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Is It Important for 401(k) Fees to Be Equitable?

Employers with 401(k) plans need to think about whether the fees their participants are paying are equitable.

By Lori Lucas

Who should pay, and how? This is a debate Americans are having on many fronts—from health care to taxes. It is also a question that more and more 401(k) plan sponsors are asking about plan fees.

There are numerous ways that 401(k) fees can be paid: Plan sponsors can pay them; participants can; or fees can be shared between the two.

When participants pay for plan administration expenses, it is most commonly done through revenue sharing and other fund allocations. Under revenue-sharing arrangements, a portion of the expense ratio is allotted to the plan's record keeper in order to offset administrative expenses. Not all revenue-sharing arrangements are created equal, though. And while some funds may offer revenue sharing, others may not. Indeed, according to a recent Callan Associates survey, nearly two-thirds of plan sponsors with revenue-sharing funds in their plan say that not all of the funds offered revenue sharing. Nearly 30 percent say that revenue sharing was offered by half of the funds or less.

Why does this matter? Take the case of a participant in hypothetical 401(k) Plan A. The administrative fees for Plan A are paid primarily through revenue-sharing agreements with the plan's mutual funds. For example, Plan A's International Equity Fund generates 35 basis points of revenue sharing, while the Stable Value Fund in Plan A generates 15 basis points. If a participant were to invest $50,000 in the International Equity Fund, he or she would contribute $175 annually to pay plan administrative expenses. However, if that same participant elected to invest in the Stable Value Fund, he or she would only contribute $75 annually to offset administrative expenses.

Like many plans, Plan A also could have funds with no revenue sharing at all. In this case, the participant could potentially invest in the 401(k) plan without contributing anything to plan expenses (although, of course, he or she would still pay the investment expenses of the fund). In short, because of variability in revenue-sharing arrangements across funds within a single plan structure, the payment of plan administration fees in Plan A isn't likely to be equitable among participants. Depending on investment choices, in fact, some participants are undoubtedly subsidizing others within the plan.

Increased fee disclosure to plan participants that may result from pending regulatory and legislative initiatives has the potential to bring the issue of fair fee payment to the forefront. Uneven administrative fees can leave plan sponsors open to uncomfortable questions by participants, or may even bias participants against funds that carry the lion's share of the administrative burden.

However, creating an investment menu with equitable administrative fees can be challenging. As we just saw, rev-

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enue-sharing arrangements—which are negotiated between the record keeper and the investment managers—are usually not consistent, and plan sponsors may have no control over share classes that are available to them.

For example, it may be that the international equity mutual fund in the example above has only one share class—the one that pays 35 basis points. That means that if the plan sponsor wishes to reduce or eliminate the fund's revenue sharing in order to align it with that of the plan's other funds, the plan sponsor's only option is to replace the fund with a *different* international equity fund.

However, replacing a fund simply because of higher-than-average revenue sharing is hardly sensible if the fund's overall expense ratio is reasonable relative to other funds in its category—and/or if the fund is meeting its performance objective. The various 401(k) fee disclosure bills that are making their way through Congress acknowledge that performance, not just fees, is important when it comes to 401(k) investments.

Another approach to reducing or eliminating revenue sharing is to replace funds with collective trusts or separate accounts. Indeed, fully unbundling the plan and eliminating all revenue sharing through the use of institutionally priced (non-revenue-sharing) mutual funds, collective trusts and separate accounts effectively eliminates the problem of uneven fee payment altogether. Administrative fees in the unbundled situation are then paid through a dollar-based per participant fee (e.g., $100 annually per participant); a percentage-based add-on administrative fee (e.g., a 10 basis point fee is assessed against every fund in the plan); or some combination of both.

The rationale for the dollar-based fee is that 401(k) administrative costs are largely fixed costs, so all participants should pay the same amount, regardless of account size. The rationale for the basis-point fee is that it would be unreasonably burdensome for an individual with a $1,000 account balance to pay the same $100 annual fee as someone with a $100,000 account balance.

According to Callan's survey, 21 percent of plans are in a fully unbundled structure. Plan sponsors that unbundle their plans often find other benefits. Beyond making the plan's administrative fee payment more equitable, unbundling can reduce overall plan cost. It can allow the plan sponsor to incorporate a broader array of institutional investment managers (including those within the defined-benefit plan). In general, unbundling the 401(k) plan can result in much greater fee and investment flexibility.

Of course, just as not all mutual funds are available in non-revenue-sharing share classes, not all have collective trust or separate account versions available. Also, the plan might be too small to qualify for the collective trust or separate account version of the fund. Even if the plan did have the economies of scale necessary, the plan sponsor might find the effort required to coordinate among the investment managers, record keeper and custodian daunting. In addition, the plan sponsor will need to be aware of potential additional costs associated with unbundling that are not factors in bundled solutions (such as separate account setup charges or fees for custom fund fact sheets).

If creating level administrative fees through the implementation of a fully unbundled approach is not possible, plan sponsors can still consider creating a more even playing field by selectively reducing or eliminating revenue sharing, and introducing a small per participant fee to offset administrative expenses. At a minimum, plan sponsors may wish to evaluate their comfort level with how revenue-sharing levels vary by fund within the plan. They may also wish to look into the possibility of greater participant disclosure around this topic.

Of course, communicating anything about fees and revenue sharing to plan participants can require a great deal of finesse—the last thing the plan sponsor wants to do is create confusion about or distrust of the plan. For that reason, the simpler and more concise the communication, the better.

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