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TO: The 401(k) Plan Community

FROM: Fred Reish
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DATE: July 29, 2013

SUBJECT: A Critical Analysis of the Recent 401(k) Plan Cost Study by Professors Ayres and Curtis

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INTRODUCTION AND PURPOSE

The purpose of this memorandum is to provide a critical analysis of a recent study of 401(k) plan costs performed by Professor Ian Ayres of Yale Law School and Associate Professor Quinn Curtis of the University of Virginia School of Law, titled "Measuring Fiduciary and Investor Losses in 401(k) Plans" (referred to herein as the "Study").[1] Our specific focus is on the portion of the Study that analyzes investment-related expenses, particularly mutual fund fees, in the 401(k) plan context.

EXECUTIVE SUMMARY

We have concluded that the Study suffers from a number of deficiencies. The primary deficiencies relate to assumptions we believe to be inaccurate and errors in data sampling.

As a result, we believe that the Study's findings are not reliable as an indicator of the reasonableness of fund fees either on an aggregate industry-wide or a plan-by-plan basis or for determining whether there has been a breach of fiduciary duty in any individual case.

The primary deficiencies are:

- Failure to consider fiduciary practices that have lead to cost reductions in recent years
- Failure to consider plan design differences and services in relation to costs
- Failure to consider the impact of revenue sharing
- Use of outdated information
- Reliance on data from the Form 5500 which may be misplaced
- Failure to consider or misapplication of other data, *e.g.,* failure to consider the impact of ERISA accounts, assuming that plans invest in funds that bear front-end loads and use of an inappropriately limited universe of plans.

[1] The Study, which is still in draft form as of the date of this memorandum, is available at http://islandia.law.yale.edu/ayres/CurtisAyres.pdf.

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OVERVIEW OF THE STUDY

The Study's abstract provides a description of its purpose and general methodology. In relevant part, it states as follows:

> *This is the first study to measure, within a unified framework, the relative costs to investors of limited investment menus, fund- and plan-level expenses, and investor allocation mistakes. Expressing these costs in terms of reduced returns allows us to compare the relative magnitude of costs attributable to plan fiduciaries, which we term fiduciary losses, and losses attributable to mistakes that investors make in choosing how to allocate among menu offerings, which we term investor losses.*

Our analysis is limited to the issue of fund-level expenses, which the authors refer to as "menu excess fee loss" as described below:

> *To measure the losses due to mutual fund expenses, we compute the difference between the pre-fee and post-fee optimum portfolio and deduct the fees associated with an optimized benchmark portfolio of low cost index funds. The difference between the pre- and post-fee optimums reflect the impact of mutual fund fees, while deducting the fees of a low-cost portfolio reflects the reality that fund expenses will not be zero. We term the return-equivalent loss associated with the difference between these two portfolios* ***menu excess fee loss****.* (Emphasis added)

The data used was taken from a database maintained by BrightScope, Inc. and was based on Form 5500 filings for 3,552 plans for the year ending on December 31, 2009. The plans included in the Study offered only publicly-listed mutual funds as investment options.[2]

The Study became the subject of significant publicity and criticism after Professor Ayres sent letters to approximately 6,000 sponsors of 401(k) plans in July 2013 which referenced the Study and, in many cases, implied that plan fiduciaries may have breached their duties under ERISA by maintaining what he referred to as a "potentially high-cost plan." The following are quotes taken from some of the letters we have reviewed:

> *Based on an extensive database of 401(k) plans, your plan ranked XX,XXX out of 46,875 plans in total plan cost. Among plans of comparable size (measured by total net assets), your plan ranked* ***worse*** *than XX percent of plans.* (Emphasis added)

> *We wanted to inform you that we are planning to publicize the results of our study in the Spring of 2014. We will make our results available to newspapers*

[2] More precisely, the dataset was limited to plans that offered as investment options only publicly-listed mutual funds other than with respect to investments without "risk." For example, plans offering Guaranteed Investment Contracts (GICs) were included but the GICs were not analyzed. The Study therefore entirely excluded plans that offered other investments, such as collective trusts, ETFs, separate accounts and the like.

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> *(including the New York Times and Wall Street Journal), as well as disseminate the results via Twitter with a separate hashtag for your company.*[3]

The letters also admonish plan sponsors to improve their plans' investment option menus, including by "adding lower fee options" and "eliminating high-fee funds that do not meaningfully contribute to investor diversification."

The focus of this memorandum is on the Study itself rather than the letters sent to plan sponsors. It appears that the statements in the letters were based on data that was not used in the Study. As noted above, the Study considered data on 3,552 plans while the letters refer to 46,875 plans. Inasmuch as we do not have access to the data on which the letters relied, we are unable to assess the validity of the statements made in the letters. Further, we express no opinion on aspects of the Study or its other findings other than those related to fund fees.

DISCUSSION OF CONCLUSIONS

We have concluded that the Study suffers from a number of deficiencies for the reasons discussed below. As is the case with any economic analysis, the conclusions drawn are necessarily limited in their validity by the quality and reliability of the data and assumptions upon which they are based. The primary deficiencies we have identified, and with which we are concerned, relate to assumptions we believe to be inaccurate and errors as to data sampling, not failures as to the Study's analysis.

In our view, the Study contains deficiencies that seriously call into question the conclusions that are drawn, especially when trying to apply those conclusions to specific plans and the conduct of their fiduciaries.

As a result, we believe that the Study's findings are not reliable as an indicator of the reasonableness of fund fees either on an aggregate industry-wide or a plan-by-plan basis or for determining whether there has been a breach of fiduciary duty in any individual case.

Before proceeding with an analysis of the Study, it is important to understand the fiduciary requirements of ERISA. Under ERISA Section 404(a), fiduciaries are required to act for the exclusive purpose of providing benefits and defraying reasonable expense. They are required to act prudently in carrying out their duties, which both the courts and the Department of Labor (DOL) have concluded means engaging in a prudent process of information gathering, analysis and decision-making. That is, fiduciaries are required to make informed, reasoned decisions that avoid prohibited transactions and are in the interest of the participants. In selecting investments and plan services, they are not required to select the least expensive alternative, only one for which the costs and compensation are reasonable, taking into account the services to the plan and participants.[4] (This is discussed in further detail in Section II below.) ERISA allows great latitude in selecting the services to be offered in a plan. It is permissible to have fewer services

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[3] Recent news stories have reported that Prof. Ayres now indicates that he will publish only aggregate data, not information and conclusions respecting individual plans.

[4] See, generally, ERISA Section 404(a). See also, for example, ERISA Regulation Sections 2550.404a-1 and 408b-2.

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at lower cost but the opposite is also true; that is, plans may offer more robust services at a commensurately higher cost without causing a violation of the fiduciary standards of ERISA.

In drawing our conclusions regarding the Study, we have focused on what we believe are five primary sources of error. We now turn to these issues.

I. Failure to Consider Fiduciary Standards

While our principal concern in this memorandum is with the Study itself, we cannot ignore the letters sent to plan sponsors that suggest potential breaches of fiduciary duties and a remedy to cure these breaches. We have a number of concerns with this implication.

First, in our experience representing hundreds of plan sponsors and working with providers that serve tens of thousands of plans, most 401(k) plans are reasonably well-managed when it comes to the reasonableness of the fees of investment alternatives. There have been a few highly publicized cases in which fiduciaries have been required to pay damages because of overly expensive mutual funds, but by and large, they relate to very large plans using retail mutual funds rather than taking advantage of their purchasing power to offer institutional class funds. On the whole, these cases do not represent the norm.

Our view is supported by a study prepared by the Investment Company Institute (ICI) in which it reached a number of conclusions regarding the favorable trend in fund fees. For example, the ICI report found:

> *At year-end 2012, 401(k) plan assets totaled $3.6 trillion, one-third of which was invested in equity mutual funds. In 2012, the average expense ratio on equity funds offered for sale in the United States was 1.40 percent. 401(k) plan participants who invested in equity mutual funds paid less than half that amount, 0.63 percent.*[5]

In other words, the fees paid for equity funds held in 401(k) plans were less than half those of funds purchased in the retail market. Looked at on an asset-weighted basis, the differences are less dramatic, but still quite significant. For example, in 2012, on an asset-weighted basis, the industry average expense ratio for equity funds was 77 basis points (.77%), while the 401(k) average was 63 basis points (.63%), a roughly 18% difference.[6]

The ICI also found that the decline in fund fees over the past 15 years (since 1998) has been significant:

> *The expenses that 401(k) plan participants have incurred for investing in mutual funds have declined substantially in the past 15 years. In 1998, 401(k) plan participants incurred expenses of 0.74 percent of the 401(k) assets they held in equity funds. By 2012, that had fallen to 0.63 percent, a 15 percent decline. The expenses 401(k) plan participants incurred for investing in hybrid and bond funds*

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[5] Investment Company Institute, "The Economies of Providing 401(k) Plans: Services, Fees, and Expenses, 2012," June 2013, available at http://ici.org/pdf/per19-04.pdf.
[6] *Id* at Figure 7.

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> *have fallen even more, by 19 percent and 23 percent, respectively, from 1998 to 2012.*[7]

The ICI explained that the decline in expense ratios in 401(k) plans was due to various factors:

> *Numerous factors contribute to the relatively low expense ratios incurred by 401(k) plan participants investing in mutual funds. Among them are (1) competition among mutual funds and other investment products to offer shareholders service and performance; (2) plan sponsor's decisions to cover a portion of the 401(k) plan cots, which allow them to select lower-cost funds or share classes; (3) economies of scale that a large investor such as a 401(k) plan can achieve; (4) cost- and performance-conscious decisionmaking by plan sponsors and plan participants; and (5) the limited role of professional financial advisers in these plans.*[8]

In our view, these findings support a conclusion that, on the whole, fiduciaries are taking their duties seriously in managing fund expenses.

Our second concern is with the assumption that fund fees are the only relevant factor in determining whether a fiduciary has breached his duties. Even if we assume (which we do not) that a fund's fees are the only relevant variable that differentiates one mutual fund from others in the same asset class, the selection of a fund with higher than average fees would only indicate a fiduciary breach if they were unreasonable. And merely because fund fees are above the median does not necessarily make them unreasonable. For example, in a 2007 case, the court concluded that "paying a fee that is above the median does not imply, or even suggest, that it is unreasonable but only that it is greater than half the numbers tabulated" and that fees between the 25th and 75th percentile represent a reasonable range of fees.[9]

For example, consider the following: If we assume that 80% of plans are well-managed, even a plan in the 70th percentile is still well-managed (we are not stating that 80% is necessarily the correct figure, but the concept remains). Any suggestion that the fiduciaries of a plan with fund fees above the 50th percentile are breaching their duties under ERISA is incorrect, in the same sense that it would be incorrect to suggest that out of 1,000 Yale professors, many of whom are respected scholars, 500 are "below average." Of course, the inverse is true as well: if the vast majority of plans are mis-managed, fiduciaries of a plan with fund fees below the 50th percentile should not necessarily be presumed to be well-performing.

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[7] *Id.* The ICI report also found that that 401(k) mutual fund fees decreased from 2011 to 2012: They stated: "The expense ratio 401(k) plan participants incurred for investing in equity mutual funds declined from 0.65 percent in 2011 to 0.63 percent in 2012. Expense ratios that 401(k) plan participants incurred for investing in hybrid funds fell from 0.61 percent in 2011 to 0.59 percent in 2012. The average expense ratio 401(k) plan participants incurred for investing in bond mutual funds dropped from 0.52 percent in 2011 to 0.50 percent in 2012."
[8] *Id.*
[9] *Dupree v. The Prudential Insurance Company of America,* 2007 WL 2263892 (S.D. Fla 2007), at page 18.

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II. Failure to Consider Plan Design and Services and the Role of Revenue Sharing

The Study does not take into account revenue sharing from mutual funds (*i.e.*, sub-transfer agency fees, servicing fees, 12b-1 fees, etc.) that reduce plan costs in analyzing fund fees. From a fiduciary perspective, the use of revenue sharing to pay plan costs is a well-recognized and acceptable practice. But the Study's authors explain in a footnote that

> *The majority of plans report that they pay no plan-level expenses. Service providers for these plans are compensated from mutual fund expenses. Since compensation paid from fund fees is not currently disclosed, it is absent from our data.*

The Study uses expense ratios of mutual funds gleaned from fund prospectuses for purposes of the analysis. We understand the statement in the quoted footnote to be an acknowledgement that revenue sharing ("indirect compensation") paid to recordkeepers and other providers that was sourced from fund fees was not accounted for, even though the fund fees themselves were counted as investment costs paid by the plans. The Study concludes as follows:

> *We find evidence that a substantial majority of funds (sic) could reduce total losses by (i) offering additional lower-fee index funds, (ii) not offering funds with high fees.*[10]

Under the Study's methodology, some plans will show high "menu excess fee losses," but without considering the impact of revenue sharing, it will not be possible to determine if this is truly unreasonable or whether a significant portion (or all) of the plan's administrative costs are being paid out of revenue sharing that is sourced in the funds offered by the plan, which would justify the "high" level of fees. A plan that offers inexpensive index funds exclusively and thus fares well in the Study, may provide no supporting services (or few services) to plan participants.

Had the Study taken revenue sharing into account, the share of fund fees paid to providers could have been reflected as a corresponding "credit" against administrative fees, allowing the Study (at least in theory) to measure whether it is generally less costly to utilize cheaper index funds exclusively and pay administrative fees directly, or offer more expensive non-index funds that compensate administrative providers "indirectly." When revenue sharing is omitted from the equation, however, such a comprehensive analysis is precluded.

When we consider that the relative administrative costs of 401(k) plans differ significantly depending on a number of variables - chief among them differences in plan design (and resulting differences in administrative complexity) and the type, quantity and quality of accompanying services provided to the plan and its participants, a plan with some higher-expense funds would likely not fare well, but its "underperformance" would be artificial in the sense that it would not receive credit for additional services paid for through fund fees even if they were beneficial and reasonably priced.

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[10] We presume that the reference to "a substantial majority of funds" was intended to be a reference to plans.

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In our view, there are numerous plan services that improve participants' retirement readiness – such as participant investment education and individualized investment advice – all of which come at an additional cost in the form of provider compensation that is often paid through fund fees. The DOL appears to share this view. In an online pamphlet titled "Understanding Retirement Plans Fees and Expenses"[11], provided as a guideline for plan sponsors, the DOL addresses the steps that sponsors should take in evaluating plan fees and expenses. It makes the following recommendations (among others):

> *Begin by establishing an objective process to aid in your decision making. This process should include an understanding of the fees and expenses you will pay and a review of those charges* ***as they relate to the services to be provided and the investments you are considering****.* (Emphasis added)
>
> *Once you have selected a service provider or investments, be prepared to monitor* ***the level and quality of the services and performance of investments*** *to make sure they continue to be reasonable and they suit the needs of your employees.* (Emphasis added)

The emphasis is on the reasonableness of fees and costs, not on the least expensive. In a pamphlet entitled "A Look at 401(k) Plan Fees," the DOL makes this point even more explicitly, noting that cheaper is not necessarily better.[12] It states:

> *Remember, too, that higher investment management fees do not necessarily mean better performance. Nor is cheaper necessarily better.* ***Compare the net returns relative to the risks among available investment options****.*
>
> *And, finally,* ***don't consider fees in a vacuum****. They are only one part of the bigger picture including investment risk and returns and the extent and quality of services provided.* (Emphasis in the original)

This is also consistent with DOL regulations noting that whether or not compensation levels are reasonable "depends on the particular facts and circumstances of each case."[13] In short, this determination cannot be reduced to an across-the-board standard.

Further, ERISA Section 408(b)(2) expressly permits:

> *Contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor.*

And the regulation under that section further explains that:

[11] The pamphlet is available at http://www.dol.gov/ebsa/publications/undrstndgrtrmnt.html.
[12] Available at http://www.dol.gov/ebsa/publications/401k_employee.html
[13] 29 CFR §2550.408c-2(b)(1).

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> *A service is necessary for the establishment or operation of a plan…if the service is* ***appropriate and helpful*** *to the plan obtaining the service in carrying out the purposes for which the plan is established or maintained.*[14] (Emphasis added)

Stripped to its essentials, the above guidance indicates that a fiduciary's duty with respect to fees and compensation is to ensure their reasonableness in light of the services provided, including an examination of their type, quantity and quality, not to minimize costs at the exclusion of all other variables. It likewise demonstrates that fiduciaries may, consistent with their duties, choose to engage appropriate and helpful services on behalf of plan participants (above a level of those which are absolutely required) so long as the compensation paid therefor is likewise reasonable under the circumstances. It appears to us that the Study would favor inexpensive plans for which only a minimum level of services are furnished, and would disfavor more expensive plans (with more robust participant services). The Study notes the following:

> *We also compute the loss due to administrative expenses, excess plan expense loss. This is the difference between the return on the post-fee optimal portfolio when* ***a competitive plan level expense of 8 basis points is included*** *and the return on the optimal portfolio when both fund and plan level fees are included.* (Emphasis added)

The assumption that 8 basis points is a reasonable benchmark for administrative costs appears to be based on the following language from a corresponding footnote:

> *A very-low cost service provider, Employee Fiduciary LLP, reports that it charges $30 per employee plus 0.08% of plan assets for administrative services for small plans…Vanguard estimates that a $5 million dollar plan would feature an all-in fee of about 32 basis points, including fund fees, which corresponds well with Employee Fiduciary's 8 basis point administration-only fee.*

As our focus is on fund fees, we do not express an opinion as to the appropriateness of applying 8 basis points as a reasonable administrative fee, except to point out our objection to applying any "across-the-board" standard for the reasons previously articulated. However, this statement seems to indicate an assumption by the Study's authors that incurring additional costs for services above those which are absolutely necessary is suggestive of an ERISA violation.

The Study also is based on what appears to be a bias in favor of index funds to the exclusion of actively managed funds. For example, the Study includes the following discussion:

> *Menu losses are certainly low, but the absolute level of funds fees is shown in Table 4 to be 71 basis points. This is comparable to the mutual fund industry as a whole. Choosing a benchmark to evaluate fee losses is a challenge, since smaller plans will inevitable (sic) have fewer good options than large plans. To give a baseline for comparison, we construct a benchmark portfolio of Vanguard index fund retail share classes. Since the shares are retail, they would be available to any plan. The comparison is striking. The retail Vanguard-only benchmark*

[14] 29 CFR §2550.408b-2(b).

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> *shows lower fiduciary losses [that is, total costs] than 90.1% of the plans in the sample if plan-level fees are excluded, and 95.0% of the plan in the sample with respect to total fiduciary loss. This suggests that better options are available than most plans are currently using.* (Footnote omitted)

In this light, we consider the effect of the Study's bias in favor of exclusive use of index funds that pay no revenue sharing. If a plan discontinues offering some funds with higher expense ratios that pay significant revenue sharing and adopts index funds exclusively, and all other variables are held equal, it will have to proceed in one of two ways:

First, it could eliminate services to compensate for the revenue sharing loss. This option, ostensibly, would cause the plan to fare better in the Study's methodology but far worse in providing services to the participants.

Second, it could make up for the loss of revenue sharing by charging administrative expenses directly to the plan, and allocating those expenses to participant accounts. This could result in a "net" gain/loss of zero, which would shift the way in which the fees are paid but would not alleviate overall the effect of fees.

Our analysis should not be interpreted as dissuading plans from using index funds. However, we have concerns about the Study's emphasis on the exclusive use of index funds and the implication that ERISA requires this. It is clear that other types of mutual funds, including actively managed funds, can be selected under ERISA's fiduciary standards. There is no authority to support the notion that ERISA requires the exclusive use of index funds or even inexpensive funds. For example, in Hecker v. Deere & Co., the 7th Circuit rejected fiduciary breach claims based upon the offering of more expensive funds under a 401(k) plan that also offered inexpensive options, pointing out that

> *The fact that it is possible that some other funds might have had even lower ratios is beside the point;* ***nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems).***[15] (Emphasis added)

In our view, the failure of the Study to consider differences in plan design and the type, quantity and quality of associated services, and the impact of revenue sharing and the related role it plays in compensating service providers is problematic and calls into question the reliability of the Study as a basis for determining fiduciary liability.

Finally, it is important to keep in mind that there are numerous services that add cost to a plan but that are justifiable in light of the benefit they provide. To the extent the Study reflects a misunderstanding regarding fiduciary duties under ERISA, we are concerned that this could cause plan fiduciaries to eliminate valuable services upon the mistaken belief that they must do so to minimize fund fees and forestall potential ERISA liability.

[15] 556 F.3d 575, 586 (2009).

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III. The Use of Outdated Information

The Study relies on data from 2009. The use of stale data makes the findings less applicable currently. We say this because of the new disclosure requirements that went into effect in 2012.

The disclosure requirements applicable to "covered service providers" under ERISA Section 408(b)(2)[16] became effective July 1, 2012. The participant investment/fee notice requirements[17] applicable to 401(k) and other defined contribution plans likewise became effective in 2012. In response to these developments, which provide greater transparency of fees related to plan services, many plan sponsors are better able to understand the fees being charged. Many have obtained benchmarking information, RFP responses or other market data on their plan's services and investments to determine the reasonableness of the fees and compensation being paid out of the plan. To the extent warranted, they have taken steps to reduce fund fees from 2009 levels.

For these plan sponsors, it appears that the Study's findings are moot. That is, post-2009, these plan sponsors fulfilled their fiduciary duties by ensuring that the fund fees paid by their plans are reasonable. In light of this, in our view, reliance on data from 2009 in a report completed in 2013 (and apparently to be published in the spring of 2014) makes the Study less than reliable, and therefore its use as a tool for determining fiduciary compliance is inappropriate.

IV. Reliance on Form 5500 Data

In addition to reliance on stale data, the Study also relies exclusively on data obtained from Forms 5500. Unfortunately, information from Forms 5500 is often incomplete and in many instances is not reflective of a plan's true fund fees (and other costs). We will not discuss each reason that this can occur, which can range from gaps in the reporting requirements themselves to unintentional errors in completing the forms. However, it is noteworthy that in November 2009, the Government Accountability Office (GAO) published a report that dealt with these issues in the context of the reporting requirement changes that became effective in 2009.[18] The GAO's summary of its findings are instructive:

> *Specifically, (the Department of) Labor has not provided sufficient guidance for sponsors and providers to accurately determine what elements of compensation qualify as eligible indirect compensation…Therefore, interpretations have been left up to sponsors and providers and may result in a range of reporting practices, causing Labor* ***to receive inconsistent and incomplete data****…*
>
> *…Because plan sponsors are likely to report indirect compensation in varying formats, it is unclear how Labor will be able to compare such data across plans. In addition, GAO previously reported that the information provided to Labor on the Form 5500 has limited use for effectively overseeing fees paid by 401(k) plans because it does not explicitly list all of the fees paid from plan assets, yet these*

[16] *See generally* 29 CFR §2550.408b-2.
[17] *See generally* 29 CFR §2550.404a-5.
[18] Both the full text of the GAO report and a summary of its findings are available online at http://www.gao.gov/products/GAO-10-54.

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> *types of fees comprise the majority of fees in 401(k) plans. For example, plan sponsors are not required to explicitly report asset-based fees that are netted from an investment fund's performance, even though they receive this information for each of the mutual funds they offer in the 401(k) plan. Thus, despite the changes to the Form 5500,* ***the new information provided may not be very useful to Labor, plan sponsors, and others.*** (Emphasis added)

These passages underscore our concerns about the Study's omission of fund fees paid to providers ("indirect compensation"). Likewise, the GAO's concerns over widespread confusion about proper reporting of indirect compensation may have further implications – if, for example, direct compensation were reported as indirect or vice versa.

Any study based on Form 5500 data will invariably be affected by third-party errors, but the Study's use of 2009 Form 5500 data in particular could be fairly expected to suffer this at a statistically high rate because the changes to the reporting requirements were first effective in that year, exacerbating the likely number and significance of reporting inaccuracies.

V. Other Data and Data Sampling Issues

We also have concerns regarding other data and data samples utilized in the Study. We focus on the issues we believe to be the most significant.

First, it is not apparent if, and how, the Study accounts for fund fees paid into a plan recapture account, whether an "ERISA account" held by the plan or an account held by the plan's recordkeeper that is used to pay other plan expenses. In fact, it could not have taken the latter into account, since there would be no way for the Study's authors to have gathered the information from Forms 5500. In either case, the fund fees will be used to reduce expenses and, in the former case, amounts may also be reallocated to participant accounts. Both provide an additional benefit to plan participants that effectively offsets a portion of the funds' expenses. Unless these benefits are considered (for much the same reasons addressed in Section II), the true "cost" to the plan attributable to fund fees will not be accurately represented. Under the methodology employed in the Study, such a plan would have higher "menu excess fee losses," but there is no way to determine whether this indicates that investment-related expenses are actually too high, whether the plan provides a higher level of services or whether participant account reallocations are being made through the recapture account.

Second, the 3,552 plan "sample" utilized is not representative of 401(k) plans generally, a fact that the Study's authors appear to concede. This is true for two reasons: first, because it excludes plans that offer investment vehicles other than publicly-listed mutual funds, and second, because it disproportionately excludes large and small plans (those that do not fall between the 20th and 80th percentile in plan size). As the authors point out,

> *One key issue is the size of plans in the sample. It is well-known that the total cost of 401(k) plans is related to the size of the plans. If our sample differs markedly from the universe of plans by size, this would suggest caution in extending our findings to plans not represented in our sample….*

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…Our sample underrepresents plans in the below the 20th and above the 80th percentile and oversamples plans in between.

We cannot determine the effect of the limited dataset considered in the Study with precision, but it would appear that the results of the analysis and the conclusions drawn are not representative of the entire universe of 401(k) plans and would be an unreliable source for determining the prudence of fiduciary conduct specifically for any given plan, especially those at either end of the size spectrum.

Finally, the Study addresses front-end sales loads for mutual funds it examined, and took these amounts into account in determining "losses" to the sample plans. In describing its methodology for measuring plan losses, the Study describes two plans that showed particularly high "fiduciary losses" (referred to as Plans 1 and 2). Plan 1 has total assets of about $400,000 and Plan 2 has assets exceeding $5.0 million. The Study includes tables that list both the expense ratios of the funds offered in these two plans and the front-end loads that are applicable to the mutual funds offered by the plans. The source of the information regarding the front-end loads is not clear, since it generally would not be apparent from the Form 5500 data used in the Study, though the loads would be reflected in the prospectuses for the various funds.

In our experience, front-end loads are almost universally waived by funds held in 401(k) plans. This is reflected in statistics reported in the June 2013 ICI study discussed earlier. The report notes that at year-end 2012, 84% of mutual fund assets in 401(k) plans were held in no-load funds and that, of the remaining approximately 15% held in load funds, they were predominantly in share classes that do not charge participants a front-end load.[19]

Front-end loads would be expected to appear on the fund prospectuses the Study's authors relied upon, but in fact, they are rarely a cost that 401(k) plans incur. It is not apparent whether the Study discounted front-end loads that were waived, nor to what extent erroneous inclusion of waived front-end loads (if this occurred) would be statistically significant to the Study's findings. It is, however, an additional source of potential error, and with respect to any single plan examined to which waived front-end loads were erroneously attributed, we would consider the error to be statistically significant in terms of its "loss" calculation.

CONCLUSION

For all the reasons set forth above, despite the academic presentation in the Study and the frank discussion of its limitations by the authors, we have concluded that the Study contains a number of significant deficiencies that call into question the conclusions reached regarding fund fees. This leads us to conclude further that the Study's findings are not reliable as an indicator of the reasonableness of fund fees either on an aggregate basis or with respect to any single plan examined. As a result, we also conclude that the Study's findings on fund fees have little or no applicability in determining whether the fiduciaries of any specific plan have breached their duty under ERISA.

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[19] Investment Company Institute, "The Economies of Providing 401(k) Plans: Services, Fees, and Expenses, 2012," June 2013, available at http://ici.org/pdf/per19-04.pdf.

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