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July 20, 2020

Office of Exemption Determinations, Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue NW, Suite 400
Washington, DC 2010

RE: Z-RIN 1210-ZA18, Prohibited Transactions involving Pooled Employer Plans under the SECURE Act and Other Multiple Employer Plans

Ladies and Gentlemen:

Morningstar welcomes the opportunity to comment on the request for information "Prohibited Transactions involving Pooled Employer Plans under the SECURE Act and Other Multiple Employer Plans." We bring multiple perspectives to this comment letter. First, we collect data from the Form 5500 and Form 5500-Short Form to provide our clients with information on retirement plans, including identifying the underlying investments. Second, we offer 3(21) and 3(38) fiduciary services to plans through our investment management business.

The department's questions focus on expectations for how the pooled employer plan and "open MEP" marketplaces will develop. We address these by using our retirement plan database to examine the landscape of existing multiple-employer plans, identifying trends within this universe that can inform our expectations for the new marketplaces. Of course, the PEP marketplace can, and hopefully will, grow much larger than the MEP marketplace, but the MEP marketplace offers the best data on the likely development of the PEP marketplace. Specifically, we will address questions 2, 3, 5, and 7 from the department on how Pooled Plan Providers and MEP sponsors can address transactions prohibited by ERISA, questions 11 and 12 on the employers that will participate in the PEP or MEP, and questions 9 and 10 on the investments we would expect in these plans.

In general, we think that the existing prohibited transaction exemptions, or PTEs, do not need to be adjusted, and between unbundled share classes and existing exemptions, there are plenty of ways for PPPs to serve the PEP marketplace. There are some areas of the SECURE Act on which the DOL could provide additional clarity. We think that the department should focus on the needs of small and midsize employers for whom PEPs are likely to be the most attractive, and the department should focus on helping PEPs scale so that they can be competitive with single-employer plans. Finally, we have policy recommendations on annual reports, which we believe are closely related to some of the questions about exemptions the department requested information about.

Existing Prohibited Transaction Exemptions Do Not Need to Be Adjusted

Based on our conversations with other industry participants, a variety of types of companies will plan to offer PEPs and serve as PPPs using a variety of business models. We believe that the kinds of conflicts these arrangements create can be mitigated through existing PTEs. Furthermore, Congress created PPPs and made them fiduciaries to protect plan participants in pooled arrangements given the principal-agent problems inherent in such arrangements, so any additional PTE should provide robust participant protections. Indeed, our research shows that many employers in existing MEPs pay unusually high fees, as discussed later. Nonetheless, to facilitate the development of a robust PEP marketplace, the department could provide some clarity to the retirement industry on whether an employer-sponsor in a PEP can choose an outside 3(38) investment advisor or whether such a choice must come directly from the PPP. Such guidance would help clarify how PPPs will mitigate conflicts within the framework of existing PTEs. Finally, in terms of mitigating conflicts, the retirement industry is increasingly moving to unbundled share classes (also called "clean shares" and often marketed as "R6 shares"), which eliminate certain conflicts, obviating the need for PTEs, and the department should encourage this shift by avoiding promulgating additional PTEs.

We believe that most PPPs with conflicts related to offering proprietary products or engaging in revenue-sharing arrangements will rely on existing PTEs 77-4 and the statutory exemption § 1108 (b)(8) for increasingly popular collective investment trusts. We think that 84-14 could be among the most relied-on exemptions, as it offers broad relief when an independent and discretionary manager manages a plan's assets.

An area on which the department could offer further clarification is around whether sponsors in a PEP can enter into agreements with other investment management fiduciaries on their own or if such arrangements must be initiated by the PPP. Section (c)(43)(B)(iii) of the SECURE Act is unclear on this point. It requires plan sponsors to retain fiduciary responsibility for investment management unless the PPP delegates this to another fiduciary. However, this might also leave room for an employer to select a 3(38) in a case where the PPP has not delegated the investment management to a third party. Clarifying this point would be helpful because, to the extent that individual employers, rather than PPPs, enter into 3(38) agreements, the PPPs would need to adjust their approach to complying with and relying on PTEs or avoiding conflicts of interest all together. The department could also offer guidance on conflict avoidance, such as how PPPs can avoid conflicts created by revenue-sharing payments or commissions by delegating investment selection to another fiduciary.

The department asked about the need for more PTEs. In general, we think there is much less need for PTEs simply because so many share classes are available in an unbundled form. Indeed, many large plans mostly rely on unbundled share classes that have no revenue-sharing, subtransfer agent, or 12b-1 fees. From January 2019 through May 2020, unbundled retirement share classes gathered $45.9 billion in inflows while bundled share classes suffered $21.2 billion in outflows. Semibundled share classes continue to be present in many plans, with these share classes gaining $28.4 billion in inflows over the same time period, but the move toward unbundled share classes is clear. Total assets in unbundled share classes as of June 2020 top $375 billion, while bundled share class retirement assets are below $150 billion. Unbundled share classes allow plan sponsors to easily disaggregate investment management costs from other costs, and we hope the PEP marketplace evolves to similarly rely on these share classes.

PEPs Are Likely to be Most Attractive – and Beneficial – to Small- and Midsize Employers

PEPs are the close descendants of MEPs, and we think that MEPs can provide useful insights into how PEPs may perform. Examining the universe of current MEPs, we find that large MEPs approach the same total cost as large single-employer plans, potentially offering a significant improvement for small- and midsize employers. Our analysis of total cost uses the Form 5500 data and Morningstar's investment databases to determine the all-in asset-based cost for a participant in a plan.[1] This fee includes both plan administrative expenses and an estimate of the investment expenses. We find that the median overall cost for MEPs with at least $10 million in assets is at most 5 basis points higher than the median cost for a single-employer plan in a similar range of assets. This analysis is based on bucketing plans into asset ranges (such as $1 million in assets, $1 million-$5 million, $5 million-$10 million, $10 million-$25 million, and so on), which allows us to determine a benchmark of investment expenses, plan expenses, and overall cost for plans of that size.

When comparing plans, it is critical to consider the total cost for a participant to invest, including investment management fees and plan administrative fees. Performing this analysis shows that large MEPs approach the cost efficiency of large single-employer plans, even though there are some additional costs associated with a plan servicing many employers. For example, we estimate the median single-employer plan with $100 million-$250 million charges 58 basis points. For MEPs, we find the median plan of this size charges 63 basis points. The slightly higher fee, generally captured in a higher plan administrative fee, is understandable given the additional complexities in operating a multiple-employer plan compared with a single-employer plan. Exhibit 1 compares the median cost of single-employer plans and MEPs across three aggregated ranges.[2]

[1] Investment information from the Schedule D and Schedule H are used to identify investments offered by the plan. Only plans for which we can identify at least 75% of plan assets to a specific share class are included.

[2] Median cost in Exhibit 1 is calculated by averaging the median cost of plans in three or four subsets of each asset range. For example, $10M-$250M comprises ranges $10M-$25M, $25M-$50M, $50M-$100M, and $100M-$250M, where we have a median cost for plans in each of these and average the four medians to reach the numbers in the exhibit.

Exhibit 1 Comparison of Total Cost of Single-Employer and Multiple-Employer Plans

	Average Total Cost in Basis Points	
Plan Net Asset Range	Single-Employer Plan	Multiple-Employer Plan
<$10M	116	136
$10M-$250M	69	74
$250M+	44	49

Source: Morningstar data and analysis.

Directly comparing MEPs and single-employer plans shows that MEPs only approach the cost efficiency of single-employer plans, not quite reaching it--but considering the single-employer plan that each member of a MEP would have access to shows the benefit of pooling resources. While it is convenient to compare similarly sized MEPs and single-employer plans, this does not capture the decision facing companies participating in a MEP or, in the future, a PEP. In theory, these plans allow many small companies to pool retirement plan resources to gain efficiencies that they could not achieve alone. Consider a plan with $125 million assets and 80 participating companies--as a MEP, the plan charges 78 basis points across plan and investment fees. This is above the median for plans in that range, but it is on the smaller end of the asset range and has many participating companies, increasing the complexity. If each of these companies were to sponsor its own single-employer plan, each would have, on average, roughly $1.5 million in assets. We estimate that the median single-employer plan with $1 million-$5 million in assets charges 111 basis points, a 42% increase from the cost of the MEP.

This analysis shows that, for existing MEPs, there is not a significant difference in overall MEP cost based on the relative sizes of the participating employers. With the PPP as a fiduciary operating the PEP, we expect that PEPs can also successfully reduce fees for participating small employers relative to what they could offer if they offered a single-employer plan. In general, we do not expect large employers to join PEPs. While large MEPs offer a significant upgrade for small- and midsize employers from the single-employer plans they could access, there is still a cost disadvantage compared with large single-employer plans due to the additional administrative work. If large employers do join PEPs, our research on MEPs indicates that this is not likely to significantly impact the cost of the MEP. In addition to benchmarking plan cost by ranges of plan size, we conducted a multivariate linear regression analysis on this data. By considering the percentage of assets attributed to each participating employer, we were able to introduce a variable to account for how evenly assets were spread among participating employers in our regression analysis. Our general model is a log-log form with statistically significant results for the variables of plan assets, number of participating employers, and number of participants with accounts. We found that the introduction of the variable expressing the spread of assets did not impact the results and the variable was not statistically significant.

PEPs Should Benefit From Economies of Scale to Offer Access to Low-Cost, High-Quality Investments, but Only If They Get Sufficiently Large

Considering our benchmarks for plan fees, investment expenses, and total cost for MEPs and single-employer plans, we find that the median large MEP offers comparably priced investment options and a comparably sized investment lineup. The median lineup size does not vary significantly across plans of different asset sizes, hovering in the high 20s. The median investment expense ratio scales as the MEP asset base grows, as expected. The inclusion of low-cost investments is emphasized by the prevalence of common/collective trusts – also referred to as "collective investment trusts," or "CITs" – in large MEPs. Among MEPs with at least $50 million in assets, more than half use CITs and the median proportion of assets in CITs is the same or high than for single-employer plans. When we analyze our investment database to compare the cost of a CIT with a mutual fund following the same investment strategy, we find that the CIT is cheaper 91% of the time, and even when considering the least expensive CIT tier and mutual fund share class, CITs are cheaper 82% of the time. Collectively, our analysis of existing MEPs shows that the investment options offered are aligned with those offered in single-employer plans in terms of lineup size and investment cost, providing a reasonable basis to expect similar lineup offerings for PEPs.

The large population of expensive, small MEPs shows how PEPs could fail. While MEP costs scale effectively with size, almost 50% of MEPs are under $10 million in assets. Further, almost three fourths of these small plans file a Form 5500-Short Form, meaning they have under 100 participants. All told, plans with under $10 million in assets that file the Short Form represent over a third of the total MEP market. Without the investment information, we have limited insight into the total cost of these plans. However, we can derive estimates from plans of the same asset base for which we have investment expense data. From those, we observe that 30.7% charge more than 150 basis points across both investment and plan fees. Since it is likely the plans for which we only have administrative fee data are even more expensive, it paints a bleak picture if the PEP market were to develop with the inclusion of the same proportion of plans of this size. One boon for PEPs in avoiding this future is that they are not restricted by the common nexus requirement for participating companies. Some MEPs may be restricted in their ability to grow if a limited number of employers share the common nexus of the plan. There is a greater potential market for PEPs, given that any company could join, which would ideally lead to fewer small PEPs. Morningstar is releasing a white paper on July 23 that reviews these issues in depth.

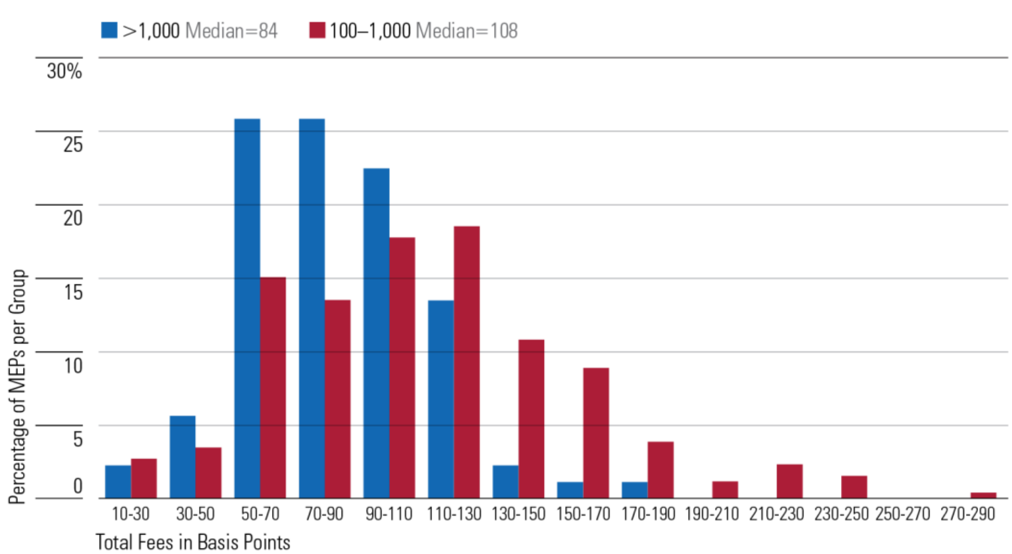
DOL Should Also Consider Reporting and Audit Relief as Part of Any Examination of PTEs

Overall, we believe PEPs have promise to improve small-employer retirement plans by expanding the potential market of each plan. Based on our analysis of existing MEPs, we see evidence that the pooling of assets by many small- and midsize employers can grant workers access to lower-cost plans. Further, we note that these plans offer a comparable number of investment options and use cost-efficient investment vehicles such as common/collective trusts with close to the same regularity as single-employer plans.

Although the department did not ask about this issue, given the wide variation we see in the existing MEP marketplace for plans under $10 million in assets and with under 1,000 participants, we recommend careful observation of these populations in the infancy of this marketplace. In particular, we recommend the department consider curbing reporting and concurrent audit relief that is available for small PEPs if they do not sufficiently scale up within a few years of inception. This would make the relief a carrot for new PEPs, while curbing long-term problems with plans that never scale.

To illustrate the issue: As with plans under $10 million, when MEPs stagnate between 100 and 1,000 participants, costs are high and have a high degree of variation compared with larger plans. The median total fee for a plan with over 1,000 participants is 84.4 basis points. Meanwhile, the median for a plan in the 100 to 1,000 range is more than 25% more at 108.1 basis points. Additionally, there is a higher standard deviation of fees over plans in this range, compared with plans with over 1,000 participants, as illustrated in Exhibit 2. For plans with over 1,000 participants, there is clustering around the mean, with 68% lying within 30 basis points and 95% within 60. Among plans with 100 to 1,000 participants, there is greater spread, with 68% of plans having total fees within 55 basis points of the mean and 95 within 109 basis points of it. With fees changing quickly as plans move through this range and the wider dispersion of fees, not having the data to assess the total cost and quality of plans could be harmful for investors if many PEPs persist here.

Exhibit 2 Side-by-Side Histogram of Total Fees for MEPs with 100 to 1,000 Participants and Over 1,000 Participants



Source: Morningstar data and analysis.

Thank you for the opportunity to comment on this important request for information.

Sincerely,

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