

### Third Edition

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# ERISA 404(a)(5) A Game Changer?

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401(k) Participant Disclosure  
Requirements Could Reconstruct  
the Industry

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February 2012

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## About DALBAR

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## Introduction

Section 404(a)(5) of ERISA<sup>1</sup> for plan years beginning November, 2011, requires that every one of 72 million plan participants are told something that they never knew... how much they pay each quarter for their 401(k) plan. In fact, most participants believe they pay *nothing* for the services provided in their 401(k).

Starting in 2012, these fees will not be hidden in the back pages of a lengthy legal document or in some fine print, but made obvious on the one document read most often and most diligently... their quarterly statement in combination with other disclosures that are repeated annually.

At the same time these 72 million people find out how much money they made or they lost, they will also see how much they paid in fees and expenses. And this amount is not some complex formula or even a percentage but is dollars and cents that can be compared to their mortgage, rent, car payments or what they spend on vacation.

Consider if only one in ten people who discover what they actually pay become concerned and do what comes naturally... ask their friends and family about it, and learn that their trusted associates pay more or pay less than they do. Of course, if this was a bad quarter and most of the 72 million people lost money, many more than 7.2 million (one in ten) may be concerned.

Many of these concerned people will camp out at their plan administrator's door, demanding to know why they are paying so much!

Most would agree that this could create a crisis.

On October 14, 2010 the US Department of Labor released final regulations concerning the disclosures that must be made to every plan participant in participant-directed individual account retirement plans such as 401(k).

The regulation requires plan fiduciaries to give workers:

- Quarterly statements of plan fees and expenses deducted from accounts.
- Cost and other information about investments available under their plan.
- Access to supplemental investment information.

Disclosures must use uniform methods to calculate expense and return information and present it in a format that makes it easier for workers to comparison shop.

This report discusses the implications of these regulations.

## Unintended Consequences

Taken alone, awakening participants to the fact that they are paying real dollars out of their retirement funds to compensate providers will be a shock to the system. In addition to the stand alone effect, it is important to recognize that the disclosure follows a period (2008) in which most participants experienced severe paper losses may have not recovered those losses, along with the reality that there may be no option to reduce expenses in their existing plans.

Viewed this way, one can expect participants who pay the highest expenses (i.e. those with the highest balances) to vigorously seek alternatives outside of their current plan. This could lead to the very rational argument that a participant may be better to suffer another 10% withdrawal penalty than to continue paying thousands of dollars in fees and expenses and continue to have their funds at risk. In short, just leave the plan and pay the taxes!

<sup>1</sup> See DoL Fact Sheet in Appendix A

## Changing the Game

The 404(a)(5) participant disclosure is the third of three regulations that, in combination, are expected transform the retirement plan business for participants, plan sponsors and service providers. The other two regulations are the 408(b)(2) disclosures to plan sponsors and Schedule C of form 5500 filed with federal regulators.

The scale of the change is based on three concurrent events that have not occurred before: plan sponsors will be mobilized; indirect costs will become visible; and participant will become engaged.

### Plan Sponsors Will Be Mobilized

In the past plan sponsors have delegated required duties to experts but new 408(b)(2) regulations require plan sponsors themselves to act to avoid fiduciary risk. Regulations make it a fiduciary breach for plan sponsors who fail to act.

**Under the new regulations, plan fiduciaries must pro-actively determine if existing service arrangements are reasonable.**

It becomes clear that the service provider cannot reasonably evaluate themselves so this determination must be performed by the plan sponsor. The regulations further require that the plan sponsor act on the determination and change the arrangement with the service provider, replace the service provider or report the service provider to regulators.

These requirements engage plan sponsors in a way that very few have been engaged in the past.

### Indirect Costs Will Become Visible

New regulations require that plan sponsors are informed of the compensation of those who are paid by a third party (typically investment firms or record keepers) to provide services to the plan. Both the payers and the recipients (typically advisors, third party administrators, custodians and trustees) are required to disclose the compensation received, services provided, fiduciary status and conflicts of interest to plan sponsors.

**The visibility of these indirect costs will increase because of the explicit disclosure and the requirement that plan sponsors make a pro-active determination that each is reasonable.**

Undoubtedly, there are plan sponsors who will question the reasonableness of certain indirect compensation, which will have a disruptive effect on the plans involved.

### Participants Will Become Engaged

The top two reasons why participant become engaged are if employers take their money away and if they stand to make more money. The 404(a)(5) disclosure requires that participants are told how much money is being taken from them, making engagement very likely.

**Disclosure of fees to participants who are unaware of the fees (estimated at 83%) is likely to engage a sufficient number of participants to apply downward pressure on plan fees and expenses.**

## Threats to Current Business Models

The stated goal of the DoL in issuing the 404(a)(5) disclosure regulations is to lower the fees and expenses charged to plan participants by \$14.9 billion in addition to a \$2 billion cost of complying. The total cost to the retirement plan industry, based on the DoL projections is \$16.9 billion in lost revenues and added expenses.

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The DoL goal is achieved by crafting the regulation to incite participants to challenge the fees they pay<sup>2</sup>.

### Plan Administrators' Response

Plan administrators of high cost plans will undoubtedly have longer lines outside their door and have to take some action... they must either find a way to answer these participants or go to a lower cost plan. Compounding the problem is the increased likelihood of participants complaining to the DoL (and possibly triggering audits) or their responding to offers from litigation attorneys, all fuelled by media reports of high fees from "talking heads" on TV and radio.

This is the dilemma that will face administrators soon after participants discover what they are actually paying. In most high cost plans there will not be a satisfactory answer and the plan administrators will be forced to seek a lower cost solution or face continued participant unrest, leading to issues such as the plan administrator's own job security.

Naturally, plan administrators will turn to their current trusted provider (investment firm, recordkeeper, TPA, adviser, etc.) who will be faced with a dilemma themselves. If the provider has no low cost solution, the administrators will be on the hunt for another provider. On the other hand, if there is a low cost solution available, the plan administrator is likely to be upset that the low cost solution was not offered before the participants were at the door.

### Aggregate Plan Fee Disclosures

In addition to the fee disclosure to participants discussed in this report, plan administrators will also be dealing with new fee disclosures required by ERISA § 408(b)(2) about the plan in aggregate starting in July, 2012. The aggregate plan fee disclosure is not directed to individual participants but to their employers. The aggregate plan fee disclosure specifies the fees paid to each service provider of the plan, the services rendered and the fiduciary status of that provider.

Each provider is required to deliver a 408(b)(2) disclosure to each plan that pays compensation to that provider of more than \$1,000, directly or indirectly. While this is a massive effort to reach out to employers, it will cost substantially less than the disclosure to 72 million participants. The DoL estimates the cost of this 408(b)(2) disclosure to be \$135 million in the first year and \$37 million in subsequent years.

<sup>2</sup> See Appendix B for DoL comments that show the intent for participants to challenge fees

This more detailed 408(b)(2) disclosure will help prepare plan administrators to address the challenges expected when the fee disclosure is made to participants. This could initiate an unprecedented round of RFP and pricing solicitations for retirement providers, requiring increased staffing in these departments to handle demand.

### Comparison of Two Fee Disclosures

The following table summarizes the differences and similarities of the participant fee disclosure that is the subject of this report and the Aggregate Plan Fee Disclosure.

	<b>Aggregate Plan Fee Disclosure -408(b)(2)</b>	<b>Participant Fee Disclosure - 404(a)(5)</b>
<b>Who receives the fee disclosures?</b>	430,000 plan fiduciaries (employers).	72 million plan participants (employees).
<b>When are the disclosures made?</b>	July, 2012.	The later of August 30, 2012 or 60 days after end of plan year, for plan years starting November, 2011.
<b>What do the fee disclosures describe?</b>	The expected expense to the plan and all its participants from covered service providers.	Each participant's individual portion of the total expenses of the plan and comparative chart of investments.
<b>Must there be a fee disclosure for each provider serving the plan?</b>	No, only covered service providers ("CSP") which consists of all fiduciaries, recordkeeping and brokerage services and all parties receiving indirect compensation. Each CSP receiving \$1,000 or more (directly or indirectly) from the plan must disclose to the plan separately. <i>(See <a href="#">CSP Determinator</a> on <a href="http://www.ERISAFeeDisclosure.com">www.ERISAFeeDisclosure.com</a> for more precise determination.)</i>	Separate providers of plan services are not disclosed. Each designated investment option is disclosed.
<b>Must the fiduciary status of each provider be disclosed?</b>	Yes, and this must be consistent with the nature of services being provided.	No.
<b>Must potential conflicts of interests be disclosed in the fee disclosure?</b>	Yes.	No.



	<b>Aggregate Plan Fee Disclosure -408(b)(2)</b>	<b>Participant Fee Disclosure - 404(a)(5)</b>
<b>Is each service being paid for by the fee described in the fee disclosure?</b>	Yes services must be described. Bundled providers must break out and estimate a cost for significant components, such as recordkeeping.	No.
<b>Are fee disclosures made in dollars and cents?</b>	Dollars and cents disclosures are required only when the expense is incurred as a flat dollar amount. If the expense is based on a formula (eg. 17 basis points) it may be disclosed that way.	Plan expenses allocated to the participant must be disclosed in dollars and cents paid by the participant. Investment expenses are disclosed in dollars and cents per \$1,000 of investment.
<b>How are expenses of investment choices reported differently from the plan expenses, such as administration and recordkeeping?</b>	Each investment manager is viewed as a separate provider to the plan and reported individually.	Plan expenses allocated to the participant and expenses incurred directly by the participant are reported quarterly. Investment expenses are reported initially, when changes occur and annually thereafter.
<b>Are offsets to fees and rebates reported in the fee disclosure?</b>	Fee offsets paid are reported by both the party paying the offset and the party receiving the offset or rebate.	The effect of the offset is reflected in the expenses and the fact that the expense was reduced is noted. For example, a 12b-1 fee paid to an adviser is an offset to the fee that the adviser would otherwise charge to the plan. It is required to disclose this offset.
<b>Do disclosures reveal past or future expenses?</b>	Plan expenses relating to the operating the plan as a whole disclosures reflect the future estimates. For expenses of individual investments, disclosures reveal past expenses, for the most part.	Since this disclosure does not require that there are contracts, the amount disclosed could be an estimate based on the past.

	<b>Aggregate Plan Fee Disclosure -408(b)(2)</b>	<b>Participant Fee Disclosure - 404(a)(5)</b>
<b>Are disclosures of past expenses theoretical or those actually paid?</b>	These are generally theoretical... assuming that the funds are in the plan for the entire reporting period.	For expenses relating to the plan administration and fees charged directly to the participant, disclosures are actual. Investment disclosures may be expense ratios that include periods before the investment was acquired by the participant, and therefore theoretical.

### Providers' Dilemma

High cost providers will be forced to find ways to reduce plan costs. This can be expected to include lowering of service levels, increased automation and elimination of services.

Lowering of service levels affect labor intensive activities such as enrollment, employee education, telephone service and in-person visits. Increased automation means that plans demanding lower fees will be forced to use electronic delivery of documents, automatic enrollment, automated phone service and expanded use of defaults and Websites. Eliminated services are likely to include brokerage windows, infrequently used plan features and even advisers that are not actively involved with the plan.

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High cost providers will also be faced with increasing influence of lower cost counterparts. There is little doubt that low cost providers will be aggressive in the face of cost concerns and offer attractive solutions to a newly interested plan sponsor population.

The events can lead to a "race to the bottom" in which the quality and breath of plan services are eroded in attempts to lower costs. This backward movement can be avoided by carefully weighing the value of plan services and not considering only the cost.

In any event, regardless of which of these scenarios materialize, there is certain to be dislocation in the provider's client base. The greatest exposure will be with the most profitable plans. These plans will either become less profitable or will go to another provider.

### Adviser Exposure

The threats anticipated here present particular problems to the advisers of 401(k) plans, depending on the particular arrangement and compensation method. Once the cost is exposed and examined, the critical question will be whether the adviser's services are both essential and economical.

When the plan sponsor is aware and agreeable to the adviser's compensation there is no real threat. Advisers who provide ongoing support with demonstrable results are not likely to be challenged, even if their compensation is a surprise to the plan sponsor.

On the other hand, advisers who receive indirect compensation, but are not providing ongoing support to either the plan sponsor or the participants, will likely be the first casualties in the mission to lower cost.

Advisers can be proactive in assisting plan sponsors to meet their requirements and thereby becoming part of the solution and avoid questioning the value of the advisor's services.

### Effect on Investment Products

The increased demand from plan participants for lower cost will create opportunities for low cost investment products and threaten the products with high price tags.

Investment firms with low cost products will seize the opportunity to focus marketing and sales activities on those products. NAV share classes can be expected to replace those that include compensation for distribution, recordkeeping and other services. This flight to low cost will be slowed somewhat as plan fiduciaries discover the cost of acquiring these services directly.

Cost savings will also be pursued through different product structures such as passively managed investments, exchange traded funds and collective trusts. Offsetting the cost advantage of these products in a market that is demanding lower cost will be the lowering of management fees through consolidation of funds to achieve economies of scale. The effect being that fewer but larger funds will be available.

While pricing of investment products may have to be revised, this can be minimized by presenting a value proposition for the oversight in actively managed funds.

## Spillover Effect

The demand for lower fees by 72 million participants and their families and 483,000 employers can awaken a sleeping giant that places similar demand on virtually every investment and financial product. The effect of the disclosure regulation will be to reach into other product areas because client behavior is altered for all.

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Among the 72 million participants there are millions of users of other financial products that are likely to be scrutinized and demands made for comparable fee disclosures. The potential added cost and lost revenue to providers was not included in the DoL estimate of \$16.9 billion.

In fact, it may be impossible to assess the economic impact of the spillover effect until the actual behavior is observed.

### Spillover of Resolution

Since most providers to 401(k) plans also do business in other areas, the preparations for the 401(k) business can be extended to defend against this spillover effect. The early effect on the non-401(k) business is likely to be an increase in request for cost information and for explanations, ultimately leading to client loss and pricing changes.

Advisers should expect unprecedented challenges to compensation and demands to explain what services are provided for that compensation. Anticipating these challenges, advisers should be prepared to offer a comprehensive explanation of the totality of services that are provided. Ultimately, the adviser should be able to switch the client into a fee based fiduciary agreement for the entire relationship.

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For investment managers this consists of a change in emphasis to low cost share classes, a shift to different product structures (passively managed investments, exchange traded funds and collective trusts) and consolidation into very large funds. Forward planning managers will communicate clear explanations of their value propositions well in advance of the effective date of the regulation so as to limit their exposure.

Insurance companies will not be able to avoid the spillover effect. An increase in premium quotes with lower close rates can be expected as the more cost sensitive public seek better values. The winning insurers will be those that are more selective in pricing to isolate market segments that can be served economically.

## Disclosure Confusion

With a reach of 72 million participants, one mildly confusing word or phrase can produce millions of service inquires. An unexpected peak in the volume of inquires combine will not afford the time to train staff and adapt systems to respond effectively. If only 5% of participants experience attempt to get answers, the effect is a severe deterioration in service producing millions disgruntled participants.

The concern about disgruntled participants makes it imperative that the disclosure documents avoid confusion that requires a service encounter. For this reason, the following analysis identifies potential areas of confusion on the model disclosure offered by the DoL.

### Tests Conducted

Several tests were performed to assess the likelihood of participants encountering difficulty understanding the sample disclosure. Before engaging in any test the sample document was stripped of all instructions and other content that is not intended for the participant.

### Document Length

Document length is a very strong indicator of the proportion of readers who will read the entire document. If the document is of high interest, as the disclosure of fees is, the reader is more likely to abandon the reading and turn to the phone for a quick answer.

Abandon rate begins to decline rapidly after half page of text (8½ X 11 page) or 150 words in the absence of graphics. With graphics this point of inflection may be pushed to a full page.

The sample disclosure consists of 4 pages and 1,500 words, making it likely that readers will abandon it and turn to the telephone for more immediate responses to their questions or concerns about their fees.

### Flesch Reading Ease

The Flesch Reading Ease test is the most widely accepted test of English readability. A score between 60 and 70 is largely considered acceptable. The following table is also helpful to assess the ease of readability in a document:

- 90-100: Very Easy
- 80-89: Easy
- 70-79: Fairly Easy
- 60-69: Standard
- 50-59: Fairly Difficult
- 30-49: Difficult
- 0-29: Very Confusing

The model disclosure scored 51.2, making it fairly difficult to read. This difficulty translates to participants abandoning the document and seeking answers elsewhere, presumably by making a phone call to a plan administrator or service provider.

### Confusing Terms

Readers encountering unfamiliar terms are more likely to call for assistance than refer to a dictionary or glossary. This test examines the document from the perspective of a literate reader but who is unfamiliar with financial or legal terms. The test identifies words and phrases that have no meaning or are confusing to readers.

The number of terms gives an indication of the probability that the intended reader, the participant will find an unfamiliar term and turn to the telephone for answers.

In this test, readers found 17 confusing terms in its 4 pages, which make abandonment very likely and turning to the telephone instead. These offending words and phrases are highlighted in yellow in Appendix C.

These terms should be replaced with language that recognizes that millions of recipients of this disclosure will not be familiar with them.

### Confusing Concepts

Concepts that are not effectively conveyed when the terms used are clearly understood is the subject of this test. This test measures how many times the readers ask "What is this trying to tell me?" The readers in this test are literate and familiar with financial and legal terms.

The number of confusing concepts is another indicator of how likely the document is to cause a service call.

This test found 18 confusing concepts in the document's 4 pages. These confusing concepts are even more like to cause a service incident than a confusing term that can be found in a dictionary or glossary. These offending concepts are surrounded by boxes in Appendix C.

The confusing concepts require that the presentation be reconsidered. Some may be eliminated from the document if the concept is not sufficiently important and carried on a supporting Website. From a communication perspective, the concepts that are retained may require either distillation into simpler concepts or a more elaborate presentation.

### Unanswered Questions

The context of the disclosure implies that the participant has a choice about the fees they pay but nothing in the communication lays out what these choices are or the course of action or consequences of making these choices. Millions of participant will be left with the unanswered question, "What to do if I don't like it?"

Without some guidance, millions of participants may take the imprudent step of withdrawing from their retirement plan. Consider the fact that most participants suffered losses of more than 25% of their plan value in 2008, so a 10% withdrawal penalty will not seem that large! The participant might argue that it is better to pay the 10% now, than it is to continue to pay the annual expenses revealed in the disclosure.

...most participants suffered losses of more than 25% of their plan value in 2008, so a 10% withdrawal penalty will not seem that large!

Avoiding this potential increase in plan withdrawals will require that participants have a less harmful way to reduce their costs. This challenge exists for participation in the plan and the investments selected. Plans must therefore examine the available investment options and lay out the participant choices in a meaningful way before the required disclosures are made. It also becomes critical to provide the participant with a source for professional advice to prevent the imprudent withdrawal from the plan.

## Conclusion

The analysis of the potential confusion effects caused by the required disclosure show that unless specific steps are taken the consequences could be:

- Spikes in the volume of service inquiries to plan administrators, recordkeepers, investment managers and advisers.
- Compromise in the ability to respond to these inquiries by virtue of the volume over a relative short period of time.
- Disgruntled participants (who are also employees of the plan sponsors and clients of the providers) because of inability to respond and unavailability of low cost alternatives.
- Exodus for plan participation because the withdrawal penalty may be viewed as a better choice than paying plan fees and taking the investment risk.

These potential consequences suggest that action should be taken to limit the potential confusion and its effects.

## Avoiding the Threats

The threats to the 401(k) industry brought about by the disclosure regulations can be greatly reduced by restructuring plan business and preparing plan sponsors for the effects of the disclosures. These actions need to be taken far enough in advance of the disclosures so that defenses can be well established before the situation becomes critical.

### Restructure

There are four approaches to restructuring the plan business:

- 1) Reduce costs
- 2) Offer different pricing options
- 3) Limit the variety of plans
- 4) Establish minimums.

#### Reduce Costs

The most difficult approach by far is to reduce the cost of what is being offered today. This will only apply to providers where there are identifiable efficiencies that can be realized without negative effects elsewhere. Examples are consolidating business units, changing vendors and renegotiating contracts/leases.

#### Pricing Structure

Less difficult is changing the pricing structure. A single bundled price can be broken down into its components that are priced as optional items. The plan sponsor, with input from participants, can make the conscious decision to retain or reject each option as long as the offer of the option occurs before the disclosure crisis.

The plan sponsor, with input from participants, can make the conscious decision to retain or reject each option...

Where unbundled pricing already exists, it is prudent to re-examine the existing prices to ensure that there are sufficient discrete options and that each is priced appropriately.

#### Limit Variety

The third restructuring approach is to limit the variety of plans. This means serving only those plans with which pricing can be competitive at the expense of the revenue loss from plans that are less profitable. This approach need not be taken in advance of a crisis because it will occur naturally, plans that are priced above the market rates or receiving service levels that are below par will ultimately seek other providers. The only question here is how graceful the exit will be.

#### Establish Minimums

The fourth approach of establishing minimums is a way to force less profitable plans to leave, so efficiencies are gained among the remaining profitable plans. This approach will lower revenues with the expectation that profit margins will increase to permit fee reductions when there is pressure to do so.



## Prepare

The restructuring approaches will only be effective if plan sponsors are prepared to make decisions before, during and after a crisis occurs. If plan sponsors are unprepared to make decisions regarding their plan costs they are likely to take the first low cost alternative offered, and suffer consequences later. More than at other times, the new regulations require an informed customer base. There are six steps to preparing plan sponsors and participants for the disclosures:

If plan sponsors are unprepared to make decisions regarding their plan costs they are likely to take the first low cost alternative offered, and suffer consequences later.

1. Understand what is currently provided and why. This is done by preparing a simple and clear summary of all the services being provided in language familiar to the average plan sponsor. Reviewing this summary reinforces what the plan sponsor is receiving.
2. Learn what lower cost alternatives are available without changing vendors. Concurrent with the review of services being offered, the plan sponsor is invited to consider other vendors and investment choices that may be higher or lower in cost. This enables the plan sponsor to put current service in perspective.
3. Get participant buy-in by involving them in the decision of what to keep and what to let go. A simple low cost survey can be used to get this involvement and is reinforced if the results are shared with participants and any necessary action taken.
4. Inform participants of notices ahead of time. Participants should have expectations set about receiving new disclosures in stand alone notices and/or in conjunction with their periodic statements.
5. Explain to participants what decisions they should make with disclosures. The first time a new disclosure is sent, each participant should also receive a decision guide for what to do about what they have learned. This will help the participant to decide if action is warranted.
6. Prepare to answer participants' complaints. Options include a hot line to call with concerns, staff specifically trained on these matters, a Website option to answer frequently asked questions and post additional questions.

Providers who prepare plan sponsors and participants properly are most likely to prevail in the crisis that is likely to materialize.

## Opportunities

As with any transformation, opportunities are created and ERISA 404(a)(5) is no exception. Reference was made earlier to low cost providers and while this is an important opportunity it is certainly not the only opportunity. There are also increased needs for services and entirely new services that will evolve.

The disclosure and the consequence will cause an increase in the number of plans changing providers. This money in motion is expected to be primarily among small plans. For the most part large plans have or are able to negotiate fees making them less likely to move.

### Low Cost Products

It is evident that the interest in low cost and unbundled products will increase as a result of 404(a)(5) disclosures. While the exact increase is impossible to forecast beforehand providers with low cost alternatives are likely to make inroads. Plan sponsors will also be more selective in the services provided given the need to justify the cost.

In using low cost products, plan sponsors will need expert guidance. This makes it critical for providers with low cost products to understand how to become positioned among the consultants and advisers who are 401(k) experts. This requires a focus and understanding of the experts' decision making process, which is quite different from the practices of sellers of bundled solutions. Experts have an institutional orientation and often look for solutions that fit a design they have prepared.

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Equally important in the market for low cost products is a flexible pricing structure that takes into consideration the specific attributes of each plan. The economics of a one size fits all solution may work when plan sponsors are not sensitive to price, but this becomes a losing proposition when they must seek the best deal. Even smaller plans can be expected to negotiate prices.

### Increased Needs

Plan sponsors and participants are typically not steeped in the financial and legal language used in the disclosures<sup>3</sup>. The mandated language is sufficiently clear for all to understand that the discussion is about cost and that will peak interest that will often lead to confusion.

Plan sponsors and participants will need to be educated on the use of the new disclosures as well as assisted in the decisions that will follow. These increased needs will increase product cost if treated as a value added service. On the other hand, if treated as a separate paid service, the added cost may be the source of dissatisfaction.

Providers have two practical options. The first is to minimize the level of support needed through effective marketing and education programs and avoid any unnecessary complexity in the disclosures. The second is to recommend the use of an adviser or independent fiduciary that will include this support in their service fee.

<sup>3</sup> See Appendix C for example of disclosure language

## New Needs

As the burden on plan administrators increases, plan sponsors will likely seek alternatives that are simpler for them to administer. New solutions that require less participant involvement and time would appear to offer the greatest relief.

There are three available structures that can be combined to reduce participant involvement and cost, without increasing plan sponsor liability. Providers that efficiently combine these structures and limit designated investment options can reduce participant involvement in enrollment, education and ongoing services.

These three structures are:

- Graduated automatic enrollment with online enrollment option. This structure calibrates the default rate for each employee to his/her compensation and age so as to set a more meaningful default and limit the need to alter the rate. Where feasible, changes to the default rate can only be performed online.
- Smart default investments with reenrollment. This structure selects a qualified default model based on known characteristics of the participant. Characteristics such as income, tax deductions, type of job, and age are used to automatically select a default model for each participant. Participants are also given the ability to add other characteristics online if they choose to do so. A plan reenrollment will convert a majority of employees to the defaulting system.
- Brokerage window and participant adviser. For participants that opt out of the default system, involvement can be kept to a minimum by assigning them to a fiduciary adviser with access to a brokerage window. In this case, the participant has unlimited investment choices but also has the guidance of a fiduciary, thus relieving the plan sponsor of the liability for investment losses.

When put together in a plan with no other designated investment options, these structures minimize the participant involvement, reduce employer costs, plan fees and improve the participant's investment portfolio.

## Conclusion

ERISA 404(a)(5) is far more likely than not to be a game changer.

It became evident during this analysis that the marketplace will be reshuffled and those firms that adapt appropriately will prosper at the expense of firms that remain committed to the business models of past decades.

## What Are Advisers Doing?

In anticipation of the larger wave of disclosures that will occur after August 2012, advisers are focused today on the 408(b)(2) plan disclosure which will immediately raise the issues of the adviser's fiduciary status and compensation.

Advisers who cannot sign on as fiduciaries of the plan could be engaged in a prohibited transaction if they list investment advice as a service. Additionally, the adviser's compensation reported to plan sponsors could raise questions, particularly if this differs from what recordkeepers report.

Advisers who recognize the issues with the 408(b)(2) have been taking steps to address them before the July 2012 deadline. These steps include:

- ✓ Determining how recordkeepers will report to plan sponsors and participants. In particular, how adviser payments from ERISA spending accounts are reported.
- ✓ Alerting broker/dealers of the fiduciary and fee disclosure requirement and seeking methods of addressing them.
- ✓ Identifying the services provided to each plan, using the set of services available as a template.
- ✓ Exploring the use of independent fiduciaries who can perform services requiring a fiduciary while the adviser continues to perform non-fiduciary services.
- ✓ Meeting with clients before the disclosure deadline to explain changes, how they operate, what their fees cover and the information that will be disclosed.
- ✓ Seeking training and certification to assume the duties of a fiduciary.

## For More Information...

... concerning DALBAR services that support the management of this regulatory change:

- DALBAR models for plan and participant disclosures
- Qualified fiduciary training organizations and fiduciary registration
- Evaluation of kits, statements, disclosure documents and Websites
- Consulting, planning and product design assistance

DALBAR, Inc.  
[info@DALBAR.com](mailto:info@DALBAR.com)  
 617-723-6400  
[www.DALBAR.com](http://www.DALBAR.com)

## Appendix A –DoL Fact Sheet

# Fact Sheet

## Final Rule to Improve Transparency of Fees and Expenses to Workers in 401(k)-Type Retirement Plans

*The Department of Labor's Employee Benefits Security Administration (EBSA) today released a final rule that will help America's workers manage and invest the money they contribute to their 401(k)-type pension plans. The rule will ensure: that workers in this type of plan are given, or have access to, the information they need to make informed decisions, including information about fees and expenses; the delivery of investment-related information in a format that enables workers to meaningfully compare the investment options under their pension plans; that plan fiduciaries use standard methodologies when calculating and disclosing expense and return information so as to achieve uniformity across the spectrum of investments that exist among and within plans, thus facilitating "apples-to-apples" comparisons among their plan's investment options; and a new level of fee and expense transparency.*

### Background

- EBSA is responsible for administering and enforcing the fiduciary, reporting, and disclosure provisions of Title I of ERISA.
- The agency oversees approximately 708,000 private pension plans, including 483,000 participant-directed individual account plans such as 401(k)-type plans.
- A "participant-directed plan" is a plan that provides for the allocation of investment responsibilities to participants or beneficiaries.
- An estimated 72 million participants are covered by these participant directed plans, which contain nearly \$3 trillion in assets.
- While workers in these plans are responsible for making their own investment decisions, current law does not adequately ensure that all workers are given the information they need or ensure that information, when provided, is furnished in a format useful to workers, particularly information on investment choices including associated fees and expenses.
- In April 2007, EBSA published in the Federal Register a Request for Information (72 FR 20457) soliciting the views, suggestions and comments from participants, plan sponsors, plan service providers and members of the financial community, as well as the public in general, on whether and to what extent rules should be adopted or modified, or other actions should be taken, to ensure that participants and beneficiaries have the information they need to make informed decisions about the

management of their individual accounts and the investment of their retirement savings.

## Overview of Final Rule

- The final rule provides that the investment of plan assets is a fiduciary act governed by the fiduciary standards in ERISA section 404(a)(1)(A) and (B), which require plan fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries.
- The final rule also provides that when a plan allocates investment responsibilities to participants or beneficiaries, the plan administrator must take steps to ensure that such participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan and the plan's investment options, including fee and expense information, to make informed decisions with regard to the management of their individual accounts.
- A plan administrator must provide to each participant or beneficiary certain plan-related information and certain investment-related information. These categories of information are described below.

## Plan-Related Information

The first category of information that must be disclosed under the final rule is plan-related information. This general category is further divided into three subcategories as follows:

### General Plan Information

- General plan information consists of information about the structure and mechanics of the plan, such as an explanation of how to give investment instructions under the plan, a current list of the plan's investment options, and a description of any "brokerage windows" or similar arrangement that enables the selection of investments beyond those designated by the plan.

### Administrative Expenses Information

- An explanation of any fees and expenses for general plan administrative services that may be charged to or deducted from all individual accounts. Examples include fees and expenses for legal, accounting, and recordkeeping services.

### Individual Expenses Information

- An explanation of any fees and expenses that may be charged to or deducted from the individual account of a specific participant or beneficiary based on the actions

taken by that person. Examples include fees and expenses for plan loans and for processing qualified domestic relations orders.

The information in these three subcategories must be given to participants on or before the date they can first direct their investments, and then again annually thereafter.

### **Statements of Actual Charges or Deductions**

In addition to the plan-related information that must be furnished up front and annually, participants must receive statements, at least quarterly, showing the dollar amount of the plan-related fees and expenses (whether "administrative" or "individual") actually charged to or deducted from their individual accounts, along with a description of the services for which the charge or deduction was made. These specific disclosures may be included in quarterly benefit statements required under section 105 of ERISA.

### **Investment-Related Information**

The second category of information that must be disclosed under the final rule is investment-related information. This category contains several subcategories of core information about each investment option under the plan, including:

#### **Performance Data**

- Participants must be provided specific information about historical investment performance. 1, 5 and 10-year returns must be provided for investment options, such as mutual funds, that do not have fixed rates of return. For investment options that have a fixed or stated rate of return, the annual rate of return and the term of the investment must be disclosed.

#### **Benchmark Information**

- For investment options that do not have a fixed rate of return, the name and returns of an appropriate broad-based securities market index over 1-, 5-, and 10-year periods (matching the Performance Data periods) must be provided. Investment options with fixed rates of return are not subject to this requirement.

#### **Fee and Expense Information**

- For investment options that do not have a fixed rate of return, the total annual operating expenses expressed as both a percentage of assets and as a dollar amount for each \$1,000 invested, and any shareholder-type fees or restrictions on the participant's ability to purchase or withdraw from the investment.
- For investment options that have a fixed rate of return, any shareholder-type fees or restrictions on the participant's ability to purchase or withdraw from the investment.



### **Internet Website Address**

- Investment-related information includes an internet Web site address that is sufficiently specific to provide participants and beneficiaries access to specific additional information about the investment options for workers who want more or more current information.

### **Glossary**

- Investment-related information includes a general glossary of terms to assist participants and beneficiaries in understanding the plan's investment options, or an Internet Web site address that is sufficiently specific to provide access to such a glossary.

### **Comparative Format Requirement**

Investment-related information must be furnished to participants or beneficiaries on or before the date they can first direct their investments, and then again annually thereafter. It also must be furnished in a chart or similar format designed to facilitate a comparison of each investment option available under the plan. The final rule includes, as an appendix, a model comparative chart, which when correctly completed, may be used by the plan administrator to satisfy the rule's requirement that a plan's investment option information be provided in a comparative format.

### **Miscellaneous**

- The rule provides plan administrators protection from liability for the completeness and accuracy of information provided to participants if the plan administrator reasonably and in good faith relies upon information provided by a service provider.
- After a participant has invested in a particular investment option, he or she must be provided any materials the plan receives regarding voting, tender or similar rights in the option.
- Upon request, the plan administrator must also furnish prospectuses, financial reports and statements of valuation and of assets held by an investment option.
- The general disclosure regulation at 29 CFR § 2520.104b-1 applies to material furnished under this regulation, including the safe harbor for electronic disclosures at paragraph (c) of that regulation.
- The final rule would also make conforming changes to the disclosure requirements for plans that elect to comply with the existing ERISA section 404(c) regulations.

### **Economic Benefits of the Final Rule**

- The Department estimates that the rule will be economically significant.
- The anticipated cost of the rule is \$425 million in 2012 (2010 dollars), arising from legal compliance review, time spent consolidating information for participants,



creating and updating websites, preparing and distributing annual and quarterly disclosures, and material and postage costs to distribute the disclosures.

- A significant benefit of this rule is that it will reduce the amount of time participants spend collecting fee and expense information and organizing the information in a format that allows key information to be compared; this time savings is estimated to total nearly 54 million hours valued at nearly \$2 billion in 2012 (2010 dollars).
- Over the ten-year period 2012-2021, EBSA estimates that the present value of the benefits provided by the final rule will be approximately \$14.9 billion and the present value of the costs will be approximately \$2.7 billion.

### **Contact Information**

For questions about the rule, contact EBSA's Office of Regulations and Interpretations at 202-693-8500.

This fact sheet has been developed by the U.S. Department of Labor, Employee Benefits Security Administration, Washington, DC 20210. It will be made available in alternate formats upon request: Voice phone: 202.693.8664; TTY: 202.501.3911. In addition, the information in this fact sheet constitutes a small entity compliance guide for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996.

## Appendix B –DoL News Release

# News Release

**EBSA News Release: [10/14/2010]**

**Contact Name: Gloria Della**

**Phone Number: (202) 693-8666**

**Release Number: 10-1432-NAT**

### **US Labor Department issues final rule to improve transparency of fees and expenses to workers with 401(k)-type retirement plans**

**WASHINGTON** — The U.S. Department of Labor's Employee Benefits Security Administration today announced a final rule to give the estimated 72 million participants covered by 401(k)-type retirement plans greater information regarding the fees and expenses associated with their plans in order to better manage their retirement savings.

Many 401(k)-type plans allow workers to make their own investment decisions. Current law does not require that all workers be given the information they need to make informed investment decisions or, when information is given, that it is furnished in a user-friendly format. This rule will ensure that all workers who direct their plan investments have access to the information they need to make informed decisions regarding the investment of their retirement savings, including fee and expense information. Under the rule, workers will receive this information in a format that enables them to meaningfully compare the investment options under their plans.

"This rule provides uniform disclosure to workers about what they pay for investment options in their retirement plans," said Secretary of Labor Hilda L. Solis. "For the first time, workers will have at their fingertips important and accessible investment-related information to comparison shop among the plan options available to them."

The final regulation requires plan fiduciaries to:

- Give workers quarterly statements of plan fees and expenses deducted from their accounts.
- Give workers core information about investments available under their plan including the cost of these investments.
- Use standard methodologies when calculating and disclosing expense and return information to achieve uniformity across the spectrum of investments that exist in plans.

- Present the information in a format that makes it easier for workers to comparison shop among the plan's investment options.
- Give workers access to supplemental investment information in addition to the basic information required under the final rule.

"We are giving workers the tools they need to make the best possible decision about investing the nearly \$3 trillion held in their 401(k)-type plans. Now they will have information about different investment options to help them make wise decisions," said Assistant Secretary of Labor for EBSA Phyllis C. Borzi.

## Appendix C –DoL Model Comparative Chart

**Annotation legend:**

- Xxx –Confusing term
- Xxx –Confusing concept

### Model Comparative Chart

#### ABC Corporation 401k Retirement Plan

Investment Options – January 1, 20XX

This document includes important information to help you compare the investment options under your retirement plan. If you want additional information about your investment options, you can go to the specific Internet Web site address shown below or you can contact [insert name of plan administrator or designee] at [insert telephone number and address]. A free paper copy of the information available on the Web site[s] can be obtained by contacting [insert name of plan administrator or designee] at [insert telephone number].

#### Document Summary

This document has 3 parts. Part I consists of performance information for plan investment options. This part shows you how well the investments have performed in the past. Part II shows you the fees and expenses you will pay if you invest in an option. Part III contains information about the annuity options under your retirement plan.

#### Part I. Performance Information

**Table 1** focuses on the performance of investment options that do not have a fixed or stated rate of return. Table 1 shows how these options have performed over time and allows you to compare them with an appropriate benchmark for the same time periods. Past performance does not guarantee how the investment option will perform in the future. Your investment in these options could lose money. Information about an option's principal risks is available on the Web site[s].

Table 1— <span style="background-color: yellow;">Variable Return</span> Investments								
Name/ Type of Option	Average Annual Total Return as of 12/31/XX				Benchmark			
	1yr.	5yr.	10yr.	Since Inception	1yr.	5yr.	10yr.	Since Inception
<b>Equity Funds</b>								
A Index Fund/ S&P 500 www. website address	26.5%	.34%	- 1.03%	9.25%	26.46%	.42%	-.95%	9.30%
					S&P 500			
B Fund/ Large Cap www. website address	27.6%	.99%	N/A	2.26%	27.80%	1.02%	N/A	2.77%
					US Prime Market 750 Index			
C Fund/ Int'l Stock www. website address	36.73%	5.26%	2.29%	9.37%	40.40%	5.40%	2.40%	12.09%
					<span style="background-color: yellow;">MSCI EAFE</span>			
D Fund/ Mid Cap www. website address	40.22%	2.28%	6.13%	3.29%	46.29%	2.40%	-.52%	4.16%
					<span style="background-color: yellow;">Russell Midcap</span>			

Bond Funds									
E Fund/ Bond Index www. website address	6.45%	4.43%	6.08%	7.08%	5.93%	4.97%	6.33%	7.01%	Barclays Cap. Aggr. Bd.
Other									
F Fund/ GICs www. website address	.72%	3.36%	3.11%	5.56%	1.8%	3.1%	3.3%	5.75%	3-month US T-Bill Index
G Fund/ Stable Value www. website address	4.36%	4.64%	5.07%	3.75%	1.8%	3.1%	3.3%	4.99%	3-month US T-Bill Index
Generations 2020/ Lifecycle Fund www. website address	27.94%	N/A	N/A	2.45%	26.46%	N/A	N/A	3.09%	S&P 500
					23.95%	N/A	N/A	3.74%	Generations 2020 Composite Index*

\*Generations 2020 composite index is a combination of a total market index and a US aggregate bond index proportional to the equity/bond allocation in the Generations 2020 Fund.

**Table 2** focuses on the performance of investment options that have a fixed or stated rate of return. Table 2 shows the annual rate of return of each such option, the term or length of time that you will earn this rate of return, and other information relevant to performance.

Table 2—Fixed Return Investments			
Name/ Type of Option	Return	Term	Other
H 200X/ GIC www. website address	4%	2 Yr.	The rate of return does not change during the stated term.
I LIBOR Plus/ Fixed- Type Investment Account www. website address	LIBOR +2%	Quarterly	The rate of return on 12/31/xx was 2.45%. This rate is fixed quarterly, but will never fall below a guaranteed minimum rate of 2%. Current rate of return information is available on the option's Web site or at 1-800-yyy-zzzz.
J Financial Services Co./ Fixed Account Investment www. website address	3.75%	6 Mos.	The rate of return on 12/31/xx was 3.75%. This rate of return is fixed for six months. Current rate of return information is available on the option's Web site or at 1-800-yyy-zzzz.

## Part II. Fee and Expense Information

**Table 3** shows fee and expense information for the investment options listed in Table 1 and Table 2. Table 3 shows the Total Annual Operating Expenses of the options in Table 1. Total Annual Operating Expenses are expenses that reduce the rate of return of the investment option. Table 3 also shows **Shareholder-type** Fees. These fees are in addition to Total Annual Operating Expenses.

Table 3—Fees and Expenses			
Name / Type of Option	Total Annual Operating Expenses		Shareholder-Type Fees
	As a %	Per \$1000	
<b>Equity Funds</b>			
A Index Fund/ S&P 500	0.18%	\$1.80	\$20 annual service charge subtracted from investments held in this option if valued at less than \$10,000.
B Fund/ Large Cap	2.45%	\$24.50	2.25% <b>deferred sales charge</b> subtracted from amounts withdrawn within 12 months of purchase.
C Fund/ International Stock	0.79%	\$7.90	5.75% sales charge subtracted from amounts invested.
D Fund/ Mid Cap ETF	0.20%	\$2.00	4.25% sales charge subtracted from amounts withdrawn.
<b>Bond Funds</b>			
E Fund/ Bond Index	0.50%	\$5.00	N/A
<b>Other</b>			
F Fund/ GICs	0.46%	\$4.60	10% charge subtracted from amounts withdrawn within 18 months of initial investment.
G Fund/ Stable Value	0.65%	\$6.50	Amounts withdrawn may not be transferred to a competing option for 90 days after withdrawal.
Generations 2020/ Lifecycle Fund	1.50%	\$15.00	Excessive trading restricts additional purchases (other than contributions and loan repayments) for 85 days.
<b>Fixed Return Investments</b>			
H 200X / GIC	N/A		12% charge subtracted from amounts withdrawn before maturity.
I LIBOR Plus/ Fixed- Type Invest Account	N/A		5% contingent deferred sales charge subtracted from amounts withdrawn; charge reduced by 1% on 12-month anniversary of each investment.
J Financial Serv Co. / Fixed Account Investment	N/A		90 days of interest subtracted from amounts withdrawn before maturity.

The cumulative effect of fees and expenses can substantially reduce the growth of your retirement savings. Visit the Department of Labor’s Web site for an example showing the long-term effect of fees and expenses at [http://www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html). Fees and expenses are only one of many factors to consider when you decide to invest in an option. You may also want to think about whether an investment in a particular option, along with your other investments, will help you achieve your financial goals.

### Part III. Annuity Information

**Table 4** focuses on the annuity options under the plan. Annuities are insurance contracts that allow you to receive a guaranteed stream of payments at regular intervals, usually beginning when you retire and lasting for your entire life. Annuities are issued by insurance companies. Guarantees of an insurance company are subject to its long-term financial strength and claims-paying ability.

**Table 4—Annuity Options**

Name	Objectives / Goals	Pricing Factors	Restrictions / Fees
Lifetime Income Option  www. website address	To provide a guaranteed stream of income for your life, based on <b>shares</b> you acquire while you work. At age 65, you will receive monthly payments of \$10 for each share you own, for your life. For example, if you own 30 shares at age 65, you will receive \$300 per month over your life.	The cost of each share depends on your age and interest rates when you buy it. Ordinarily the closer you are to retirement, the more it will cost you to buy a share.  The cost includes a <u>guaranteed death benefit</u> payable to a spouse or beneficiary if you die before payments begin. The death benefit is the total amount of your contributions, less any withdrawals.	Payment amounts are based on your life expectancy only and would be reduced if you choose a <u>spousal joint and survivor benefit</u> .  You will pay a 25% <b>surrender</b> charge for any amount you withdraw before <u>annuity payments</u> begin.  If your <u>income payments</u> are less than \$50 per month, the option’s issuer may combine payments and pay you less frequently, or return to you the larger of your net contributions or the cash-out value of your income shares.

**Table 4—Annuity Options**

Name	Objectives / Goals	Pricing Factors	Restrictions / Fees
Generations 2020 Variable Annuity Option  www. website address	<p>To provide a guaranteed stream of income for your life, or some other period of time, based on your account balance in the Generations 2020 Lifecycle Fund.</p> <p>This option is available through a variable annuity contract that your plan has with ABC Insurance Company.</p>	<p>You have the right to elect fixed annuity payments in the form of a life annuity, a joint and survivor annuity, or a life annuity with a term certain, but the payment amounts will vary based on the benefit you choose. The cost of this right is included in the Total Annual Operating Expenses of the Generations 2020 Lifecycle Fund, listed in Table 3 above.</p> <p>The cost also includes a guaranteed death benefit payable to a spouse or beneficiary if you die before payments begin. The death benefit is the greater of your account balance or contributions, less any withdrawals.</p>	<p>Maximum surrender charge of 8% of account balance.</p> <p>Maximum transfer fee of \$30 for each transfer over 12 in a year.</p> <p>Annual service charge of \$50 for account balances below \$100,000.</p>

Please visit [www.ABCPlanglossary.com](http://www.ABCPlanglossary.com) for a glossary of investment terms relevant to the investment options under this plan. This glossary is intended to help you better understand your options.





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