Revenue Sharing in DC Plans: What Does It Mean for Plan Sponsors?

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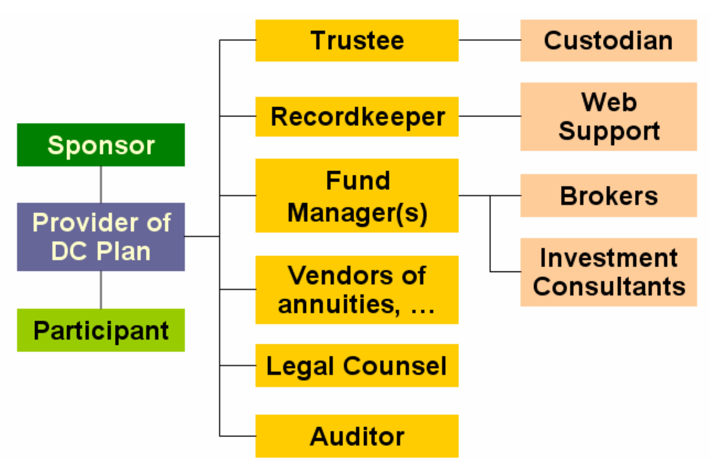
The Department of Labor places fiduciary duty on companies sponsoring defined contribution (DC) plans to pick and monitor plan providers carefully and to ensure that charges for the many services needed to operate such plans are reasonable. Accordingly, plan sponsors must understand their plans' features and compensation structure. Fund managers often share revenue with plan providers, who may then compensate parties rendering ancillary services. Many fee-sharing arrangements are opaque; plan providers do not always volunteer the details of their revenue-sharing arrangements. Below, we discuss some pitfalls plan sponsors may face by not assertively managing DC plan fee revenue sharing; we suggest some questions that plan sponsors should consider asking.

DC plans are complex and require a host of services to operate effectively. Service providers deserve to be compensated, but plan sponsors may not understand their DC plans' flow of fees and revenue-sharing arrangements.

Most plan providers – usually banks, mutual fund companies, or insurance companies – are general contractors. They subcontract with (and compensate) others to manage recordkeeping, trustee functions, fund management, and provision of annuities and other investments. Service providers can in turn subcontract services. For example, trustees may subcontract with custodians, recordkeepers may subcontract with web design and web hosting firms, and fund managers may subcontract with brokers and investment consultants. The figure below illustrates these relationships.

Possible financial stakeholders in a DC plan



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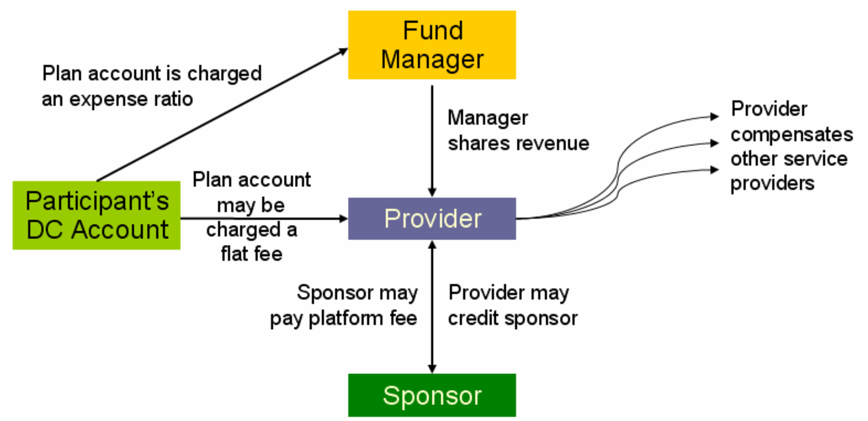
The fee flow can get complex. Ultimately, all services are either charged against participants' accounts or paid for by sponsors. Participants pay fees to fund managers, typically as a percentage of assets ("expense ratio") that varies with fund type. Fund managers share revenue with plan providers, who may receive additional revenue as per-participant "platform fees" from sponsors or per-fund recordkeeping fees from participants' accounts. Providers later compensate other service providers – see the figure below.



The magnitude of compensation depends on plans' assets, number of participants, and complexity. Fund managers typically earn more net compensation than other parties. Expense ratios typically vary inversely with plan size, but not by much. Recordkeeping costs enjoy larger economies of scale and typically constitute 1% to 10% of total fees, depending on plan size. Trustee costs are typically modest and vary little.

Plan sponsors may not understand revenue sharing clearly. A 2006 survey by Deloitte Consulting, International Foundation, and International Society of Certified Employee Benefit Specialists asked plan sponsors about disclosure by providers. Thirty-seven percent indicated that their providers did not fully disclose their costs, and 44% said that their providers did not fully disclose revenue-share arrangements. So a sizeable fraction of sponsors cannot assess how much their providers profit from their plan.

We now highlight the main fees and suggest questions that plan sponsors should consider asking themselves and their plan providers.

Fee	Explanation	Questions to Consider
Fund management	Ongoing fund maintenance expenses for research, portfolio selection, and compliance.	What management fees are charged for each fund offered? How do they compare with similar funds' fees?
12b-1	To defray marketing and distribution expenses. Often waived on institutional funds.	DC plans require minimal marketing; are you charging 12b-1 fees?
Sub-transfer agent	To process orders, maintain shareholder records, manage dividends, etc.	Who is performing these functions? The fund's transfer agent or recordkeeper?

The fees described above are expressed as a percentage of assets and charged annually against DC plan assets. Their sum is the fund's expense ratio. Averaged over all fund options offered by their plans, half of the reporting sponsors responding to the aforementioned survey had expense ratios of 51-85 basis points. (Larger plans tend to have lower ratios.) Do you know the average expense ratio of your plan's funds? How does it compare? Remember, every basis point of expense reduces participants' realized returns.

The expense ratio of funds that invest in other funds – such as life-cycle funds and some international funds – is typically only a "wrap fee" for the parent fund. Plan sponsors could ask about fees charged by underlying funds, as participants ultimately bear these, too.

Expense ratios are widely used to summarize ongoing expenses. But they might only be the start, not the end, of sponsors' fee discussions with providers. Additional fees may apply:

Fee	Explanation	Questions to Consider
Platform fee	A per-participant fee paid by the sponsor to the provider. May supplement or partially substitute for revenue shared by fund managers.	What, if any, trade-offs exist between funds' expense ratios and platform fees?
Front-end sales load	One-time fee, charged at time of purchase. In 2006, 75% of mutual funds held in 401(k) plans had no sales load.	Most purchases are automated; why not offer a no-load fund?
Back-end sales load	One-time fee, charged at time of sale to discourage frequent trading. Usually decreases to zero over time.	Why carry mutual funds with back-end sales loads when no-load funds with the same investment strategies may be available? Is the plan large enough to qualify for "institutional" rates – no loads, low or no 12b-1 fees?
Surrender charges	Fees charged for terminating annuities early.	Are surrender charges competitive and disclosed clearly in the prospectus?
Transaction costs	Brokerage costs incurred as funds buy and sell underlying securities (as distinct from plan participants buying fund shares). These costs are rarely disclosed. Actively managed, small cap, and smaller funds can incur costs exceeding 100 basis points – on top of their expense ratio.	For each fund offered, what has the annual transaction cost been for the last three years? Does the provider offer index funds with lower transaction costs?

If you can't answer the questions posed above, you may be risking your participants' returns – and exposing your company as plan sponsor to additional risk.