Control 401(k) Costs With a Zero Revenue-Sharing Strategy

A "Zero Rev" Approach is a fairer way to treat participants

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It's difficult for HR professionals to get an accurate read on the administrative costs of their 401(k) or other defined contribution retirement plans. One reason is the bewildering process known as revenue-sharing.

Revenue-sharing is the behind-the-scenes transfer of revenue from investment funds to the recordkeeper. In many cases, few if any payments are made directly by plan sponsors to their recordkeeping vendors for providing quarterly statements, web sites and day-to-day administration. The lack of payment, however, does not mean the administrative services are free. It more likely indicates that the recordkeeper receives the fees it needs, and the profits it desires, from agreements with the funds offered within the menu.

Plan sponsors are required to administer their plans in the most fiscally prudent manner possible. The responsibility for communicating with plan participants typically falls to HR. One strategy to help meet these requirements while simplifying the fee process and controlling costs is a zero revenue-sharing ("Zero Rev") policy.

Litigation Impact

Excessive 401(k) fees, including those siphoned off by revenue-sharing, have received increased attention, culminating in lawsuits against some of the nation's largest employers including Kraft, John Deere and Caterpillar, among others. While many of these suits eventually fizzled, Caterpillar agreed to pay $16.5 million to settle its suit in November 2009, and a significant judgment (final amount to be determined) was awarded against Edison International in July 2010.

The crux of these suits is that plans with hundreds of millions or more in assets should offer investment menus at a cost that reflects their buying power. Higher investment costs yield higher amounts of revenue-sharing, and plaintiffs argue that large plans should become less expensive, and more cost effective, as they grow. They suggest that plan sponsors should monitor the amount of revenue being paid and that participants should reap the benefits of the larger asset base through lower investment expenses.

A given fund might be offered in five share classes, each with a different expense ratio. The principal difference between share classes is the amount of revenue-sharing paid, with the most expensive versions paying the highest amount of revenue-sharing. Those behind the lawsuits seek to compel employers to use the lowest cost share class where it is available. Many employers and their HR departments might not even be aware of the cheaper share classes, and the amount of revenue a fund pays is often a deciding factor in whether or not a recordkeeping vendor offers it as a choice.

The main takeaway from the Edison case—at least from the plaintiff's side of the table—is that employers have an obligation to investigate and pursue low-cost versions of the investments they offer within their plan.

Even employers that strive to offer low-cost investments within their plans can unwittingly become involved in a potentially inequitable revenue arrangement if their plan offers company stock and self-directed brokerage accounts. In almost every case these investments pay nothing in the way of revenue-sharing. Participants with some or all of their assets in company stock and brokerage accounts are therefore contributing little if anything towards recordkeeping costs while the other participants using the core fund options within the plan are paying a disproportionate amount of fees via their investments.

This situation can be exacerbated (in the view of those looking to file lawsuits) if officers and executives are the primary beneficiaries of the company stock and brokerage accounts.

New DOL Rule

The U.S. Department of Labor (DOL) issued an interim final rule regarding the disclosure of soft dollar revenue, to become effective in July 2011. In the meantime, the new disclosure requirements related to the Schedule C of Form 5500 are already pushing much of this information into the public domain.

Barring a complete change of course on the part of Congress and the regulatory bodies, soon revenue-sharing must be disclosed. The vendors in the industry will be tightening the language in their agreements to make sure that the full responsibility for investment selection, and revenue-sharing, remains with the plan sponsors. The majority of plans meanwhile use investments that could be offered in a less expensive form or share class.

A 'Zero Rev' Solution

It is nearly impossible to create a situation where every menu option, including company stock and brokerage accounts, pays the same amount of revenue. In addition, it's neither practical nor fair to apply an asset-based fee to specific, non-revenue paying funds. That's because long-tenured employees with higher balances would pay disproportionately high fees (a 0.20 percent asset charge on a $1,000 investment pales in comparison to the same charge on a $500,000 investment). Continuing to use even modest amounts of revenue-sharing to pay the administrative costs means that the fees will continue to rise as the assets in the plan grow. Plan sponsors are certain to share the heat when this occurs.

A better way to treat participants in a fair and uniform manner is to avoid revenue-sharing. This can be achieved by using the "Zero Rev" approach: changing the pricing arrangement to a flat, per-head fee and using investments that pay no revenue-sharing. Under Zero Rev, fees are linked to the number of participants in the plan (more participants equals more fees for the recordkeeper; the reverse is also true). The growth of the assets is not a factor, and investment expenses are dramatically lower.

Overcoming Obstacles

Although the Zero Rev approach seems straightforward, there are a number of issues for retirement plan managers to consider. One of the most significant issues involves communication to plan participants.

Plans heavily reliant on revenue-sharing do not, by design, impose hard dollar fees directly on participants, as all of the freight is borne silently by the investments. Those contemplating this change should be prepared to deal with negative feedback from participants who might perceive this as a fee increase, even though the reality is that eliminating revenue-sharing might have reduced fees.

In addition, be prepared for pushback from those participants that will pay increased fees (a new annual fee on those who previously held all assets in company stock or brokerage accounts). HR managers uncomfortable with discussing the previous level of revenue-sharing might find it difficult to convey the "before" and "after" of fees with this change in approach.

Another obstacle can come in the form of the universe of investments made available by the recordkeeper. For example, if a group annuity policy is the backbone of the investment menu, it's likely not possible to remove revenue-sharing as it is embedded in the fabric of the contract. Moreover, some of the largest recordkeepers typically associated with mutual funds require that a certain amount of their proprietary funds, which are not available in non-revenue share classes, be offered within the menu.

And some recordkeepers might refuse to price their services on a per-head basis, as it prevents their fees from rising when plan assets appreciate.

Apart from the restrictions of the recordkeeper, one of the biggest hurdles comes from the mutual fund industry, which has grown with the 401(k) industry and has willingly structured itself to accommodate the pay-to-play, revenue-sharing approach. There are many mutual fund families that simply do not offer share classes that don't pay revenue-sharing fees. Eliminating revenue-sharing might require excluding from consideration some funds commonly offered in 401(k) plans.

Finally, any plan sponsors looking for the purely level playing field are not going to be able to use the services of a broker for their plan. There is no way to pay a pure broker (one not licensed to accept fees vs. commissions) if none of the investments involved pays finder's fees or 12b-1 fees. Moreover, even those advisors who are purely fee-only typically charge an asset-based fee, which again involves a significantly higher fee (in terms of dollars) for participants with large account balances.

The Zero Rev solution is, therefore, available only to those plan sponsors who partner with a recordkeeper that agrees to price their services on a per-head basis and offers an open architecture approach to the investment menu.

HR professionals at small companies will probably find that current recordkeeper and fund company practices exclude the Zero Rev approach, at least for the time being. Ultimately, regulatory changes might compel significant movement on this issue.

Questions for Your Recordkeeper

Regardless of the size of the plan, HR should demand an analysis of all fees related to the plan from the retained advisor, particularly those related to revenue-sharing. Here are a few questions benefit plan administrators might ask their recordkeepers to help determine whether a Zero Rev approach makes sense for their plan. Responses should come in writing and provide details on a fund-by-fund basis:

- **How much did the recordkeeper receive** in the prior two calendar years in the way of soft dollar revenue-sharing payments?

- **Is the recordkeeper willing to price services on a per-participant basis** with revenue-sharing amounts eliminated from the plan or credited back against the per-participant fees?

- **Can the recordkeeper provide a listing of less expensive share classes** of the existing funds in the menu that are available on their platform?

- **Can the recordkeeper verify** which, if any, funds available on their platform do not offer revenue-sharing fees?

- **Is the recordkeeper willing to reduce its fees** once the participant count reaches a particular figure?

In addition to recordkeeper queries, HR departments might want to assess how the potential changes inspired by trial lawyers or required by regulators might impact their plans, including:

- **Are the funds in our plan's share classes** available in less expensive classes/forms?

- **When did we last benchmark** the current recordkeeping and advisory fees we are paying for our plan?

- **When was the last time we pursued a reduction** in recordkeeping fees for our plan?

- **Would eliminating revenue-sharing reduce the number of funds** being screened for our plan? If so, would this have a potentially negative impact?

- **Do we pursue less expensive share classes** for the investments in our plan as the assets increase?

- **Does our plan's investment policy statement** accurately reflect the limitations of the recordkeeper regarding fund availability and revenue-sharing requirements?

The legal and regulatory environment makes the time it takes to pose these questions and document the answers a worthwhile investment for plan sponsors. If Zero Rev or similar approach is a viable option for a company's 401(k) plan, HR should be the catalyst for bringing the changes to the attention of senior management as well as communicating the information accurately to plan participants.

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