoring both investment options and plan service providers, including assuring that the costs of both are reasonable. In making these selections, employers consider different vendors, investment options and services in order to ascertain which best fits the needs of their plans and participants at a reasonable price. In order to determine the reasonableness of the price, employers must consider all expenses involved, including both expenses associated with particular investment products, as well as expenses incurred in connection with the administration of the plan.

Of course, the amount of expenses must be considered in light of the specific options and services provided. For example, a plan that offers participant loans may be more expensive to administer than one that does not offer loans. Similarly, employers select their features, including administrative features and investment options, to address the unique needs and

demographics of their workforce. For example, an employer with financially sophisticated employees may provide ten investment options or a "self-directed brokerage window." An employer with a less investment-experienced workforce and a new plan may select fewer options or "branded" investment options the names of which employees will recognize.

Employers are increasingly diligent at investigating and monitoring plan and participant services, performance of investment options and related expenses.<sup>6</sup> Many employers use detailed Requests For Proposal (RFPs) to identify and compare services offered, service quality and related fees and costs. This is reflective of fierce competition that is characteristic of the 401(k) market. And this competition is not limited to large plans; as was noted in recent testimony before the ERISA Advisory Council, because the small employer market is so competitive, vendors provide virtually every feature found in large plans to small plans at a very reasonable cost.<sup>7</sup> Among these features are "bundled services" products, which provide a comprehensive package of administrative, custodial and investment services. Among plans with fewer than 250 employees, 85 percent rely on a bundled product. Similarly, about 75 percent of employers with 250-1,000 employees use these products.<sup>8</sup> Bundled services products relieve employers from the obligation to contract separately with custodians, investment managers, recordkeepers and education consultants to obtain the services and investment menu for a successful 401(k) program. Service providers have also developed new investment options for the 401(k) market, including lifestyle and asset allocation funds and self-

---

<sup>6</sup> See, e.g., Tallman, J., "Sponsors of Defined Contribution Plans Becoming More Diligent in Obtaining Services," 24 BNA Pension & Benefits Reporter No. 41 at 2338-9 (October 10, 1997).

<sup>7</sup> Statement of Edmond F. Ryan, Senior Vice President, Massachusetts Mutual Life Insurance Company, before Advisory Council working Group on Guidance for Selecting and Monitoring Service Providers, September 10, 1996.

<sup>8</sup> Source: Morgan Stanley Asset Management; Access Research, Inc. (1995).

directed brokerage and mutual fund windows. Plan services also continue to expand. Daily valuation and trading capabilities, 24-hour voice response lines and sophisticated educational materials, programs and software are popular services quickly becoming industry standards.

Employers also are responsible for monitoring the quality, performance and cost of providers and investment options on an ongoing basis and, if necessary, should consider whether any changes are warranted. In this regard, service providers are well aware that if they do not perform well and do not price competitively, an employer may find another provider. One study estimated annual bundled service provider turnover rates to be about 10 percent in the small, medium and large employer market sectors.<sup>9</sup> A significant effect of competition and employer diligence is that some providers are lowering plan service fees.<sup>10</sup>

### C. Participant Information

Unlike a defined benefit plan, a participant-directed 401(k) plan places the responsibility and risk of an investment choice on the employee. Thus, employees are entitled to complete information about their investment choices and full information about fees and expenses. These expenses include both expenses associated with investment options and fees charged in connection with the administration of the particular plan.

---

<sup>9</sup> Estimated annual bundled services provider turnover rates are 9% for small employers of under 100 employees, 12% for medium employers with 100-1000 employees and 11% for large employers with over 1000 employees. "SPARK Marketplace Update," Access Research, Inc. (1996). Similarly, a 1995 RogersCasey/KOMA defined contribution plan survey (which did not distinguish bundled and unbundled services) found that in the previous year 22% of plans had hired new investment managers, 15% new trustees and 18% new recordkeepers.

<sup>10</sup> LaMassa, P., "The Best Defense: State Street Lowers Fees For Most Profitable 401(k) Clients," Fund Market Alert, Institutional Investor, August 25, 1997, in which a firm representative, addressing fee reductions, states, "It's a preemptive strike before someone else entices a client away.... Our clients are getting bombarded with other vendors' proposals."

In the case of mutual funds, all fees and expenses related to the fund are set forth in a standardized fee table at the front of each fund's prospectus as required by the federal securities laws. The fee table includes the fund's overall expense ratio, individual categories of fees and the effect of fund expenses on a hypothetical investment. The prospectus also includes other information, such as investment objective and historical investment return information, that an employer or participant needs to determine whether a fund is appropriate. The Securities and Exchange Commission has proposed changes to the mutual fund prospectus to make it more understandable to the average investor. The Commission also has proposed a new disclosure form for mutual funds -- the "profile prospectus." The profile prospectus would contain specified information about a mutual fund in a standardized format. The profile is ideally suited for the 401(k) market, as it would enable employees to make ready comparisons among different funds offered under a particular plan. Because the fee table would be required to be included in any fund profile prospectus, employees would be able to easily compare and contrast the total fees associated with particular funds.

ERISA does not require that employees be delivered information concerning their investment choices that is comparable to a mutual fund prospectus or profile. However, in order to fall within the safe harbor of section 404(c), which limits an employer's fiduciary responsibility for participant investment decisions, participants must be provided with or have the opportunity to obtain sufficient information to make informed decisions regarding investment alternatives. In particular, under regulations adopted under section 404(c), a participant must be provided, among other things: (1) "a description of the available investment alternatives . . . including a general description of the investment objectives and risk



and return characteristics. . . [and] the type and diversification of the assets comprising the [alternative's] portfolio"; (2) "a description of any transaction fees and expenses which affect the participant's . . . account balance in connection with . . . purchases or sales. . . (e.g., commissions, sales loads, deferred sales charges, redemption or exchange fees)"; and (3) "in the case of an investment alternative subject to the Securities Act of 1933 . . . a copy of the most recent prospectus. . . ." Thus, at least in the case of plans that comply with the section 404(c) safe harbor, employees do receive complete information about a mutual fund's fees and expenses, because they receive the fund's prospectus. For the reasons noted above, we believe that the new profile prospectus, once it is adopted by the SEC, would be the ideal document to satisfy this requirement.

Under section 404(c), however, employees may not receive comparable information in the case of many other investment alternatives that are not subject to the Securities Act and, thus, are not required to prepare a prospectus. The only disclosure about such products a plan fiduciary is required to deliver to participants under the section 404(c) regulations is a "general description" and an explanation limited to transaction-related fees, as opposed to annual operating expenses of the investment vehicle. Plan fiduciaries are required to deliver information about operating expenses of an investment vehicle only upon request by a participant. This violates Justice Brandeis' admonition that, "To be effective, knowledge of the facts must be actually brought home to the investor." Many participants will not know that they should ask for this information and, thus, they will never receive it. Accordingly, the Department should consider requiring that operating expense information with respect to any

---

" 29 C.F.R. Sections 2550.404c-1(b)(2)(i)(B)(1)(ii), (v) and (viii).

investment alternative be actually delivered to all participants, at least in the case of plans that fall within section 404(c).

Additionally, neither section 404(c) regulations nor any other provision of ERISA explicitly requires full disclosure of plan administration fees borne by participants. For instance, ERISA section 102 and regulations thereunder, which require employers to provide summary plan descriptions, makes no mention of these fees. And the regulation under section 404(c) mandates disclosure of only the charges a plan imposes for the "reasonable expense of carrying out investment instructions . . . with respect to their individual accounts."<sup>12</sup> This rule reaches only transactional fees and does not cover, for instance, any annual or quarterly assessment to pay for the plan's administration.

In order to ensure full disclosure, the Department should require plan fiduciaries to affirmatively disclose to all participants the nature of any plan-level fees that affect participant accounts. While ERISA clearly permits the costs of plan administration to be paid from plan assets, employees should be informed of assessments borne by participant accounts.

#### **D. Conclusion**

The mutual fund industry supports full disclosure of 401(k) plan fees to both employers and participants. Employers have a fiduciary duty to request and consider fees associated with plan administration and with investment options. The Department of Labor should take steps to assure that participants will be provided with full disclosure about expenses they will bear –

---

<sup>12</sup> 29 C.F.R. Section 2550.404c-1(b)(2)(i)(B)(2)(ii).

both disclosure as to expenses associated with investment options, similar to disclosure already required in mutual fund prospectuses, and disclosure of plan administration fees.

Issues relating to 401(k) fees are best dealt with through disclosure. As Justice Brandeis said, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."