Benefit Financial Services Group

White Paper

Rushing to Levelize Fees May Increase Liability

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Introduction

Over the past decade, the Department of Labor ("DOL") has implemented several regulations resulting in a significant increase in fee-related ERISA lawsuits and enforcement actions. Plan fiduciaries continue to look for programs that can provide safe-haven from potential liability, which has led to a recent rise in the popularity of fee levelization. While recordkeepers and advisers push fee levelization for marketing purposes, it is important to remember that fee levelization is simply a tool that can improve the transparency and utilization of indirect revenue as a method of paying plan-related expenses. The process of fee levelization requires additional layers of analysis and documentation and, if done incorrectly, can ***create additional liability*** for plan fiduciaries.

Revenue Sharing

For many years, the source of funding administrative costs associated with a retirement plan has been revenue sharing received from the investments options offered in the plan. Recordkeepers receive these payments that are labeled as various fees, such as 12b-1 and sub-TA. Because these fees are included in the overall expense ratio of the investment options, administrative services can be provided without direct charges to the participants or the plan sponsor. In the past, recordkeepers and/or brokers would ensure that investment options all shared enough revenue to cover their service costs. The Department of Labor's recent 408(b)(2) Regulations required the disclosure of all these payments and, as a result, significantly reduced the average cost of administrative services. An ever increasing number of plans are entering into service agreements with a stated revenue requirement where the recordkeeper is required to deposit all excess revenue into a Plan Expense Reimbursement Account. These arrangements, along with open architecture investment lineups, shift the burden of revenue generation to plan fiduciaries, as a shortfall in revenue often leads to a hard-dollar fee.

Managing revenue sharing and share class utilization would be easy if there were a standardized structure for all investment options and recordkeepers. However, an institutional share class of ABC Fund Company likely shares a different amount of revenue with Recordkeeper A than an institutional share class of XYZ Fund Company. What is worse is that an institutional share class of ABC Fund Company might also have different revenue sharing arrangements with Recordkeeper A and Recordkeeper B. These factors along with the day-to-day movement of participant assets make it nearly impossible to align the revenue generated by the investment options with the revenue requirement of the Recordkeeper. However, the hypothetical plan below was somehow able to accomplish that goal. The revenue requirement of the recordkeeper is 0.20% which exactly matches what the plan is generating at this point in time.

Fund Name	Total Assets	Expense	Revenue Sharing
Bond Fund A	$1,000,000	0.70%	0.20%
Equity Fund A	$1,000,000	1.00%	0.40%
Index Fund	$1,000,000	0.10%	0.00%
Plan Weighted:		0.60%	0.20%

At the plan level, everything seems to be in order, but individual investors may have an issue. An investor who believes in passive management and has invested all of their account in Index Fund, is not contributing to the administrative costs of their plan. Instead, their portion of the recordkeeping fees is being subsidized by the investor who has invested entirely in Equity Fund A. This inequity is what is leading the retirement plan industry toward fee levelization, a process by which the allocation of administrative costs is spread equitably across plan participants.

Fee Levelization

At first glance, the recommendation would be to simply change the funds to share classes that all provide revenue sharing of 0.20%. The concern is that Index Fund only offers one share class, and Equity Fund's only other share class does not provide any revenue sharing. The next step and the most basic form of fee levelization is to utilize all funds that pay zero revenue sharing. Charges for recordkeeping and other administrative services can then be directly debited from participant accounts on either a pro rata or per capita basis. The problem arises when one or more of the funds do not offer share classes with zero revenue sharing. Without a complicated administrative process, allocating fees equitably now directly conflicts with the plan fiduciary's responsibility to select prudent investment options. Should the plan fiduciary remove a strong performing fund meeting all Investment Policy Statement Criteria, simply because it does not have a revenue sharing structure that fits plan goals? The answer is "no," and this is the first problem that new fee levelization systems are attempting to remedy.

The second issue that arises out of the basic form of fee levelization is that investment management fees often vary by share class. For simplification purposes, consider that an investment's expense ratio is broken up into two types of fees. The first is the portion that is kept by the investment manager to pay for the management of the investments. The second is revenue sharing. By subtracting one from the expense ratio we can get the value of the other. The chart below compares the A shares discussed earlier with their Instl shares counterparts. For this purpose Bond Fund has an institutional share class with zero revenue sharing available.

Current Scenario

Fund Name	Expense	Management Fee	Revenue Sharing
Bond Fund A	0.70%	0.50%	0.20%
Equity Fund A	1.00%	0.60%	0.40%
Index Fund	0.10%	0.10%	0.00%
Plan Weighted:	0.60%	0.40%	0.20%

Proposed Scenario

Fund Name	Expense	Management Fee	Revenue Sharing
Bond Fund I	0.50%	0.50%	0.00%
Equity Fund I	0.80%	0.80%	0.00%
Index Fund	0.10%	0.10%	0.00%
Plan Weighted:	0.47%	0.47%	0.00%

The switch from Bond Fund I was fairly straight forward. The Instl share class shares 0.20% less revenue, but the expense ratio is reduced by the same 0.20%. This leaves room to simply add the 0.20% recordkeeping charge, which was previously covered by revenue sharing, to the participant account. However, the change from Equity Fund A to Equity Fund I was not as simple. The I share was 0.20% less expensive than the A share, but offered 0.40% less revenue sharing. This means that the amount of money retained by the investment manager is actually higher. When a share class change results in a greater reduction in revenue sharing than expense, we call the change "inefficient." In the current scenario, the 0.60% expense is covering the costs of the investment management as well as the recordkeeping. Due to the inefficient change on the Equity Fund in the proposed scenario, the 0.20% recordkeeping fee would need to be added to the 0.47% expense ratio, resulting in a total plan fee of 0.67%. Basic fee levelization led to an increase in total plan fees of 0.07%.

Inefficient share classes are actually very common. Although we have yet to see a lawsuit against plan fiduciaries for moving to institutional share classes, it is likely only a matter of time. A recent fee lawsuit against Anthem, Inc. involving Vanguard funds surprised many. Vanguard is typically known for providing inexpensive mutual fund options. However, the lawsuit alleged that by selecting higher-priced share classes of mutual funds rather than lower-cost collective investment trust versions of those same funds, Anthem fiduciaries breached their fiduciary duty. In effect the plaintiff is stating that a fee cannot be reasonable, no matter how low it is, if you can get the exact same service for a lower price. (For more advanced readers - there is likely an argument to be made that a collective investment trust is not exactly the same service as a registered mutual fund). The same premise holds true when dealing with share class efficiency.

Recently, one of BFSG's clients underwent a DOL audit. The DOL auditor's questions about the retirement plan were more significant and extensive than we have seen before, largely targeted at the share classes offered to participants. The Plan was not utilizing the lowest cost institutional shares. Fortunately, with our assistance, the client had prudently documented the reason for keeping the share classes with higher expense ratios in the plan. Due to a lucrative legacy revenue sharing agreement with the plan's recordkeeper which provided a per capita revenue sharing amount, the share classes with high expense ratios were by far the most efficient. The revenue in excess of the recordkeeper's requirement was recaptured through a PERA and reallocated to participants periodically. A change to a lower cost share class would have resulted in an economic detriment to participants. The key here is the extensive documentation, which demonstrated that the use of the share classes with higher expense ratios had not occurred by mere accident. Ultimately, the DOL closed their audit with no findings regarding the share class usage.

The industry is working toward administrative solutions that will be able to accomplish fee levelization without forcing plan fiduciaries to make investment selection decisions based on available share classes, and allow the fiduciaries to utilize the most efficient share class. Only a few recordkeepers are currently able to effectively administer fee levelization. One solution includes crediting all of the revenue sharing from an investment back to the participants with assets in that particular investment and then applying the recordkeeping charge to each participant. Some recordkeeper's only have the ability to do this on a quarterly basis using the allocation at the end of the quarter to determine the reallocation back to participants. Unfortunately, this does not directly tie fee reimbursement to the participants who actually paid the fees as participants move their monies between funds on a daily basis. A better method is to consider average balance over the period, but very few recordkeepers have this capability streamlined. Even fewer recordkeepers have the ability to make adjustments on a daily basis, applying charges to participants who are actually underpaying, and credits to participants who are actually overpaying.

Conclusion

While fee levelization appears to be the future for the retirement plan industry, it is important for plan fiduciaries not to rush in and allow other areas of governance to suffer. A thorough process that examines and documents the impact of moving to such a system is necessary. Many view the transparency and equity that the process brings as straight forward, but in the current state of the industry it provides for additional layers of complexity that need to be managed in order to avoid potentially increasing liability.

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