INDUSTRY VOICES June 6, 2014

(b)est Practices: What Do You Know About Revenue Sharing?

June 6, 2014 (PLANSPONSOR.com) – What do you know about revenue sharing? If your answer is anything other than, “a lot”, it’s really important that you read on.

By PS

Almost all retirement plans participate in some form of revenue sharing, so don’t think this doesn’t apply to you. Without a good understanding of the revenue sharing taking place in your plan, you cannot possibly be fulfilling all of your fiduciary obligations.

Revenue sharing is the *secret sauce* that makes plan economics work. Technically, thanks to the recent 408(b)(2) fee disclosure regulations, it’s not really secret anymore, but to the average plan sponsor, it might as well be. The dots are disclosed, but they can be very hard to connect. You need to spend some time to get up to speed on this topic.

The retirement plan industry is loaded with jargon, which can frustrate a well-intentioned employer. But, since the jargon is there, you either need to learn it or hire an expert to help you. What do you know about 12b-1 or sub-TA? They are at the heart of revenue sharing, so let’s take a look at each.

12b-1 fees, a/k/a “trails” or “service fees” are monies paid by fund companies to broker-dealers to service the funds’ clients. They are often expressed as a number of “basis points”, or one-hundredths of a percent. 12b-1 fees are part of a fund’s expense ratio. For example, if the XYZ Growth fund’s expense ratio (annual operating expenses) is 1.00% and it pays a 12b-1 fee of 0.25% (25 basis points), that means 0.75% of the fund’s assets go toward other expenses annually.

Traditionally, 12b-1 fees have been sent to the broker of record on an account, and although disclosed in the fund’s prospectus, the investor never sees them. It’s a way for the broker to get paid for the time and responsibility they incur over the year watching over the client’s account. It’s a legitimate form of compensation in the context of individual investment accounts.

However, in the qualified plan world, such as 403(b), 401(k), defined benefit and profit sharing, the decision-makers are held to a fiduciary standard. Fiduciaries have many responsibilities, one of which is to understand the compensation being paid to service providers and to determine whether that compensation is reasonable.

12b-1 payments are generally handled in one of two ways: paid directly to the plan’s broker, or paid into an account over which the fiduciary has control. This latter arrangement is often referred to as an “ERISA account” or a “plan expense reimbursement account.” In both cases, the plan’s fiduciaries are obligated to understand the amount of payments being made, and they are obligated to ensure that any plan costs are reasonable. The recent 408(b)(2) regulations require that these payments be disclosed to plan fiduciaries at least annually. However, it’s a rare fiduciary that has read through and understood a fee disclosure report. You should be that rare fiduciary. Ask your providers for a detailed plain-language explanation of the fees your plan is incurring.

In the case of 12b-1 fees being paid directly to the broker, there are two issues that should be of concern to the plan’s fiduciaries. They both center on the reasonableness issue. How much are they getting, and what are they doing to earn it? Since it's going directly from the fund company to the broker, you can't intercept this money. The broker is going to get it. So, the question turns to the value the plan is receiving from the broker. Some brokers earn their keep and others are largely absent. If, as a fiduciary, you allow a service provider to receive more compensation than they have actually earned, you have engaged in a "prohibited transaction" (PT). The consequences for engaging in PTs can be very unpleasant. Remember, fiduciaries are there to look out for the interests of the plan's participants, period.

The second issue with 12b-1 fees going directly to a broker centers on the issue of "advice". Each fund determines the level of 12b-1 fees it pays. The amounts can range from zero to 1.00%. While most are 0.25%, it is common for money market funds to pay zero and for bond funds to pay 0.10% to 0.15%. The Department of Labor is quite concerned about service provider conflicts of interest. If a broker is giving advice to a plan or its participants, they have some ability to control the flow of money into different investments. If the level of the broker's compensation varies from fund to fund, they can potentially steer plan assets away from lower-paying funds. That would be a prohibited transaction, and the plan's fiduciaries would have engaged in a PT by virtue of having allowed this to happen.

This creates an interesting conundrum in any instance where the broker receives "non-level compensation" (differing amounts of 12b-1 income from options on the plan's fund menu). If they are providing advice, it's a PT. If they aren't providing advice, how are you justifying their compensation? What exactly are they doing to earn what they are getting paid? If their lack of providing advice makes their compensation unreasonable, that's a PT as well. You *need* to examine these issues in the context of your own plan, and to take any remedial action as may be necessary.

Sub-TA credits are the other form of revenue sharing. Traditionally, these payments have gone directly from the fund company to the plan's recordkeeper. They are a form of reimbursement for work the fund company would normally do, but which has been "outsourced" to the plan's recordkeeper. For example, if the XYZ Growth Fund was on a qualified plan's investment menu, XYZ would maintain a single omnibus account in the name of the plan. The plan's recordkeeper would assume the responsibilities for tracking the participant-level balances, sending quarterly statements, and maintaining the participant website and call center. Essentially, sub-TA payments treat the recordkeeper as a subcontractor. These payments are completely legitimate, *provided that* the amounts are reasonable. Again, it is a fiduciary responsibility to make this determination.

The reasonableness determination doesn't need to be overly complicated. Gain a thorough understanding of what you are paying. Review service provider agreements and chronicle your actual experience to see what services the plan is receiving. Then use some form of benchmarking. This could involve a commercial benchmarking service that publishes comparative reports, it could involve networking (if you have adequate relevant data points) or it could involve the more costly and time consuming process of taking the plan out to bid.

What if the plan's expenses are high? Many mutual funds offer multiple share classes to retirement plans, each with different revenue sharing amounts. As you would expect, share classes with higher revenue sharing carry higher expense ratios, which eat into participant returns. It costs money to run a qualified plan, and participants benefit by having it available to them. Most employers rely on revenue sharing to fund some portion of a plan's costs. It's your job to make sure only reasonable amounts of money come from plan assets for this purpose.

The most effective means of control is to have an ERISA account in your plan. Not all providers allow this, or may impose a size requirement to have one. An ERISA account captures all revenue sharing payments. The fiduciaries then authorize *reasonable* payments from this account to the plan's service providers. If excess revenue sharing is being received by the plan, the fiduciaries can roll down to less expensive share classes of the plan's investments and/or to pay the surplus back into participant accounts.

If you don't establish tight control, the growth of your plan's assets over time may lead to higher than reasonable amounts getting paid to service providers. This is because most revenue sharing is asset-based. If a recordkeeper's workload is about the same this year as last, why should they get more compensation just because the market had a big year and inflated the asset base? In a large plan, this phenomenon can lead to six figure comp bloat over time. That's bad for plan participants and bad for fiduciaries.

The bottom line: What you don't know about revenue sharing can hurt you and your employees. Service providers deserve to be compensated at a reasonable level, based on what they are doing for your plan. Understanding and controlling this compensation is one of your most important fiduciary obligations. "Getting it" won't take you long, and then it can become part of your annual plan routine.

Jim Phillips, President of Retirement Resources, has been in the investment industry for more than 35 years, the past 18 of which have been focused in the area of qualified retirement plans. Jim worked for major national investment firms for 14 years before "going independent" in 1990. Jim is an Accredited Investment Fiduciary, has contributed to two books on 401(k), and his articles have been published in Defined Contribution Insights, PLANSPONSOR's (b)lines and ASPPA's 403(b) Advisor, and Jim is a RetireMentor on MarketWatch.com. His work has been acknowledged with multiple Signature Awards from the PSCA, he has been named to the 2012 and 2013 list of Top 100 Retirement Plan Advisers, by PLANADVISER Magazine, and he was a finalist in 2012 for the Morningstar/ASPPA 401(k) Leadership Award. Jim has been a frequent speaker at national conferences, including SPARK, ASPPA, AAO and the PLANSPONSOR and PLANADVISER National Conferences.

Patrick McGinn, CFA, Vice President of Retirement Resources, is a CFA charterholder and has been in the securities industry since 1993. In addition *to the Chartered Financial Analyst designation, he is an Accredited Investment Fiduciary and a member of the Boston Security Analyst Society. Together with Jim, Patrick has co-authored a number of articles which have been published in industry publications on topics about managing successful 401(k) and 403(b) plans. His work has been acknowledged with multiple Signature Awards from the PSCA, and he has been named to the 2012 and 2013 list of Top 100 Retirement Plan Advisors, by PLANADVISER Magazine. He was a finalist in 2012 for the Morningstar/ASPPA 401(k) Leadership Award.*

NOTE: This feature is to provide general information only, does not constitute legal advice, and cannot be used or substituted for legal or tax advice.

Any opinions of the author(s) do not necessarily reflect the stance of Asset International or its affiliates.

Tagged: 403b, Fees