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Leveling the Playing Field - Moving Past Revenue Sharing in Defined Contribution Plans

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Today many 401(k) and 403(b) plans pay for the cost of recordkeeping fees through revenue sharing that exists as one component of a mutual fund's expense ratio, but did you know that these amounts can vary among funds? Some of your participants could even be paying significantly more than others, despite the fact that everyone in the plan has access to the same recordkeeping services. This arguably inequitable distribution of plan administration fees is causing plan sponsors to take a closer look at the revenue sharing in their plans to determine if there is a better way to cover plan expenses.

What is Revenue Sharing?

Certain components of a mutual fund's expense ratio, including 12b-1 fees, sub-transfer agency fees, and shareholder servicing fees, are commonly referred to in the defined contribution world as revenue sharing. The practice of revenue sharing originated as a way for mutual funds to pay for maintaining investment records at the individual participant level. Today, revenue sharing is often paid to the recordkeeper, or the plan itself, and is a way to offset the cost of overall plan administration. Historically, most plan sponsors have simply used revenue sharing to cover the costs of running the plan.

Non-Level Recordkeeping Fees

More recently, plan sponsors have been looking for alternatives to revenue sharing due to the lack of transparency and potential inequality of how recordkeeping fees are allocated.

In the example below, two participants with the same balance, but different investments, pay different amounts towards recordkeeping. Participant A pays $113 or 0.25% annually, while participant B only pays $53 or 0.12%.

Participant A: $45,000 balance

Investment Selection	Expense Ratio	Revenue Share
Active Large Cap Growth Fund	0.85%	0.25%
Passive Large Cap Blend Fund	0.05%	0.00%
Active Small Cap Fund	1.10%	0.50%
Weighted Average Totals:	**0.67% ($300)**	**0.25% ($113)**

Participant B: $45,000 balance

Investment Selection	Expense Ratio	Revenue Share
Passive Intermediate Bond Fund	0.07%	0.00%
Passive Large Cap Blend Fund	0.05%	0.00%
Active Foreign Large Blend Fund	0.84%	0.35%
Weighted Average Totals:	**0.32% ($144)**	**0.12% ($53)**

This difference occurs because mutual fund companies have different revenue sharing agreements with the recordkeeper. While there is no legislation requiring that revenue sharing be equitable, the Department of Labor (DOL) has indicated that how plan sponsors allocate plan expenses is a fiduciary decision.

What is Fee Levelization?

Fee Levelization is a method by which all participants pay a similar amount or percentage of invested assets for recordkeeping. This can be accomplished in two primary ways: by offering investment options that don't share revenue, or by leveling recordkeeping fees through an accounting mechanism.

1) Zero Revenue Sharing Approach

Having an investment menu made up of only zero revenue sharing options is a simple solution that has gained in popularity, and can be used by virtually any recordkeeper. In the example below, zero revenue sharing mutual funds are used to populate the investment menu. In order to pay for the plan's recordkeeping and administrative costs, which in this example is 0.15% on plan assets, the same asset-based fee is assessed to each participant account.

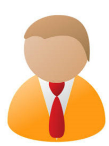
Participant A: $45,000 balance

Investment Selection	Expense Ratio	Revenue Share
Active Large Cap Growth Fund	0.50%	0.00%
Passive Large Cap Blend Fund	0.05%	0.00%
Active Small Cap Fund	0.80%	0.00%
Weighted Average Totals:	**0.45% ($202)**	**0.00% ($0)**
Asset Based Fee	**0.15% ($68)**	
Total Participant Cost	**0.60% ($270)**	

The challenge for plan sponsors is that not all fund companies offer zero revenue sharing options; this may limit the universe of available investment options.

2) Debit/Credit Approach

Another solution that may be considered is a debit/credit approach that equalizes recordkeeping fees. In the example below, an accounting method is used to credit or debit participant accounts based on the specific funds held and the 0.15% asset-based recordkeeping costs of the plan.



Participant A: $45,000 balance

Investment Selection	Expense Ratio	Revenue Share	Credit/ Debit	Net Expense	Net Rev Share
Active Large Cap Growth Fund	0.85%	0.00%	-0.10%	0.75%	0.15%
Passive Large Cap Blend Fund	0.05%	0.00%	0.15%	0.20%	0.15%
Active Small Cap Fund	1.10%	0.00%	-0.35%	0.75%	0.15%
Weighted Average Totals:				**0.57% ($256)**	**0.15% ($68)**

The benefit of this approach, in addition to fee levelization, is that it allows a plan sponsor to retain the same universe of investment options without the need to make fund changes. Unfortunately, not all recordkeepers currently have the systems capabilities to offer the debit/credit approach, but many are investing in technology upgrades that will allow them to offer it.

As part of the overall fee review, plan sponsors are also considering the benefits of a flat per-participant fee, frequently referred to as a per capita fee. For this option, Committees may want to examine the demographics of the plan and the philosophy of the organization. A per capita fee could most negatively impact participants with a low balance, but there are potential solutions to this problem. For instance, some plan sponsors have considered paying the cost for participants with a balance under a certain threshold. While this is uncommon, there are potential solutions based on the preferences of the plan sponsor and the abilities of the recordkeeper. As with any of these solutions, plan sponsors will want to think about how this “new fee” will be viewed by participants and consider a thoughtful communication strategy to address potential participant concerns.

Final Thoughts

Plan sponsors should be aware of all fees paid, especially those paid by participants. Revenue sharing has worked well historically, but more plan sponsors are going beyond ensuring that overall plan fees are reasonable and are recognizing that these costs may not be shared equally among participants. To address this problem, a move towards fee levelization can change the game for plan sponsors and help to level the playing field.

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