Understanding the Various 401(k) Service Fee Arrangements

By Sheldon M. Geller

Plan sponsors and investment committees must understand the way in which 401(k) plan assets are used to pay plan service providers and investment advisors in order to avoid the payment of excessive plan fees and the selection of imprudent investment options. Committees need to make informed decisions, whether being served by a fiduciary advisor or a non-fiduciary record keeper. Committees must also be able to demonstrate that they acted in the best interest of their plans under the Department of Labor's (DOL) recently published regulation, "Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Investment Advice" (29 CFR 2510.3-21). If committees have not documented that they have acted in their plans' best interest, they may face private legal actions and regulatory enforcement sanctions for the breach of their fiduciary duties.

Direct versus Indirect Compensation

Existing service provider fee arrangements contemplate either direct or indirect compensation. Direct compensation, including asset-based fees, fixed fees, and transaction fees, is charged to plan assets, allocated to participant accounts, and disclosed on participant statements. Indirect fees, including asset-based fees and fixed fees, are offset with revenue sharing generated on plan asset investments and made a part of fund expense. The AICPA's *Audit & Accounting Guide for Employee Benefit Plans* describes revenue sharing as an agreement between an investment fund and a custodian pursuant to which the fund pays a portion of its management fees to a service organization to help reduce plan costs.

The danger with indirect fees is that committees do not always see or regularly approve them as a part of plan administration. In an ideal world, committees would not have to deal with multiple share classes and automatic fee offsets and would be able to assume that their service providers and investment advisors are always acting in their best interest. The retirement plan marketplace is not an ideal world, however, with its many conflicts and self-dealing service models. Excessive fee claims can arise as a result of a committee's failure to monitor fund expense and indirect fee offset payments.

Service Provider Compensation Arrangements

The retirement plan marketplace offers various service provider fee arrangements, commonly described as cost-based, revenue required, revenue sharing, and fee equalization. The cost-based model carries many possible fees, including a base fee, a participant fee, and an asset-based fee, categorized by services rendered by different providers for recordkeeping, administration, compliance, documents, and trusteeship. This approach is most often applied in unbundled service arrangements and is similar to the way in which employers pay for non-plan services.

The revenue requirement model, the most prevalent, carries a bundled, stated, fixed fee, or revenue requirement, expressed as a percentage of plan assets by a single service provider. This fee may be paid with revenue sharing offsets or direct charges to plan assets; the service provider uses this revenue to offset its fee requirement. Excess revenues may be credited to participant accounts, whereas a shortfall may be charged to participant accounts or billed to the plan sponsor. This model is increasingly common in the mid-to-large plan market and can be easily monitored.

The revenue sharing model's fee comprises the revenue sharing generated on plan asset investments to subsidize a single service provider's bundled recordkeeping, administration, and trustee fee. This model does not include a stated, fixed fee or periodic reconciliation of revenue and expense, and there are no excesses or shortfalls. Although the service provider assumes the risk that revenue will not meet its compensation requirement, the investment committee assumes a greater risk of using plan assets to pay excessive fees. Fund changes may be restricted if they adversely impact the revenue sharing amount needed to meet the provider's compensation requirement. Fee compression has resulted in the widespread use of this model to enable service providers to retain revenue sharing in excess of contractually stated fees, especially among small plans with no negotiating leverage and nominal committee oversight.

Finally, the fee equalization model uses a contractually stated fee customarily expressed as a percentage of plan assets of a single service provider. This bundled fee is charged directly to participant accounts or billed to the employer. This model charges the same fee rate to all participants, whereas other models may charge a different rate to participants based upon each fund's revenue sharing rate. Therefore, this model equalizes the different revenue sharing rates of the funds in the plan's investment menu—considered a best practice. Very few service providers offer the fee equalization model, as it involves advanced technology and systematic debits and credits to participant accounts.

Investment Advisor Compensation Arrangements

Committees should not be lulled into thinking that an absence of load funds indicates an absence of conflicted advice. Higher expense share classes, which include level loads, have proliferated to provide trailing broker commissions or fee offsets for retirement advisors. Although it is an accepted industry practice for an advisor to charge an asset-based fee, committees should negotiate a fixed fee that only increases with their approval.

There is a difference between a fee-only advisor and a fee-based advisor. A fee-only advisor should not accept third-party payments, and revenue sharing should be rerouted to offset recordkeeping fees or allocated to participant accounts. A fee-based advisor should—but generally does not—apply revenue sharing to lower plan costs and customarily uses higher expense share classes to subsidize fees.

Committees should also recognize the fundamental difference between sales and advisory organizations. Advisory firms should be structured to provide advice in the committee's best interest and produce successful outcomes, even as they seek a profit. Advice is a fiduciary function, and accordingly, committees must demonstrate a well-defined process to support fiduciary decisions relating to advisor and recordkeeping compensation and investment fund selection.

Pricing out share classes should be a part of a committee's due diligence. Advisors should recommend share classes to the committees they serve that will demonstrate that the recommended funds and share classes are in the plan's best interest.

Plan Expense and Reimbursement Accounts

Some service providers credit revenue sharing in excess of contractually stated fees to a suspense account or a bookkeeping account. Suspense accounts, including custodial accounts and recapture accounts, are better than recordkeeping entries because committees can control the disposition of revenue sharing held in actual accounts and therefore avoid the retention of excess revenue by the plan's service provider. Funds in bookkeeping accounts may be contractually limited to the payment of only recordkeeping fees, whereas funds in suspense accounts may be used to pay recordkeeping, advisor, and plan audit fees. Moreover, committees should utilize suspense accounts to better comply with DOL Advisory Opinion 2013-03A (July 3, 2013), which requires that a plan sponsor entering into a revenue sharing arrangement be able to demonstrate that it acted in the best interest of plan participants. Committees should account for the funds in suspense accounts at year-end and use them all during the subsequent plan year.

Neither the Employee Retirement Income Security Act (ERISA) nor the DOL has provided guidance as to the operation of plan expense accounts and reimbursement accounts. Accordingly, sponsors and committees should demonstrate that the maintenance of these accounts is in the best interest of plan participants.

3(21) Investment Fiduciary versus 3(38) Investment Fiduciary

ERISA allows sponsors and committees to shift the liability for investment decisions to a retirement advisor who is a 3(38) investment fiduciary. Accordingly, committees can delegate fund selection and monitoring responsibilities to a 3(38) advisor because she has discretion, which makes that advisor legally responsible. In practice, 3(38) advisors will consult, and discuss decisions, with committees, which nevertheless have the ultimate responsibility to monitor their activities.

In contrast, 3(21) advisors only recommend and assist committees and do not assume responsibility for the selection and monitoring of investment options. Because they have no discretion, they have no legal responsibility, which is instead retained by committees. [See the United States Government Accountability Office's Report to the Ranking Member, Committee on Education and the Workforce, House of Representatives, "401(k) Plans: Improvements Can be Made to Better Participants in Managed Accounts," June 2014.]

Obligations and Best Practices

Case law supports the proposition that committees have a "continuing duty" to act in employees' best interest by monitoring investments and removing "imprudent" or needlessly costly fund options [Tibble v. Edison International, 575 U.S. ___ (2015)]. Committees that have knowingly or unknowingly failed to do so run the risk of paying damages based upon seemingly minor fees that resulted in excessive loss of investment returns over time.

Although the new DOL rule will make liable retirement advisors, ERISA also makes liable the committee, which is a named fiduciary. In order to properly manage fiduciary risk, committees should ask their retirement advisors to provide a written representation that they will uphold a fiduciary standard, disclose potential conflicts, indicate how they handle conflicts, and clearly list all investment costs. In addition, investment committees are obligated to review service provider compensation disclosure statements and to document their determination that fund expenses and service fees described therein are reasonable and that investment fund options are prudent regarding share class expense and performance. Committees should make certain that their service providers offer, and their retirement advisors recommend, funds that are best for their plans, rather than providers and advisors.

In 2015, there was significant DOL audit activity in this area, including $696.3 million in recoveries from plan sponsors, 2,441 civil investigations, and 275 criminal investigations (DOL Employee Benefits Security Administration, "EBSA Restores Over $696.3 Million to Employee Benefit Plans, Participants and Beneficiaries," http://1.usa.gov/1Ogps0F). Meanwhile, defined contribution plan assets continue to increase, thus increasing compensation paid to advisors and providers creating excessive and unreasonable fees.

It is critical for sponsors and committees to uncover imbedded fees, conflicts of interest, service disclaimers, and contract limitations in 401(k) service and advisory arrangements. Accordingly, committees should consider the following best practices and recommendations:

- Establish a board-appointed investment committee
- Adopt a committee charter and investment policy guidelines
- Implement a process to comply with investment policy guidelines
- Hire a 3(38) advisor and negotiate a fixed investment advisor fee
- Eliminate or minimize revenue sharing utilizing the suspense account
- Implement a process to select low-expense share classes for each fund
- Understand all fees paid with plan assets to service providers and advisors
- Determine that service and advisor fees paid with plan assets are reasonable
- Demonstrate that revenue generation and fee offset methodology is reasonable
- Document compensation fee disclosure review and reasonableness determinations.

Investment committees must approach plan management and governance with an actionable strategy, including written committee charters and investment policy statements, for the selection and retention of retirement advisors and service providers. ❑

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