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Fee Levelization and Defined Contribution Plans

The growth of 401(k) or Defined Contribution (DC) plan investments has been on a steady climb since the beginning of this century. As of September 2019, investors held about $5.9 trillion in assets within 401(k) plans. Nearly 10 years before that, the number was $3.1 trillion and in 2000 assets stood at about $1.7 trillion. Of last year's total tally, approximately $3.7 trillion was held in mutual funds alone.[1] Due to this growth, the topic of fees is more important than ever.

Prior to 2011, mutual fund managers had little motivation to disclose fees—administrative or otherwise. There were few regulations in place to encourage fee disclosure, and generally not much impetus from sponsors or participants demanding more transparency. However, this attitude has shifted dramatically over the past decade, which has put pressure on the industry, government, and regulators to respond.

The clearest direction to date comes from the Department of Labor (DoL)'s guidance to ERISA Section 408(b)(2), which required service providers to give plan sponsors all the fee information they need "in plain English." As part of this guidance, plan fiduciaries must be able to assess the reasonableness of fees, identify conflicts of interest, and satisfy their fiduciary disclosure and requirements.

By shining a light on this issue, plan sponsors have had to rethink their models. Complicated fee structures invited a rash of litigation. The revenue-sharing model that was being employed allowed mutual funds within the same retirement plan to employ varying revenue sharing rates that could vary significantly from one investment option to the next. Charging uneven rates between investment options meant some participants paid a disproportionate share of the costs for maintaining the plan.

Plan Assets in 401(k)s

[1] Investment Company Institute, The U.S. Retirement Market, Q3 2019

It's important to underscore that administrative fees can pose litigation risk if the plan sponsor fails to negotiate the best price and/or leverage the size of their plan to reduce fees. **To ensure that a plan sponsor is fulfilling their fiduciary responsibility, the key is to maintain fee transparency and avoid subsidization of recordkeeping fees with hidden administrative fees.**

Moreover, fees that are not transparent make it harder to determine how and what services were provided, how providers were being compensated to assess potential conflicts of interest, and how fees might impact performance.

One solution has been to introduce fee levelization, a fee collection method that enables retirement plan fees (i.e., participant services, recordkeeping, compliance, and more) to be shared amongst all participants in an equitable fashion. Let's take a closer look at some of the key issues.

Avoiding Risk and Litigation

There are many reasons for plan sponsors to scrutinize fees—but one important reason is to mitigate litigation risk. A recent report from the Center for Retirement Research at Boston College notes that excessive fees are one of the three main reasons for litigation against 401(k) plan sponsors, in addition to inappropriate investment choices and self-dealing. In 2016 and 2017, there were 107 lawsuits filed – the highest level since the Financial Crisis of 2008.[3]

Because lawsuits are prevalent, and plan participants ever vigilant, plan sponsors are more vulnerable to litigation depending on their investment choices. According to the same report, to help prevent lawsuits, fiduciaries should select funds that charge no more than a "reasonable fee," while at the same time periodically assessing fees going forward to ensure both reasonableness and consistency. Plan sponsors must establish that they are taking the right measures to ensure they are offering the lowest-cost version or "share class" of a specific fund. Offering funds that are in the more expensive "retail" share class when a lower cost institutional fund is available is a practice that may put a plan sponsor at risk.

In 2017, property management firm Greystar found itself dealing with a class-action suit alleging it breached its fiduciary duties by allowing excessive administrative and investment fees to be charged.[2]

Pitfalls of Revenue Sharing: Disparate Payments and the "Free Rider Effect"

In some cases, revenue sharing was provided to plan sponsors by recordkeepers or mutual fund companies as a way to cover administrative expenses by collecting expenses and then refunding them back to the plan sponsor. Unfortunately, even though this system worked well for plan sponsors looking to cover fees without alarming participants, not all mutual funds charge or pay at the same levels of revenue sharing. Some funds have no revenue sharing whatsoever. Participants within the plan may not realize that those who invest in a mutual fund with a higher revenue-sharing fee will end up paying the bulk of the administrative costs for the plan (and support co-workers' plan costs, which is sometimes known as the "free-rider effect").

Addressing the inequality of the revenue sharing model has been a key driver for a better system. It's known by many names: Revenue sharing, 12b-1 fees, sub-transfer agency fees, shareholder servicing fees and profit-sharing payments. Regardless of the names, the fees work to cover recordkeeping, accounting, and other administrative costs, and can reach as high as 100 basis points annually. Essentially, fees are collected from plan participant accounts, via their mutual fund investments, and shared with the recordkeeper to cover their own costs. In some cases, recordkeepers will pass some of those cost offsets back to the plan sponsors to help offset their own plan costs. Rebates are, on occasion, offered back to plan participants, as well.

Up to this point, the discussion has centered on fee rebates and recordkeeper transparency. However, we have also noted that even in revenue-sharing arrangements, fee payments can be disproportionate and unequal. Fee levelization is a system whereby plan sponsors split administrative fees equally among all employees enrolled in the plan.

[2] "Excessive Fee Suit Filed Against Greystar Management", Planadviser, May 16, 2019
[3] "401 (k) Lawsuits: What are the Causes and Consequences?" George S. Mellman, Geoffrey T. Sanzenbacher, Center for Retirement Research at Boston College, May 2018

Fee Levelization:
Rebalancing the Equation

In order to re-balance the lopsided nature of expense sharing within plans, "fee levelization" can be implemented to allow recordkeepers to administer programs so that every investment option has the same revenue-sharing percentage amount. By doing this, all plan participants pay an equal share of the administrative costs, regardless of funds used or revenue provided.

Two things occur when fee levelization is instituted:

- ☑ Employees are treated more equitably, and
- ☑ plan sponsors mitigate liability risk.

The first step of fee levelization involves establishment of required revenue, which covers administration fees. Each investment then has a percentage of revenue sharing available, which is assessed against the levelized administration cost.

For example, if a fund had a revenue-sharing component of 0.10% and required revenue was 0.50%, the plan fee would be leveled by 0.40%, meaning that participants would pay 0.40% to the recordkeeper. If the Fund's available revenue sharing was 0.60% and the required revenue was 0.50%, the fee would be leveled by −0.1%, meaning that participants would receive a credit back of 0.10%.

Fund Name	Revenue Sharing	Required Revenue	Plan Credit (-) or Fee (+)
Fund A	0.50%	0.50%	0.00%
Fund B	0.10%	0.50%	+0.40%
Fund C	0.60%	0.50%	-0.10%

Fee Levelization Options:
Per-Capita versus Pro-Rata Allocation

Even within fee levelization there are a variety of options for plan sponsors to consider. For example:

1) **Under a pro-rata model**, participants will pay a percentage of their account balance with those at the highest balance paying the higher amounts.

2) **Under a per-capita model**, means each participant is charged equal dollar amounts regardless of the account size or balance.

There are also hybrid versions of fee levelization that combine both pro-rata and per-capita methodologies. In a hybrid model, flat rates may be charged for each account per quarter. A flat dollar amount might make administration easier, especially in light of more stringent disclosure requirements.

Towards a Prudent Process

Plan sponsors have myriad decisions to make when structuring the right DC plan for their plan demographics, workplace, and the variety needed to ensure plan members are adequately served by their retirement savings plan. One of the decisions must center on transparency and fairness of fees. Fee levelization is one important tool to consider when achieving consistency and fairness in the distribution of administration fees for plan participants, regardless of account size. Plan sponsors will also want to consider how best to create a fee structure that mitigates risk and litigation.

As plan sponsors are the fiduciaries of their DC plans, it is critical to consider the best possible outcomes for plan participants' retirement savings. Going forward, one of the important issues you will have to consider is how adopting fee levelization can equalize fee payments, make them more transparent, and provide a structure that is compliant with DoL rules and regulations.

Takeaways and Considerations

All DC plans are different. The investment options offered as well as the size, the participant population and the membership, participation all affect the makeup of each plan. Because there is no one-size-fits-all approach, different fee structures will be required for the different plans available.

There are many choices to consider and varying tax benefits, depending on the option you choose, and plan sponsors should have a list of questions to ask recordkeepers to help them ensure they are fulfilling their fiduciary responsibilities.

Plan sponsors may want to consider how larger plans compare to smaller plans in terms of their revenue-sharing fee structures. It is important to consider methodologies for sharing revenue credits, paying for revenue shortfalls and/or structuring fees on a pro-rata, per-capita, or hybrid model.

Every plan will have a diverse set of earners, and plan sponsors will need to consider if they (or others) should share a disproportionate share of the tax burden. All plan designs and fee structures need to be considered in the context of innovation and what fits your plan versus simply looking at costs as the key decision-making driver.

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