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Evaluating Investment and Advisory Fees: Plan Sponsors Face a Challenge

by Mary L. Patch, QKA, QPFC

There have been many articles in the media as of late focusing on retirement plan fees. As the legislators continue to evaluate fees within retirement plans, plan sponsors should continue to demand their service providers' move towards the disclosures outlined in the proposed 408(b)(2) regulations. It is up to the plan sponsor to determine if the compensation for services provided is appropriate.

This process can be challenging for a plan sponsor. There are no standards in place to determine the "appropriateness" of fees a plan should pay. Each provider can offer a slightly different basket of services and charge any level of fee they desire. It is important to remember the cheapest solution is not always what is best for the participants. There are many other aspects of the plan that the fiduciary must take into consideration during the evaluation process.

Fees within a plan include investment management; administration, recordkeeping, communication and education; financial advice to participants; and plan sponsor investment consulting. The level of services in each of these areas may vary based on the provider's service model. It may also vary based on the level of fiduciary responsibility the provider may or may not contractually accept. Because of these moving parts, it can be difficult to create an "apples to apples" comparison of fees from one platform to another. Therefore, reviewing fees strictly on the basis of determining an "all in" fee can be somewhat dangerous for a plan sponsor.

When reviewing the investment management expense of a mutual fund, it is important to understand the variations that exist in the marketplace. The expense ratio is similar to

the cost of running a business. There are fees associated with managing an investment, just as there are fees for operating a business. The main component of the expense ratio is the cost of the management of the fund. Reviewing this portion of the expense ratio will help the plan sponsor determine how much they are paying for active management.

The plan sponsor should review the "R Squared" statistic of the fund. This statistic quantifies the level of active fund management that is occurring. On a scale of 1 to 100, the lower the R Squared for the fund, the more active

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fund management is occurring. If the R Squared factor is 95 or higher, it is considered to be a "shadow index fund," meaning only 5% of the performance is generated by the manager making investment decisions that affect performance.

A fund with a high R Squared factor should theoretically have a lower expense cost. This point of contention is the premise of the class action lawsuit brought against Northrup Grumman. The case is based on an alleged fiduciary breach that the plan sponsor "Failed to inform themselves of, and understand, the various methods by which vendors in the 401(k) retirement industry collect payments and other revenues from 401(k) plans." The allegation states the employees of Northrup Grumman were led to believe they were paying a fee for active fund management; however, they were not receiving that service.

Another factor of the expense ratio is the distribution expense, commonly known as commissions or 12(b)1 fees. Mutual funds may compensate a registered representative of a broker-dealer for making their fund available to the representative's clients. The mutual fund may pay a one-time "finder's fee" to the representative for transferring a plan into their funds. They may also pay that representative a front-end (at the time of purchase), back-end (at the time of sale) or ongoing commission on those investments. Recently, fund companies have also developed different share classes specific to the retirement plan industry, referred to as R Shares, to facilitate payments to the representative.

For a plan sponsor to determine how much a registered representative is paid for his or her services, they should understand the various types of share classes and compensation structures. As an example, the American Funds offer five different retirement share classes that vary by the ongoing commission [or 12(b)(1)] being paid to the representative for providing services to the plan. Depending on the total assets in the plan and the level of services being provided, one share class may be more appropriate than the other.

Share Class	Ongoing Commission
R1	1.00%
R2	0.75%
R3	0.50%
R4	0.25%
R5	0.00%

The ongoing commission is built into the expense ratio of the fund, thereby automatically reducing the performance of the investment. In a broker-dealer environment, the representative has the flexibility to determine which of the share classes is in line with what he or she would like to be paid. This method is an acceptable compensation structure; however, it is important for the plan sponsor to challenge this arrangement if they deem the level of compensation to be inappropriate.

Another factor of the expense ratio is the existence of sub-transfer agency fees or revenue sharing. As a practice of business, a mutual fund company will compensate a custodian for maintaining the records of their mutual fund. If the custodian maintains an account for an individual, they retain those fees. If the custodian provides services to a pooled retirement plan account and without providing recordkeeping or shareholder services to each participant, they may revenue share with the recordkeeper of the plan. If they are the custodian and also the recordkeeper, they may utilize a portion of the fund cost to help subsidize the plan expenses. It is also possible for a recordkeeper to "recapture" any 12(b)1 payments that are not being paid to a broker-dealer.

Revenue sharing is not necessarily a bad practice. All providers incur costs for maintaining the records of a retirement plan. It is the lack of disclosure of these arrangements and whether or not the revenue sharing is a motive for the funds being selected for the plan that should be questioned. If the funds being offered are selected solely on the basis of giving the plan sponsor the appearance of having an inexpensive plan, this misrepresentation could be considered a breach of fiduciary responsibility on the part of the plan sponsor and the representative making the recommendation.

Not understanding the flow of revenue sharing within a retirement plan can compromise the plan fiduciaries. However, if the revenue sharing credits are used in connection with an ERISA account, this arrangement can provide the employer with flexibility in paying the plan fees. By funneling the credits offered into a separate account, the plan sponsor can then determine which fees they will pay and which will be offset by the credits available in the account. By moving towards compliance with the proposed 408(b)(2) regulations, a plan sponsor may gain better understanding of these arrangements.

The plan sponsor always retains fiduciary liability for the plan no matter what type of advisor they select, but it is important to understand the terms of the advisory contract. It is up to the plan sponsor to understand what liability is transferred to their advisor and what remains with them through this contract. It should detail the scope of the advisory services and whether they will act in a fiduciary or non-fiduciary capacity with respect to the plan *and* its participants. The advisor may acknowledge fiduciary responsibility under ERISA 3(21)(A), ERISA 3(38) and 405(d)(1) – or not at all. The fee the advisor receives should be based on the level of fiduciary responsibility he or she accepts. If there is no assumption of responsibility, the fee should be significantly lower than that of an ERISA 3(38) independent fiduciary.

On May 4, 2006, W. Scott Simon wrote an article for Morningstar.com entitled "Fiduciary Focus: Non-Fiduciary Investment Consultants" that summarizes the different types of advisors and contracts that exist. In this article he details the "beautiful world" that can exist if a plan sponsor hires a consultant that accepts in writing their status as an ERISA 3(38) "investment manager" and ERISA 405(d)(1) "independent fiduciary." He quotes Fred Reish in the article stating "An ERISA-defined investment manager/independent fiduciary, therefore, takes on much of the decision-making and removes from the shoulders of the plan fiduciaries virtually all of the fiduciary responsibility."

A plan sponsor not familiar with the various fee structures available in the marketplace should consider hiring an independent firm ***specializing in ERISA plans*** to review the fees for them. This type of advisor is familiar with the varying services that can be provided to a plan and understands the terms of ERISA that must be followed when reviewing the fees. The ERISA advisor's compensation should be calculated as a flat fee or a percentage of the assets in the plan. He or she should not represent any particular "products or investments" that would create a conflict of interest during the review.

It is important to know that reviewing the fees associated with a plan is not limited to evaluating "all in" costs. Understanding how the "all in" cost is derived and who is being compensated what for the services will ensure the plan sponsor is meeting their fiduciary duty. If the IPS is not adhered to and necessary services are not being provided to the plan participants, having an "all in" inexpensive plan will not absolve the plan sponsor of their other fiduciary obligations.

As an example, if the sponsor's investment committee lacks the expertise to effectively review the investments, it would not be in the best interest of the employees to eliminate an independent fiduciary's services, nor his or her fee. Similarly, if your employees need independent advice to ensure they make the appropriate investment decisions, this service should not be eliminated either. By shopping for the lowest "all in" costs, the plan sponsor may be accepting more liability for their plan and the participants than they realize. If the sponsor does not want to accept the liability for the fund selection, it would be important for them to hire an ERISA 3(38) fiduciary for a fee.

Conclusion

In summary, if a plan sponsor creates a detailed list of necessary services, determines an appropriate fee to provide each service and implements a strategy to continually evaluate the "reasonableness" of those fees, they can be assured they have met their fiduciary duties. A sponsor has not met their fiduciary obligation by simply reviewing the "all in" costs associated with their plan. It is important the plan sponsor understands the fees for services provided and documents the decisions they have made. These efforts will help them ensure their plan participants have all the tools necessary to guide them to a successful retirement at a reasonable cost.

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