Considerations for Direct Charges to Participant Accounts in Defined Contribution Plans

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Many plan sponsors have been actively evaluating the cost structures of their defined contribution retirement plans with regards to how administrative expenses are charged. Those services can include recordkeeping, compliance, investment consulting, legal, and audit fees. Ten years ago, most plans paid for these services through fund "revenue sharing," which is typically a component of a mutual fund's expense ratio. Some might recognize these fees as "12b-1" or "sub-TA (transfer agency)" fees. Today, many plans are rapidly moving away from fee payments based on revenue sharing because of the opaque and disparate manner in which these fees are applied across various mutual funds.

So, what are plans doing? Many are opting to eliminate all revenue sharing from funds, which has the effect of lowering fund expense ratios. Let's consider an example:

Current Structure for Plan A

Total plan assets: $50 million
Weighted average publicly quoted expense ratio: 0.59%, or $295,000 in total for the plan
Weighted average revenue sharing (i.e. sub-TA + 12b-1 fees): 0.19%, or $95,000 (part of the $295,000)
Range of revenue sharing across funds: 0.00% to 0.35% (with a weighted average of 0.19%)
Administrative costs (i.e. recordkeeping, advisory, legal, audit): $95,000, or 0.19% of plan assets

That $95,000 of revenue sharing goes into an account that is controlled by the plan sponsor, which can only be used to pay for qualifying plan expenses such as recordkeeping, advisory, legal, and audit services.

Participant A

Now assume that Participant A in Plan A has a balance of $100,000 and is 100% invested in a fund that has a quoted expense ratio of 0.75% and a revenue sharing amount of 0.35%. This means the value of the participant's account is reduced by $750 each year. $400 is going to the fund management company while $350 is going to the revenue share account.

Participant B

Next, assume that Participant B in Plan A has a balance of $100,000 and is 100% invested in an index fund that has a quoted expense ratio of 0.10% and a revenue sharing amount of 0.00%. This means the value of the participant's account is reduced by $100 each year. $100 is going to the fund management company while $0 is going to the revenue share account.

	Participant A	Participant B
Account Balance	$100,000	$100,000
Expense Ratio	0.75%	0.10%
Expense in Dollars	$750	$100
Revenue Sharing % (Part of Expense Ratio)	0.35%	0.00%
Revenue Sharing in Dollars Collected from Funds	$350	$0

In the above situation, Participant A is contributing $350 for plan administrative expenses while Participant B is contributing $0. While participants are informed about fund expense ratios through numerous communications, most participants are unaware of "revenue sharing" in their plan's available funds, or that this amount might vary among funds and participants. Surveys show that employees trust their employers to make decisions that look out for their best interests, which is exactly what it means to be a fiduciary.

New Structure for Plan A
Total plan assets: $50 million Weighted average publicly quoted expense ratio: 0.40%, or $200,000 in total for the plan Weighted average revenue sharing (i.e. sub-TA + 12b-1 fees): 0.00%, or $0 Range of revenue sharing across funds: 0.00% to 0.00% Administrative costs (i.e. recordkeeping, advisory, legal, audit): $95,000, or 0.19% of plan assets # of participants: 1,000

Now assume that Participant A has a balance of $100,000 and is 100% invested in a fund that has a quoted expense ratio of 0.40% and revenue sharing amount of 0.00%. This means the value of the participant's account is being reduced by $400 per year. $400 is going to the fund management company while $0 is going to the revenue share account.

Next, assume that Participant B has a balance of $100,000 and is 100% invested in an index fund that has a quoted expense ratio of 0.10% and revenue sharing amount of 0.00%. This means the value of the participant's account is being reduced by $100 per year. $100 is going to the fund management company while $0 is going to the revenue share account, which is used to pay for plan expenses.

	Participant A	Participant B
Account Balance	$100,000	$100,000
Expense Ratio	0.40%	0.10%
Expense in Dollars	$400	$100
Revenue Sharing % (Part of Expense Ratio)	0.00%	0.00%
Revenue Sharing in Dollars Collected from Funds	$0	$0

Two things should be apparent:
1- The plan's weighted average fund expense ratio has dropped sharply, from 0.59% to 0.40%
2- The $95,000 that went into the revenue share account to pay for administrative costs has dropped to zero.

The plan still needs to come up with $95,000 to pay for administrative costs. How does it do this?

1- The sponsor can choose to pay the costs directly, including it as part of the overall retirement benefit. Across the entire industry, including plans of all sizes, the plan sponsor picks up all of the administrative costs approximately 36% of the time and will share administrative costs with participants an additional 21.6% of the time. See the chart below.

How Often Is The Plan Sponsor Paying Administrative Expenses?						
Plan Size	Overall	$10MM-$25MM	$25MM-$50MM	$50MM-$100MM	$200MM-$500MM	Greater Than $1 B
Fees Shared Between Sponsor and Participants	21.6%	22.2%	25.5%	19.8%	22.6%	26.6%
Fees Covered by Sponsor Only	36.1%	34.4%	32.3%	34.7%	25.3%	14.3%

Source: 2016 DC PlanSponsor Survey

2- The sponsor can also choose to have the fees covered through a direct participant charge applied to each participant's account balance, which shows up as a line item charge on a quarterly statement. There are three basic methods to apply the charge:

1- As an equal percentage of each individual's balance, i.e. 0.19% of account balance
2- As an annual flat fee per participant, in which one's balance does not matter, i.e. $95 per person
3- As a hybrid approach which includes both a flat fee and a percentage, e.g. $40 + 0.11% of a participant's balance. This more complex approach is used less frequently.

Let's take a closer look at each method:

In the percentage method (Method #1 above), all participants pay the same proportion of their account balances, but the actual dollar amount paid by participant can vary substantially. A person with a $30,000 account balance and a 0.19% charge would see annual fees of $57, while a person with a $500,000 account balance would see a fee of $950.

Under the flat fee per participant method (Method #2 above), the fee would be $95 per year regardless of one's balance. The drawback to this method is that for new employees or lower earning employees with smaller balances, this fee represents a larger proportion of his or her balance. For example, for someone with $10,000 in the plan, this fee represents 0.95% of his or her balance

The hybrid method (Method #3 above) tries to find a middle ground. Using the $40 flat fee and along with an 0.11% charge, a person with a $10,000 account balance would pay $51 (i.e. $40 + $11 (i.e. $10,000 X 0.11%)), while a person with a $300,000 account balance would pay $370 (i.e. $40 + $330 (i.e. $300,000 X 0.11%). Not all plan record-keepers are currently technologically capable of applying the hybrid method.

The table below compares charges for participants with different account balances under the three different methods.

	Method #1	Method #2	Method #3
Participant Balance	Percentage of Assets (0.19%)	Per Participant ($95)	Hybrid ($40 + 0.11% of Assets)
$10,000	$19	$95	$51
$40,000	$76	$95	$84
$50,000	$95	$95	$95
$100,000	$190	$95	$150
$300,000	$570	$95	$370
$500,000	$950	$95	$590
$1,000,000	$1,900	$95	$1,140

The table illustrates that individual charges can vary significantly under the percentage of assets method. An individual with a $500,000 account balance pays $950 per year while someone with a $10,000 balance pays $19 per year. This example might support a conclusion that the only fair method is the flat per participant fee of $95. However, remember that the average balance in this example is $50,000. Because of skewness that occurs in most plans due to a small number of very large balances, the median is almost always lower than the average balance, perhaps closer to $40,000 in this example. It is this group of individuals who are often in the most vulnerable position to be short of funds in retirement, and as a result, every dollar matters. Additionally, participants with high balances are typically the highest compensated and generally receive a proportionately higher match. For example, an executive with a $500,000 balance might be earning $200,000 per year and receiving $6,000 in annual match contributions while someone earning $40,000 per year would be receiving $1,200. There are legitimate cases to be made for all three methods.

WHICH METHODS ARE PLAN SPONSORS CHOOSING?

Broad trends show that more plans are using a percent of assets approach, but that the per participant fee approach is gaining in usage and is used by most very large plans. A 2015 survey from Vanguard shows that the percentage of plans with more than $1 billion in assets that have adopted a flat per participant fee is now 52%, up from only 9% in 2012. The Plan Sponsor Council of America (PSCA), a non-profit association for the retirement plan industry, recently completed its own 2016 survey of over 600 plans showing that the most popular method is currently percentage of assets at 43%, but that the utilization of flat per participant fees increases as plans get larger:

2016 Survey – Plan Sponsor Council of America (PSCA)						
Plan Size by Number of Participants						
Fee Type	1-49	50-199	200-999	1K-4,999	5,000+	**All Plans**
Percent of Assets	36.0%	43.3%	55.6%	41.0%	34.4%	**43.0%**
Fixed Dollar Per Participant	38.0%	25.0%	19.3%	39.3%	56.3%	**34.2%**
Revenue Sharing Hybrid Combination	26.0%	31.7%	25.2%	19.7%	9.4%	**22.9%**
Total	100.0%	100.0%	100.0%	100.0%	100.0%	**100.0%**

WHAT IS THE DEPARTMENT OF LABOR'S STANCE?

The Department of Labor (DOL) has regulatory authority over ERISA plans, such as 401(k) plans. ERISA contains no provisions specifically addressing how plan expenses may be allocated among participants and beneficiaries. However, in May 2003, the DOL did issue Field Assistance Bulletin 2003-03 which provided some guidance. The bulletin states:

> *"fiduciaries must select the method or methods for allocating plan expenses [which would] require a process by which the fiduciary weighs the competing interests of various classes of the plan's participants and the effects of various allocation methods on those interests.... In this regard, a method of allocating expenses would not fail to be "solely in the interest of participants" merely because the selected method disfavors one class of participants, provided that a rational basis exists for the selected method."*

The bulletin also specifically states that both pro rata and per capita are permissible, and notes that it would be arbitrary to apply a per capita fee to investment management fees, which generally fluctuate with the amount of assets:

> *While a pro rata method of allocating expenses among individual accounts (i.e., allocations made on the basis of assets in the individual account) would appear in most cases to be an equitable method of allocation of expenses among participants, it is not the only permissible method. A per capita method of allocating expenses among individual accounts (i.e., expenses charged equally to each account, without regard to assets in the individual account) may also provide a reasonable method of allocating certain fixed administrative expenses. On the other hand, where fees or charges to the plan are determined on the basis of account balances, such as investment management fees, a per capita method of allocating such expenses among all participants would appear arbitrary.*

WHAT IS THE LEGAL ENVIRONMENT REGARDING DIRECT PARTICIPANT CHARGES?

Much of the recent litigation involving 401(k)-style plans has revolved around fees, particularly for large plans. While court rulings on the appropriate level of fees have been rare, and sometimes contradictory, several recent settlements have included requirements on how fees are levied, or how administrative services are charged. Notably, in 2014's Beesley vs. International Paper, which involved a $41.5 million settlement, one of the conditions included was a prohibition against charging recordkeeping fees as a percentage of assets. Similar conditions were reached in 2012's George vs. Kraft, which involved a $14.2 million settlement, and 2011's Kanawi vs. Bechtel, which involved a $26.2 million settlement. To date, there have been no settlements requiring sponsors to eliminate an equal per participant fee.

Case	Date	Settlement	Terms (which relate to admin/participant fees)
Beesley v. International Paper	1/31/2014	$41.5 million	Fees for recordkeeping cannot be set as a percentage of assets
George v. Kraft	6/26/2012	$14.2 million	Fees for recordkeeping cannot be set as a percentage of assets
Kanawi v. Bechtel	3/1/2011	$26.2 million	Fees for recordkeeping cannot be set as a percentage of assets
Krueger vs. Ameriprise Financial	7/14/2015	$36.5 million	Negotiate flat fees for services
Kruger v. Novant Health	9/29/2016	$32 million	No fees on percentage of asset basis

CONCLUSION

The landscape for how plans and plan sponsors charge fees to participants is changing rapidly. The key guiding principles for the future will be transparency, fairness, equality, and as always, the best interests of plan participants.