Avoid Getting Sheared by Revenue Sharing

RETIREMENT SERVICES

It's not easy to track investment revenue shared with 401(k) plan recordkeepers—but fiduciaries must.

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The retirement plan industry has evolved rapidly in the last decade, driven in part by new regulations but also by new plan design concepts, investment solutions, and other initiatives aimed at helping participants achieve "retirement readiness." What hasn't changed much is how many plans pay recordkeeping fees. Recent litigation in the large-plan market, though, may provide an impetus for plan sponsors in all markets to consider fully transparent alternatives in the future.

Revenue Sharing

One of the most common approaches to recordkeeping fee payment is revenue sharing. Under these arrangements, some (or all) of the funds in a 401(k) plan's investment lineup pay a portion of their expense ratio to the recordkeeper to cover administrative fees (and sometimes pay broker commissions). There is nothing inherently wrong with this approach—neither the Employee Retirement Income Security Act (ERISA) nor the Internal Revenue Code prohibits it, and it is not particularly problematic when closely monitored.

Therein lies the problem.

A Duty to Monitor Fees

ERISA requires employers to ensure that plan costs remain reasonable. To do this, employers should be certain of a few key items:

- What is the "required revenue" that the recordkeeper needs to cover its fees?
- Is that level of required revenue reasonable?
- Is it competitive with comparable offerings in the marketplace?
- How much revenue do the funds in the plan share with the recordkeeper?

Far too often, employers evaluate recordkeeper capabilities and fees through an RFP process, establish new relationships with vendors whose fees and services fit their needs—and then they put the fee monitoring process on the back burner. It isn't until many years later that someone—hopefully not a representative of the Department of Labor or a plaintiff's attorney—points out to them that the recordkeeper's fees have become excessive.

That's the problem with revenue sharing in a nutshell, because it's "out of sight," it often falls "out of mind." And the consequences from losing sight of plan-related expenses can be severe, as experienced by City National Corporation, Lockheed Martin, and Kraft Foods, among notable others.

Better—and Simpler—Approaches

To avoid revenue sharing ambiguity, employers should opt for one of two alternative approaches. Either request that recordkeeping fees be calculated on a per-participant basis (e.g., $100 per-participant, per-year) or as a percent of assets (e.g., 0.25 percent of assets per year). Of these two approaches, only one—the per-participant fee—effectively prevents fees from becoming excessive as plan assets increase. It's important to note, though, as with any approach, these still require periodic benchmarking to ensure competitiveness.

What to Do With the Revenue Sharing?

With these alternative approaches, fund revenue sharing can still be used to offset administrative fees. In some cases, however, the funds will generate more revenue than is necessary to pay the fees. Under these circumstances, employers must be sure to either return "excess" revenue sharing from the funds to participants via a reallocation process, or deposit it into an "ERISA reserve" account from which permissible plan expenses may be paid.

Action Item

If you currently use revenue sharing to pay for recordkeeping fees, be sure the amounts retained by your provider are reasonable. As a best practice, and in light of current litigation, you might also want to consider one of the alternative approaches described above and avoid the revenue sharing trap altogether. Advisors with industry expertise can help you evaluate appropriate fee levels and understand the implications of different alternative fee structures for your participants and your plan management.

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