Comments on Proposed Disclosure Requirements For Individual Investment Plans

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Introduction

The Labor Department's proposal to require the sponsors of participant-directed individual account plans, such as 401 (k) plans, to provide participants with uniform, comparative disclosures of the fees associated with each available investment product makes economic sense. This proposal emphasizes convenience and accessibility in financial disclosures for participants, and thereby helps to extend the principle of financial transparency that has already been implemented in other settings, such as disclosure of union spending on representational activities, political activities and lobbying, and gifts. While I applaud the regulation itself, I find the accompanying cost-benefit analysis wanting in several respects.

First, the Department argues that, on average, the fees currently paid by participants for investment products within their defined contribution plans "are higher than necessary by 11.3 basis points per year" because plan participants undervalue fee transparency, and that the proposed disclosure – by extending the principle of transparency – will reduce the fees paid by participants for investment products. Reviewing the literature that the Department cites, however, I do not find support for the contention that participants pay fees that are higher than necessary, let alone by 11.3 basis points. Moreover, the Department's suggestion that the proposed disclosure will result in participants paying lower fees for investment products within their defined contribution plans is inconsistent with the economic context in which plans and participants select investments.

Second, the Department reasons that the proposed disclosures – because of the uniform, comparative format – will reduce the amount of time that some participants spend researching their plan's investment options. Here, I believe, the Department has dramatically understated the potential benefits of reducing search costs. The proposed regulation would save participants time by summarizing fee and historical performance data in a tabular format, allowing easy comparison. And this potential for time savings is available to all participants, not just a few.

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In the final promulgation, I encourage the Department to revise its cost benefit analysis to better capture the benefit to all participants of transparent disclosures in terms of reduced search costs. The Department should also remove its unsupported assertions concerning possible reductions in fees paid for investment products. The benefits of reduced search costs to all participants are more than sufficient to justify the expected costs of implementation.

This comment discusses these issues. Section 1 addresses the literature cited by the Department regarding the expense ratios of mutual funds. Section 2 exposes key flaws in the economic logic of the Department's argument that disclosure will reduce the fees paid by participants for investment products within defined contribution plans. Section 3 notes that, even if fees paid for investment products do decline, the cost of participation may not, given the wide ranges of services offered within defined contribution plans and the interdependence of fee arrangements across service providers for some plans. Finally, Section 4 suggests an alternative, broader approach to quantifying the potential benefits from reducing participants' search costs.

1. The cited literature does not support the claim that the expense ratios of mutual funds offered by DC plans are "higher than necessary" by an average of 11.3 basis points.

The Department argues that the competitive market for investment management has not resulted in adequate disclosure because plan participants "underestimate the impact of fees and expenses…and undervalue transparent fee disclosure." [2] As evidence of this under-valuation, the Department points to the "wide dispersion of fees paid in 401(k) plans." [3] As a result, the Department estimates that "plan participants on average pay fees that are higher than necessary by 11.3 basis points." [4]

The Department cites five authorities that ostensibly support their claim that participants pay fees that are higher than necessary by, on average, 11.3 basis points per year.[5] Following a

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[2] Department of Labor, "Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans," FEDERAL REGISTER 73(142), July 23, 2008, ("DOL Proposal"), p. 43019.

[3] DOL Proposal, p. 43020.

[4] DOL Proposal, p. 43020, footnote 13.

[5] DOL Proposal, p. 43020, footnote 13. The exact same sources are also cited in footnote 18 of the more recent proposal concerning investment advice (Department of Labor, "Investment Advice – Participants and Beneficiaries," FEDERAL REGISTER 73(164), August 22, 2008 ("DOL Investment Advice Proposal"). The five articles are: Deloitte Financial Advisory Services LLP, "Fees and Revenue Sharing in Defined Contribution Retirement Plans," Unpublished report, commissioned by the DOL (December 6, 2007); James J. Choi, David Laibson, and Brigitte C. Madrian, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds," NBER WORKING PAPER #W12261 (May 2006); Edwin J. Elton, Martin J. Gruber, and Jeffery A. Busse, "Are Investors Rational? Choices Among Index Funds," THE JOURNAL OF FINANCE, 59(1) (February 2004); Brad M. Barber, Terrance Odean, and Lu Zheng, "Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows," JOURNAL OF BUSINESS, 78(6): 2095-2119 (2005); and Sarah Holden and Michael Hadley, "The Economics of Providing 401(k) Plans: Services, Fees and Expenses, 2006," INVESTMENT COMPANY INSTITUTE 16 Research Fundamentals, No. 4, (September 2007).

request for additional explanation of how the 11.3 basis point figure was calculated, the Department sent a note, which stated in part:

> …the Department used a fraction of the dispersion of fees paid on mutual funds as a proxy for possible fee savings…. For each study the asset-weighted dispersion of fees was examined with attention to the degree to which some fees exceed typical levels. The estimate of 11.3 basis points was selected from the low end of the distribution.[6]

This additional explanation cited four of the original papers, as well as one additional paper.[7] I examined all six of these sources for information on the asset-weighted dispersion of fees and for information on "typical" fee levels.[8, 9]

None of these articles support the Department's premise that plan participants pay "higher than necessary" fees by, on average, 11.3 basis points.

- Choi et al. (2006) and Deloitte (2007) contain no data on the dispersion of fees paid for investment products within DC plans from which one might draw any conclusion regarding whether those fees are too high, let alone the extent to which investors pay fees that are "higher than necessary."[10]
- Elton et al. (2004) and Hortaçsu and Syverson (2004) analyze the fees charged by S&P 500 index funds prior to 2001, but contribute nothing to our understanding of current fees. Nor do these authors specifically address the fees of products within DC plans. Moreover, in the context of studying differences in expense ratios, these articles do not control for other attributes of the mutual funds, such as service differences. Finally, neither paper includes data on the level of assets associated with various fees, precluding any calculation of the weighted-average fees that investors pay or the degree to which investors have paid fees that are higher than that average.
- ICI (2007) and Barber et al. (2006) are the only cited articles that provide data on asset levels associated with a specific distribution of fees for diversified equity funds, and only the ICI survey specifically addresses fees within the context of DC plans. Even these articles, however, do not report fee distribution data in a format that lends itself to the

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[6] Email from Dr. Anja Decressin, Division of Research and Economic Analysis, Office of Policy and Research, Employee Benefits Security Administration, Department of Labor, August 28, 2008 ("Supplemental Email").

[7] In this email, the Department replaced Elton et al. (2004) with Ali Hortaçsu and Chad Syverson, "Product Differentiation, Search Costs and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds," THE QUARTERLY JOURNAL OF ECONOMICS (May 2004).

[8] The Department does not define what it means by "typical levels" of mutual fund fees.

[9] A brief review of each paper is included in the appendix.

[10] In constructing their experiment, Choi et al. purposely select four S&P 500 index funds with different front-end loads and expense ratios. The authors, however, provide no information on the distribution of fees from which these four examples are chosen.

> sort of calculations implied by the Department. Nor does it appear that any manipulation of the fee distribution data in these articles would lead to the conclusion that 11.3 basis points is the low end of the range of fee distributions.[11]

Moreover, these six articles do not necessarily support the general contention that mutual fund fees are higher than necessary. At most, some of these articles document the existence of some dispersion in retail mutual fund fees. That some investors choose to pay more than the average fee is, therefore, undeniable – but the cause of the dispersion is not clearly explained by these articles.

Several authors, notably Elton et al. (2004) and Hortaçsu and Syverson (2004), posit the existence of search costs as an explanation for why some investors select higher-fee investment options when lower-fee alternatives are available. Their idea is that if investors find it difficult or expensive to "comparison-shop" across fund alternatives, some funds may be able to charge relatively higher fees to some investors, even while most investors enjoy lower fees constrained by competition. The experiment conducted by Choi et al. (2006), however, suggests that search costs are an inadequate explanation for the observed dispersion in fees: in comparing four S&P 500 index mutual funds, more than 80 percent of test subjects chose to invest in a fund other than the lowest-fee option, even after viewing a comparative fee table, much like the proposed disclosure at issue here.

Perhaps a better explanation for the observed fee dispersion requires broadening our understanding of the product in question to include the associated services that are sometimes packaged with a mutual fund, such as financial planning tools or advice from brokers. Investors with different preferences for these extra services will choose mutual funds packaged with different levels of services– and those funds offering more services will naturally charge higher prices than those that offer fewer services. This is consistent with the evidence in Barber et al. (2005), that less experienced investors choose funds that are sold through firms that provide broker recommendations in conjunction with investment products. Over time, as investors gain experience with financial markets, they tend to select products with lower sales charges (implying less guidance). Thus, viewing mutual funds as integrated products, packaging services with investment management, can explain the observed dispersion in fees.

This view of the evidence, however, does not lead one to the conclusion that mutual fund fees are "higher than necessary." Rather, it stresses that investment products – including S&P 500 index funds – are not homogeneous goods, differentiated only by price. More services can be purchased, at higher prices – but this in no way suggests that the same bundle of services could be had for lower cost.

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[11] Nor do these authorities enable the replication pursuant to OMB Circular A-4 of the analysis leading to the Department's stated conclusion that plan participants pay an average 11.3 basis points of "higher than necessary" fees. OMB Circular A-4 at 17 ("A good analysis should be transparent and your results must be reproducible. You should clearly set out the basic assumptions, methods, and data underlying the analysis and discuss the uncertainties associated with the estimates. A qualified third party reading the analysis should be able to understand the basic elements of your analysis and the way in which you developed your estimates.")

2. There is no economic reason to expect that the proposed disclosure will reduce the cost of participation in defined contribution plans, given the context in which plan participants select investment options.

The Department anticipates that the proposed disclosures will result in plan participants paying lower fees for investment management. The Department identifies three mechanisms by which this predicted reduction in fees may occur: (1) the market price for investment management services may fall "as more fee transparency fosters more price competition"[12]; (2) participants "will more consistently pick the lower cost comparable investment alternatives under their plans" thereby obtaining "equal value without incurring the [same] expense" [13]; and (3) the required disclosures may lead plan fiduciaries "to select less expensive comparable investment alternatives."[14]

The Department suggests that, as a result of paying lower fees for investment management, the proposed regulations would save participants $307 million per year (in 2009 dollars), over each of the first ten years, providing a total benefit of approximately $2.3 billion.[15] The Department does not specify how much of the reduction is attributable to each of these mechanisms.

The logic of Department's argument, however, is inconsistent with the economics of the markets in which services are provided to plan sponsors and participants. I have identified five fundamental problems.

The Department's own evidence contradicts its premise that plan participants undervalue transparent fee disclosure.

A basic premise of the Department's analysis is the market has failed to provide transparent disclosures because plan participants do not place sufficient value on such information. While the Department acknowledges that, "in general, the market delivers products that are deemed valuable by consumers… [t]he lack of (mandatory) transparent fee disclosures in this market

[12] DOL proposal, p. 43020. The proposal goes on to state that "The Department believes that fee reductions attributable to the proposed regulation will mostly reflect efficiency gains, especially in the longer run. Downward pressure on fees will favor more efficient means of producing investment and other plan services. It will also reflect a diminution of the market for services whose costs exceed their benefits (such as movement from more active to more passive investment management in cases where the latter is more efficient)." (DOL Proposal, p. 43021)

[13] DOL proposal, p. 43020.

[14] DOL proposal, p. 43020.

[15] The Department estimates the long-term benefits by assuming that the reduction in fees is permanent. To reflect the time value of money and the fact that some of these expected savings occur in later years, the Department reduces the annual value in future years by the discount rate. With a seven percent discount rate, these purported annual savings amount to approximately $2.3 billion over the first ten years of the regulation; with a three percent discount rate, these savings amount to $2.7 billion over the first ten years of the regulation.

suggests to the Department that individuals may underestimate the impact that fees and expenses can have on their account balances, and thus undervalue transparent fee disclosure."[16]

The Department's premise ignores that information similar to that required by the proposed regulation is already provided by the overwhelming majority of plans.[17] According to the Department's own analysis, 95 percent of plans already provide most of the information currently described in the proposed regulations. Therefore, one might conclude that the market – despite the absence of mandatory disclosure – has responded to the desire of plan sponsors and participants for information.

This premise is also inconsistent with evidence from a recent AARP survey, which tested participants' financial understanding: 79 percent of respondents, when faced with a choice between two mutual funds that differed only in their expense ratios, selected the lower-fee product.[18] Also, because the information was presented in a comparative format in the AARP study, there is no reason to think that the 14 percent who had no preference or the six percent who preferred the higher-fee product would have been swayed by the proposed regulations.[19]

The investment management industry charges competitive prices already.

The Department's proposition that fees for investment products are higher than necessary is inconsistent with evidence that the investment management industry is competitive. Economics teaches that, in competitive markets, suppliers are not able to sustain excessive prices. Therefore, competitively-set fees will reflect the value provided by those products as well as the cost of providing the products to the market.

The evidence regarding the competitiveness of the market for investment management services, generally, and the mutual fund industry, in particular, is incontrovertible. The sheer number of institutional investment managers is compelling evidence of the competitiveness of the market in which plan participants receive investment management services. In 2007, more than 750 institutional investment managers served the defined contribution marketplace. Of these, only three had market shares of at least five percent (measured based on assets), the largest of which accounted for just 7.2 percent of the market.[20]

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[16] DOL Proposal, p. 43019.

[17] According to the Department's own analysis, 95 percent of plans voluntarily comply with 404(c) regulations or provide similar information. (DOL Proposal, p. 43022.) The Department acknowledges that "participants in section 404(c)-compliant plans already receive much of the information that would be required under the regulation." The incremental information would be a summary of fee and performance information in a comparable format.

[18] AARP, "401(k) Participants Awareness and Understanding of Fees," July 2007, p. 7.

[19] *Ibid.* One percent of respondents did not answer the question.

[20] Pensions & Investments, MONEY MANAGERS SURVEY, 2007 EDITION, covered 760 institutional investment managers serving the defined contribution plan market.

Likewise, the mutual fund industry gives investors choices of more than 8,000 mutual fund portfolios, offered through more than 20,000 separate classes of shares.[21] Even focusing on only those mutual funds commonly offered by defined contribution plans, Pensions and Investments reports that, as of 2007, there were more than 300 domestic equity funds with DC assets greater than $100 million, and more than 100 domestic equity funds with DC assets greater than $1 billion.[22] With this many products and firms all vying to gain a share of investors' assets, the mutual fund industry has little alternative but to compete aggressively for investors and plans, providing attractive combinations of services at competitive prices.

In addition to these casual observations, economic experts have shown that the mutual fund industry not only has all the common indicia of competitive markets, but also that expense ratios of mutual funds are generally consistent with mutual fund providers responding to competitive markets. For example, Coates & Hubbard (2006) document the ease of entry and exit in the mutual fund industry, the ability of new entrants to garner market share quickly, the absence of evidence for economies of scale serving as a barrier to entry, and the prevalence of price competitive behaviors.[23] Earlier, Baumol et al. (1990) published a similar study, with similar findings, focusing on money market mutual funds.[24, 25]

Given that fees for investment management products are already set within the context of a competitive market, there is no reason to believe that the proposed uniform disclosures of those fees to plan participants will cause investment managers to reduce their fees.

In the context of a competitive market, dispersion in fees does not imply that the prices of some investment management products are "higher than necessary."

The Department errs in its presumption that price dispersion is evidence of market inefficiency. In competitive markets, it is common for consumers to see different prices for products that may appear, at first, to be identical.[26] From a consumer's perspective, the valuable characteristics of any product may include related services and amenities provided in conjunction with the product (such as customer service), the reputation of the provider, and the

[21] ICI Factbook 2008, Table 1, p. 110.

[22] Pensions & Investments, MUTUAL FUNDS MOST USED BY DEFINED CONTRIBUTION PLANS, 2007 EDITION.

[23] Coates, IV, J. C. and Hubbard, R.G., (2007) "Competition in the Mutual Fund Industry: Evidence and Implications for Policy," THE JOURNAL OF CORPORATION LAW, 33(1), pp. 151-222.

[24] Baumol, W. J., et al., 1990, THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION, Boston: Kluwer Academic Publishers.

[25] The Department even cites some of this literature in its proposal regarding investment advice. See Department of Labor, "Investment Advice – Participants and Beneficiaries," FEDERAL REGISTER 73(164), August 22, 2008 ("DOL Investment Advice Proposal"), p. 49904, footnote 16.

[26] See John W. Pratt, David A. Wise, and Richard Zeckhauser, "Price Differences in Almost Competitive Markets," 93 QUARTERLY JOURNAL OF ECONOMICS 189 (May 1979); Saul Lach, "Existence and Persistence of Price Dispersion: An Empirical Analysis," 84 REVIEW OF ECONOMICS AND STATISTICS 433 (August 2002).

ease of acquisition. Differences in these and other characteristics entail different costs, and thus imply different prices. Even on the Internet, where search costs are low and it is common for consumers to have access to comparative price information, price dispersion persists.[27]

The Department's argument implies, incorrectly, that investment management products are largely homogeneous goods, differentiated only by the prices charged to investors.[28] Investment management products, however, have many different attributes (such as risk profile, investment style, management tenure, expected returns, years since inception, brand, etc.) that are of value to participants. Differences in prices reflect the different values that investors place on the combinations of attributes provided by different products at the margin, as well as differences in the cost of providing various products. Moreover, even products with similar investment management strategies may still differ in ways that are meaningful to investors, leading to differences in price.[29]

Because investment management services are not homogeneous from the perspective of consumers, one cannot reasonably conclude that fee dispersion across these products is evidence that some fees are "higher than necessary."

Access to uniform, comparative fee disclosures need not lead plan participants to alter their investment decisions in favor of funds with lower fees.

The Department's analysis suggests that, confronted with uniform comparative fee data, "29 percent of participants will spend time researching their plans' designated investment alternatives (sic) fee and expense information and are, therefore, likely to benefit from reduced search time and corresponding reduced costs."[30] In other words, the Department predicts that

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[27] Online examples of price dispersion across identical products include such products as books, CDs, and life insurance products. See Michael R. Baye, John Morgan, and Patrick Scholten, "Price Dispersion in the Small and in the Large: Evidence from an Internet Price Comparison Site," 52 JOURNAL OF INDUSTRIAL ECONOMICS 463 (2004); Jeffrey R. Brown and Austan Goolsbee, "Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry," 110 JOURNAL OF POLITICAL ECONOMY 481 (2002); Karen Clay, Ramayya Krishnana, and Eric Wolff, "Prices and Price Dispersion on the Web: Evidence from the Online Book Industry," 49 JOURNAL OF INDUSTRIAL ECONOMICS 521 (2001); and Michael D. Smith and Erik Brynjolfsson, "Consumer Decision–Making at an Internet Shopbot: Brand Still Matters," 49 JOURNAL OF INDUSTRIAL ECONOMICS 541 (2001).

[28] DOL acknowledges that some of the differences may be explained by differences in plan features, but then concludes – without specific support – by saying that "The Department believes, however, that a significant portion of the variation in plan fees is due to market inefficiencies." (DOL proposal, p. 43020)

[29] Sean Collins, "Are S&P 500 Index Mutual Funds Commodities?" INVESTMENT COMPANY INSTITUTE PERSPECTIVE, 11(3) (August 2005).

[30] DOL Proposal, p. 43021. The DOL proposal appears to be inconsistent regarding the extent to which all participants will benefit from lower fees. In one analysis, DOL calculates benefits assuming that there is an across-the-board 10 percent reduction in fees due to the disclosure. (DOL Proposal, p. 43021) Elsewhere, DOL uses 29 percent as the "percentage of plan participants predicted to make a change in allocation to lower fee investments." (DOL Proposal, p. 43022) The apparent inconsistency can be resolved, however, with a closer reading of the underlying survey data. This 29 percent figure is taken from an Employee Benefits Research Institute survey; the correct interpretation of the survey is discussed

29 percent of participants will research the costs of the available investment options, and all of these participants then switch to lower fee alternatives.

The Department's conclusion presupposes that plan sponsors offer their participants investment options that include multiple products with the same investment objectives, risk profiles, and performance, but with different fees – and that participants have routinely chosen the higher-fee investment options.

The underlying model of choice implicit in the Department's analysis is not realistic. Each plan sponsor pre-screens investment options and selects some number – spread across a variety of investment objectives – to comprise the plan's investment menu.[31] Typically, the sponsor will offer only a few options within any asset class or investment approach. For some investment objectives, such as a broad-market index fund, the plan sponsor may offer only a single option. Only after the menu has been set do participants select funds. Because a sponsor will consider fees (among other attributes) in selecting investment options for its plan, it is unlikely that participants will have the choice between funds which – apart from different fees – are otherwise identical.[32] Thus, the Department's argument for disclosure lowering fees is inconsistent with the context in which plan participants actually select investment options.

Moreover, the Department has misinterpreted the 2006 Employee Benefits Research Institute ("EBRI"), which they use to estimate that 29 percent of plan participants will switch to lower fee investment options. The survey indicates that 29 percent of participants who received educational materials from their plan sponsor in the last year modified their retirement plans as a result.[33] The most common response, however, was for participants to increase their

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in more detail in this section. (Helman, et al., "Will More of Us Be Working Forever? The 2006 Retirement Confidence Survey," EMPLOYEE BENEFITS RESEARCH INSTITUTE ISSUE BRIEF #242, April 2006 ("EBRI #242"), p. 21.)

[31] For example, among plans recordkept by Vanguard, more than 90 percent offer short term reserves (in the form of a money market fund, a stable value fund and/or a guaranteed investment contract), fixed income funds, balanced funds, domestic index funds, large-cap value funds, large-cap blend funds and international equity funds. More than 70 percent of plans also offer large-cap growth funds, mid cap funds, and small-cap funds. Thus, the majority of plans select funds that cover 10 asset classes/investment objectives and strategies. Counting life-cycle funds as a single option, 67 percent of plans offered between 11 and 25 options, and the average number is 17 funds. Therefore, it stands to reason that most plans are offering no more than a few funds in any given asset class/investment strategies and objectives. (Vanguard, HOW AMERICA SAVES, 2007, pp. 29-31.)

[32] This, however, is precisely this exercise that participants faced in Choi et al.'s experiment, raising questions about whether their findings apply in the context of investment choices made within DC plans. In that experiment, subjects were asked to compare four S&P 500 index funds that ostensibly differed only in their fees and inception dates (causing differences in historical rates of return). The authors, however, did not remove the names of the funds, leaving open the possibility that respondents attached some value to the brand names of the options. Also, the Department alludes to the possibility that participants may switch from actively managed products to lower-fee index products. In fact, active and passive investment products reflect markedly different investment strategies and are not close substitutes for one another.

[33] EBRI #242, p. 21.

contributions (48 percent of those making modifications); only 33 percent of those making modifications adjusted their asset allocation.[34] So, at most, about 10 percent of participants adjusted their asset allocations after receiving educational materials.[35]

Furthermore, there is no reason to believe that the participants in the EBRI survey uniformly chose funds with lower fees. Instead, participants may have re-allocated their investments to achieve a different risk exposure, or to increase diversification – either of which might involve making choices that could increase average fees. For example, a participant that was invested in company stock (usually at zero cost), might have moved a large percentage of assets into an index fund – increasing average cost, but creating a more diversified portfolio.

Similarly, a participant may have decided to shift some assets from fixed income funds (which tend to be relatively low fee options) to international or small cap equity funds (which tend to have relatively higher fees); such a move would tend to increase average cost, but might be a more appropriate risk profile for some participants. Thus, there is no basis for interpreting the EBRI study as evidence that nearly 30 percent of participants would choose lower priced funds, if presented with comparative fee and performance data, as the Department has done.

In other regulations, the Department already addresses information provided to plan sponsors; given this, the current proposal will not alter the information available to plan sponsors, and so cannot be expected to alter sponsor's menu selections.

Separately, the Department has proposed new regulations regarding the information that plan sponsors should obtain from service providers in order to evaluate the compensation that each provider receives for the particular services rendered, and the potential for conflicts of interest between service providers and the plan.[36] The disclosures contemplated in the 408(b)(2) proposal are entirely separate from the information covered by the proposal at issue here.

Plan sponsors, as fiduciaries of their plans, are charged with ensuring that participants are offered a choice among prudent investment alternatives. As such, plan sponsors have informational needs that may differ from participants, and those differences are addressed by separate regulatory endeavors.

Creating uniform, comparative fee and performance disclosures for the investment products that a plan sponsor has already investigated and included in its plan is not likely to add to the

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[34] *Ibid.*

[35] That is, of the 29 percent who made changes, 33 percent changed their investment mix. 33 percent of 29 percent is 9.57 percent of all plan participants. While this corresponds to the estimated 10 percent reduction in average fees in the Department's analysis of possible benefits from reduced fees in plans that already comply with 404(c) or provide similar information to participants, there is no similar explanation for the Department's predictions concerning plans that do not currently comply with 404(c) disclosure rules.

[36] Department of Labor, "Reasonable Contract or Arrangement under Section 408(b)(2) – Fee Disclosure," FEDERAL REGISTER 72(239), December 13, 2007.

information already available to plan sponsors regarding the cost to participants of the selected investment options. Thus, the proposed regulation should not be expected to alter sponsor's menu selections.

3. The Department's focus on fees for investment products ignores the interdependence between fee arrangements for various plan services and products.

A reduction in investment option fees does not necessarily translate into lower total plan costs by participants.

From the perspective of participants, a defined contribution plan is an integrated product, offering at least two basic services: investment management and recordkeeping services. In addition, a plan sponsor may offer other, related services, such as general planning for retirement, educational seminars, or financial planning tools regarding asset allocation. Selecting investment options and negotiating fees for services is the responsibility of the plan sponsor. Once selections are made, the plan sponsor bundles the various services together, and presents the package of services to participants as an integrated product.

Plan sponsors that choose to offer mutual funds as investment options may be able to secure an arrangement with the mutual fund provider that reduces the amount of direct recordkeeping expense paid by plan participants.[37] This recordkeeping fee reduction is possible because mutual funds distributed through defined contribution plans avoid some costs that they normally bear when distributing the product to retail investors (i.e., outside of defined contribution plans), such as the cost of maintaining participants' account records, mailing statements and required disclosures, and even some customer services. Instead, the plan's recordkeeper fulfills these functions. In recognition of these funds' avoided costs, it is common for mutual fund advisors to "share" a portion of the fees paid by participants, such as by crediting the plan or making payments to the recordkeeper.[38] In other words, some amounts that participants pay for investment management products are typically used to defray the cost to participants of the administrative services associated with the plan.

The amount of money available to defray plan expenses varies from firm to firm, and fund to fund. Deloitte (2006) reports typical ranges of revenue sharing rates, by type of fund. For example, while passively-managed equity funds typically pay no more than 10 basis points, and

[37] Department of Labor, "Understanding Retirement Plan Fees and Expenses," May 2004, p.3. A recent survey of 401(k) plan sponsors indicates that 46 percent of plans pay for recordkeeping services through investment revenue (Deloitte Consulting LLP, "401(k) Benchmarking Survey, 2008 Edition," p. 24)

[38] This description of revenue sharing only applies in circumstances where a plan sponsor purchases recordkeeping and investment management products – at least to some extent – from different providers. When a plan sponsor uses a "bundled" model, purchasing recordkeeping and all investment management services from a single provider, revenue collected through fund expense ratios may still be used to defray plan administrative costs, but without explicit transfers.

in some cases may contribute nothing at all to defray plan's administrative costs, actively-managed equity funds may contribute as much as 35 basis points to plan expenses.[39]

Thus, at least for plans that offer mutual funds within their investment menus,[40] an increase in participants' reliance on investment products that contribute less to plan recordkeeping costs (such as most domestic index funds) would require a plan sponsor to choose between cutting back on plan services and increasing participant fees for recordkeeping. Similarly, when participants opt for investments that provide more revenue sharing, plan sponsors are able to reduce per participant payments for recordkeeping, and/or increase available services.

4. The Department understates the potential savings from increasing transparency and, therefore, reducing the amount of time that participants dedicate to research.

Independent of the anticipated reduction in participant-paid fees for investment products, the Department projects that the proposed disclosure regulation will reduce the amount of time that participants "spend searching for and compiling fee and expense information."[41] Essentially, by reducing the amount of time necessary for participants to compile information on fees and performance in a comparative format, the regulation enables participants to make more productive use of their time.

The Department is absolutely correct to identify reduced search costs as a benefit of the proposed regulation. In fact, the Department may have understated the benefits of lower search costs, by assuming that only a particular subset of participants would gain. Specifically, the Department assumed that only the 29 percent who, in an EBRI survey, reported making changes to their retirement plans after receiving educational materials would benefit from lower search costs.

A more reasonable assumption is that all participants who think that fees and/or performance are important criteria for evaluating options and who read the educational materials provided by their plans would save time, because the proposed regulation would make it less time consuming to read and understand the data on comparative fees and historical performance. According to EBRI's 2007 Retirement Confidence Survey, 73 percent of defined contribution plan participants rely on written materials sent by their plan sponsor in making retirement savings and investment decisions.[42]

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[39] Deloitte Financial Advisory Services LLP, "Fees and Revenue Sharing in Defined Contribution Retirement Plans," Unpublished report, commissioned by DOL (December 6, 2007), p. 13.

[40] Deloitte Consulting reported that, as of 2008, 79 percent of plans included mutual funds among participants' investment options. (Deloitte Consulting LLP, "401(k) Benchmarking Survey, 2008 Edition," p. 20)

[41] DOL Proposal, p. 43021.

[42] Helman, et al., "The Retirement System in Transition: The 2007 Retirement Confidence Survey," EMPLOYEE BENEFITS RESEARCH INSTITUTE ISSUE BRIEF #304, April 2007, p. 14.

Also, rather than simply value the saved time using participants' wage rates, one should also consider that the proposed uniform disclosures could reduce the expense of consulting financial professionals, by reducing the amount of time spent by those professionals in reviewing plan options. Use of professional financial planners is common: the EBRI study notes that 64 percent of participants seek the advice of a financial professional in making decisions regarding retirement planning; 40 percent say this advice is the most helpful source of information in their retirement planning.[43] Thus, the Department might consider valuing saved time as a weighted average of participant wage rates and financial planners' wage rates,[44] where the weights reflect the propensity of participants to rely on financial planners.

These straightforward adjustments to the Department's assumptions almost triple the expected benefit of reduced search costs from $4.6 billion under the Department's analysis to $12.2 billion.[45]

Furthermore, the availability of the information in a clear format may encourage financial newspapers, magazines, and Web sites to produce articles on comparative expenses of different funds. This could spread the information further, not only to people who participate in DC plans, but also to those who are considering their investment options more generally. This increased information is potentially valuable, yet hard to quantify, and I will not try to do so here.

In contrast, the expected implementation costs, according to the Department, are $759 million, discounted over ten years. Currently, the propensity of participants to accept electronic delivery of documents is a key component of the cost of distributing the disclosure materials.[46]

Based on these cost estimates, the expected benefits in terms of reduced search cost exceed the implementation costs by more than $11 billion. This does not include benefits of additional media articles on comparative expenses of different funds.

The general conclusion (that the potential benefits exceed implementation costs) is not particularly sensitive to the amount of time, per participant, saved by the proposed disclosures. The Department's proposal assumes that participants in 404(c) compliant plans will save one hour per year, and that participants in non-compliant plans will save 1.5 hours per year. Even if

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[43] *Ibid.*

[44] Average wage rates of personal financial planners are available from the Bureau of Labor Statistics, Occupational Employment and Wages. As of May 2007, the mean hourly wage for personal financial planners was $42.89.

[45] In valuing this time, I use the average wage rate for financial planners, as reported by BLS for the 40 percent of plan participants who stated that advice from a financial profession was the most helpful in making retirement decisions; for the remaining 60 percent, I use DOL's estimates of average participant wages.

[46] DOL Proposal, p. 43024. To the extent that more than 38 percent of participants choose to receive electronic disclosures over the coming ten years, implementation costs could be lower than the Department's estimate.

these time savings are reduced by 50 percent, the expected benefits of reduced search time is approximately $6.6 billion, or more than eight times the expected implementation cost.

Conclusions

There is no support for the assertion that fees for investment products selected by participants in defined contribution plans are "higher than necessary." Nor is there any reason to expect that the proposed regulation will induce investment managers to lower their fees, inspire plan participants to direct a greater percentage of assets to lower-fee investment options, or lead plan sponsors to alter their investment menus. Thus, the Department estimates regarding the potential benefits from reduced fees should be ignored in evaluating whether the benefits of this regulation exceed the expected cost of implementation.

There is, however, a strong argument that the vast majority of plan participants would save time as a result of the proposed regulation. This time saving more than justifies the costs of implementation.

Appendix

As discussed above, the Department of Labor, in its cost-benefit analysis of a proposed regulation, cites five authorities to support its claim that DC plan participants pay fees that are higher than necessary by, on average, 11.3 basis points per year.[47] In addition, the Department cited a sixth article in an explanatory email.[48]

This appendix summarizes each article, with particular attention to whether the data presented contribute to our understanding of whether and/or to what extent fees are higher than necessary.

Articles with no information on fee dispersion of mutual funds

Two of the articles, Deloitte (2007) and Choi et al. (2006), contain no data on fee dispersion from which one might draw any conclusion regarding whether fees are too high , let alone the extent to which investors pay fees that are higher than necessary.

In a report commissioned by the Department of Labor, Deloitte reports the distribution of average investment management expense ratios in 401(k) plans, as of 2006.[49] Specifically, 13 percent of plans had average expense ratios less than 50 basis points; 37 percent had average fund expense ratios between 51 and 85 basis points; 21 percent had average expense ratios that ranged from 86 to 125 basis points; just one percent had an average expense ratio that exceeded 125 basis points. Data on fees were unavailable for 28 percent of the plans surveyed.

The Deloitte report, however, explicitly notes that "*this distribution should not be interpreted as the distribution of expense ratios of mutual funds in 401(k) plans.* Survey respondents reported the average expense ratio of funds in their plan. The plan may have included some low cost- and high-cost funds that canceled."[50]

Because this study contains no data on the dispersion of fees for mutual funds, it cannot provide a basis for the Department's conclusion that investors pay mutual fund fees that are higher than necessary, let alone by 11.3 basis points.

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[47] DOL Proposal, p. 43020, footnote 13. The exact same sources are also cited in footnote 18 of the more recent proposal concerning investment advice (Department of Labor, "Investment Advice – Participants and Beneficiaries," FEDERAL REGISTER 73(164), August 22, 2008 ("DOL Investment Advice Proposal").

[48] *Supra*, notes 6 and 7.

[49] Deloitte Financial Advisory Services LLP, "Fees and Revenue Sharing in Defined Contribution Retirement Plans," Unpublished report, commissioned by the DOL (December 6, 2007), emphasis added. Cited in DOL proposal, footnote 13; DOL Investment Advice Proposal, footnote 18; Supplemental Email.

[50] Deloitte Financial Advisory Services, p. 9, emphasis added.

As is the case with the Deloitte report, the working paper by Choi et al. [51] contains no data on underlying dispersion of mutual fund fees, nor any data regarding "typical" fees.

Rather, Choi et al. report the results of an experiment designed to test the respondents' ability to identify and act upon information that directly affects investment returns of funds with identical underlying portfolios, in an artificial context constructed to separate expected investment returns from other services provided by mutual fund advisors. In this artificial construct, the only rational economic basis on which subjects can choose between the offered options is the fee schedule: the investors who choose the investment with the lowest fees will earn the highest returns.

In the main experiment, first-year MBA and college students and Harvard staff members were asked to allocate $10,000 across four S&P 500 index funds.[52] Because all funds invested in the same underlying securities, in the same proportion (mimicking the S&P 500 index), the expected investment returns for the funds differed only in their expense ratios and front-end sales charges ("loads").

The experiment was designed to give the subjects a financial incentive to maximize expected returns, and to insulate subjects from any differences in services offered by the various mutual fund advisors. If the subjects correctly understood the incentives, they should have invested all assets in the index fund with the lowest total cost of investment. The authors, however, did not remove the names of the funds used in the experiment, leaving open the possibility that respondents attached some value to the brand names of the funds.

The results of the experiment, however, show that the majority of respondents did not behave as though fees were an important determinant of returns, constructing portfolios that paid fees, on average, 56 to 122 bps above the minimum. Most subjects allocated assets to multiple funds, demonstrating a fundamental misunderstanding of the concept of diversification.

Providing the test subjects with comparative fee information – in a table similar to that proposed by the Department – reduced the percentage of assets allocated to higher-fee index funds, but still did not lead subjects to minimize fees.[53] Specifically, 18 percent of the Harvard staff assets, 19 percent of MBA assets and 19 percent of college assets were invested in the lowest-cost fund when subjects were given only the fund prospectuses; when subjects were given a fee summary table in addition to fund prospectuses, these percentages increased to 27

[51] James J. Choi, David Laibson, and Brigitte C. Madrian, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds," NBER WORKING PAPER #W12261 (May 2006). Cited in DOL proposal, footnote 13; DOL Investment Advice Proposal, footnote 18; Supplemental Email.

[52] A companion experiment asked participants to complete a similar exercise based on four otherwise similar small cap value funds. Because the Harvard staff sample was collected approximately two years after the other experimental subjects, and because one of the funds offered in the first experiment was no longer available, the staff subjects had a different set of choices than the initial subjects.

[53] Average fees paid fell from 424 to 377, but could have fallen as low as 309.

percent, 43 percent and 30 percent, respectively. In total, more than 80 percent of the subjects did not minimize index fund fees when provided with a comparative fee table.[54]

In another control, the test subjects were presented with a summary table listing returns since inception. Because all the funds are invested in the S&P 500, this is irrelevant data for predicting future returns. Nevertheless, participants showed a strong propensity to chase historic returns.

Because Choi et al. present no data on the dispersion of fees for mutual funds within DC plans, this article cannot provide a basis for the Department's conclusion that plan participants pay mutual fund fees that are higher than necessary, let alone by 11.3 basis points.

Articles with information on fee ranges for S&P 500 index mutual funds

Two of the articles, Elton et al. (2004) and Hortacsu and Syverson (2004), contain limited data on the range of expense ratios charged by S&P 500 index funds. While it is true that these articles document some dispersion in the fees charged by these funds, the articles do not control for other attributes of the mutual funds, such as service differences. Moreover, the data in these studies do not lend themselves to a calculation of the degree to which investors have paid fees that are higher than some asset-weighted typical amount (which the Department claims to have done), because the authors do not include data on the assets associated with each fee level.

Elton et al.[55] examined 52 S&P 500 index funds, and reported dispersion in fees from 6 to 135 basis points, with an average of 44 basis points. The data appear to be annual, covering the period January 1996 through December 2001; thus, the summary fee data mix together five years of data.

Hortaçsu and Syverson[56] examined 82 S&P 500 index funds as of the year 2000, and documented expense ratios ranging from 9.6 to 268 basis points. The authors also document fee dispersion in other funds with other asset classes and investment approaches: the ratio of the 75th percentile of fees to the 25th percentile of fees appears to lie between 1.5 and 2.5 for most non-index funds (meaning that if the 25th percentile fee is 50 basis points, the 75th percentile fee is between 75 and 125 basis points).

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[54] Choi, et al. (2006), p.4.

[55] Edwin J. Elton, Martin J. Gruber, and Jeffery A. Busse, "Are Investors Rational? Choices Among Index Funds," THE JOURNAL OF FINANCE, 59(1) (February 2004). The DOL, inexplicably, cites a working paper version of this now-published paper. See DOL proposal, footnote 13; DOL Investment Advice Proposal, footnote 18. This citation was omitted from the Supplemental Email.

[56] Ali Hortaçsu and Chad Syverson, "Product Differentiation, Search Costs and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds," THE QUARTERLY JOURNAL OF ECONOMICS (May 2004). This article is only cited in the Supplemental Email; it was omitted from DOL proposal, footnote 13 and DOL Investment Advice Proposal, footnote 18.

In both articles, however, the authors did not include data on the assets associated with each fee level, precluding any calculation of either the asset-weighted average fee paid, or the degree to which investors have paid fees that are higher than some "typical" level.

Articles with limited information on fee dispersion

Only two of the articles, ICI (2007) and Barber et al. (2006), contain both information on fee dispersion and information on the distribution of assets associated with particular fees. Neither article, however, leads to the conclusion that fees are higher than necessary. Also, in both articles, the information on fee distribution is limited. Moreover, it does not appear that any straightforward manipulation of these data would lead to the Department's conclusion regarding the magnitude of the "higher than necessary" fees.

In Barber et al. (2005), the data on the distribution of fees is constructed in a manner such that one cannot reasonably draw any conclusions about the amount by which investors paid fees higher than some typical amount at any point in time. These authors report average expense ratios of diversified US equity mutual funds over time (1969-1988), by expense decile. The "average" expense ratio for each decile has been computed over approximately 30 years. For example, the mutual funds with the lowest 10 percent of expense ratios each year are grouped together, and the authors report the average expense ratio over all the sample years. It is impossible to know from these data what the fee dispersion is in any given year. Moreover, the authors make no attempt to control for attributes that are likely to affect costs, such as a focus on small cap stocks.

Even if one could somehow control for these deficiencies in Barber et al.'s reported fee distributions, it does not appear that any manipulation of these data would lead one to the conclusion that 11.3 basis points is the low end of the range of fee distributions: even if one wanted to argue that any fee outside of the lowest decile is higher than necessary, a position for which there is no basis, and calculate the average amount by which the average expense ratios of each decile exceed the average expense ratio in the first (i.e., lowest-fee) decile, the weighted average would be 34 basis points, and the simple average would be 84 basis points.[57]

Moreover, Barber et al.'s analysis does not clearly establish that mutual fund fees are higher than necessary, because the authors have not excluded reasonable explanations for some investors selecting higher-fee investment products. For example, their data can just as easily be interpreted as evidence of investor learning, and the value of financial services and broker recommendations. Investors choose to pay higher fees, especially in the form of front end sales charges, which are usually associated with broker recommendations, when they first begin

[57] To arrive at these figures, I first computed the difference between the average expense ratio reported for each decile and the average expense ratio of the first (i.e. lowest fee) decile. In the case of the weighted average of these differences, the weights are equal to the share of total assets in each decile, where the total included those assets in the lowest fee decile. If one were to exclude the 31 percent of assets in the lowest-fee decile from this calculation, including from the total assets, then the weighted-average difference from the lowest-fee decile is 54 basis points, and the simple average is 93 basis points.

investing in mutual funds; then, as they gain more experience, these investors shift their purchases toward products without loads, which do not come bundled with advice.

In the final article cited by the Department, a survey published by the ICI,[58] the fee ranges are so broad that it is difficult to have confidence in any estimate one might construct from the reported data. Specifically, the ICI found that 23 percent of 401(k) stock mutual fund assets are held in funds that had expense ratios lower than 50 basis points; 54 percent of stock mutual fund assets were held in funds with expense ratios between 50 and 100 basis points; 20 percent of stock mutual fund assets were held in funds that had expense ratios ranging 100 to 150 basis points; and just three percent of stock mutual fund assets were in funds that had expense ratios greater than 150 basis points.

Because these ranges are large, it is unclear how the Department would have used this study to derive the claimed 11.3 basis point excess. Moreover, it does not appear that any manipulation of these data would lead one to the conclusion that 11.3 basis points is the low end of the range of fee distributions: even if one wanted to argue that any fee above the weighted average fee for the investment objective is higher than necessary, a position for which there is no basis, and calculate the average amount by which expense ratios exceed the weighted average, there is simply not sufficient detail to make sensible calculations. Attempts to use the mid-point of each range to calculate such a weighted difference lead to figures that are substantially smaller than 11.3 basis points, and frequently negative.[59]

[58] Sarah Holden and Michael Hadley, "The Economics of Providing 401(k) Plans: Services, Fees and Expenses, 2006," 16 Research Fundamentals, No. 4, (September 2007). See DOL proposal, footnote 13; DOL Investment Advice Proposal, footnote 18; Supplemental Email.

[59] For each asset class for which the ICI reports data, I first computed the midpoint of each fee range. I then calculated the difference between each midpoint and the weighted average expense ratio reported by the ICI for each asset class. To compute the weighted average of these differences, I applied weights equal to the share of total assets in each range. Using this procedure, it is possible for the weighted-average difference to be negative when a large portion of assets in the lowest fee range (i.e., zero to 50 basis points), but the weighted average over all ranges is above the midpoint of the lowest range. For example, for money market funds, the weighted-average expense ratio is 43 basis points. 75 percent of assets are in the lowest fee range (0-50 bps), 20 percent of assets are in the next lowest range (50-100 bps), and four percent are in the next range (100-150 bps). (Shares do not add to 100 due to rounding.) The procedure described, therefore, would calculate the weighted average based on 75 percent of funds being below average, by 39 basis points. Hence, it is not surprising that the weighted average would be negative.