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White paper

Understanding retirement plan fees

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Why should plan sponsors and plan participants care about retirement plan fees?

Let's do the math…

- Assume that an employee has 35 years until retirement and a current 401(k) account balance of $25,000
- If returns on investments in the account over the next 35 years average 7% and fees and expenses reduce average returns by 0.5%, the account balance will grow to $227,000 at retirement, even if there are no further contributions to the account
- If fees and expenses are 1.5%, however, the account balance will grow to only $163,000
- The one percentage point difference in fees and expenses would reduce the account balance at retirement by 28% or $64,000.[1]

As you can see from the example, fees have a direct and potentially significant negative impact on a participant's account balance over time.

Retirement plans are not free, however. There is a cost associated with the administration and maintenance of a retirement plan. There may also be additional cost associated with obtaining investment or education services for the plan sponsor and participants. Who pays those fees?

An employer may choose to pay some or all of these expenses on behalf of the plan so that the plan participants retain the full value of their accounts. By having the employer pay the expenses outside of the plan, the employer can take a business deduction for the expense, account balances grow more without the drag of plan expenses, and because plan assets are not being used to pay the fees, Employee Retirement Income Security Act ("ERISA") concerns are reduced. More commonly, fees and expenses associated with the administration of the plan are generally paid by plan participants out of the plan's assets. When retirement plan assets are used to pay fees, we must consider the implications of ERISA.

ERISA was adopted by Congress in 1974 to set minimum standards for most private sector employer sponsored retirement plans to provide protection for individuals in these plans. Part of that protection derives from the duties (and liability for breaching those duties) imposed on certain individuals and entities that are defined as plan fiduciaries under ERISA. Among the duties imposed on plan fiduciaries is the duty of loyalty. This requires a plan fiduciary to act solely in the interests of, and for the exclusive benefit of, plan participants and beneficiaries for the exclusive purpose of providing benefits to them and defraying reasonable expenses of administering the plan.[2] This means a plan fiduciary has an obligation to determine, on an ongoing basis, that fees and expenses paid out of plan assets remain necessary and reasonable. Failure to do so could lead to a claim by plan participants or by the Department of Labor ("DOL") that the plan fiduciary breached his or her fiduciary responsibility.

Four ways to calculate fees

Depending on the service or transaction being performed, plan fees are generally calculated in one of four ways:

- Asset-based fees
- Per-participant fees
- Transaction-based fees
- Flat-rate fees

Asset-based fees are based on the amount of assets in the plan and are generally expressed as percentages or basis points. For example, a plan might pay 0.25% or 25 basis points on applicable assets. Fees collected in this manner may include the operating expense of a mutual fund, the annuity wrap fee found on many annuity products designed for use in qualified plans, or wrap charges found in trust platforms. As assets increase, the amount of the asset-based fee increases.

Per-participant charges are based on the total number of eligible employees or actual participants in the plan. Plan sponsors should confirm whether a per-participant fee is being charged for all participants in the plan or all eligible employees. Certain qualified plan rules consider all eligible employees as participants in the plan. A third-party administrator may charge for general administrative services on a per-participant basis.

Transaction-based fees are based on the execution of a particular plan service or transaction. Examples would include a distribution, a QDRO (qualified domestic relations order) calculation, or a participant loan.

Finally, flat rate fees are charged to a plan regardless of the number of participants in the plan and may include eligibility determinations, vesting calculations, Form 5500 filings, etc.

Categories of plan fees
Notwithstanding the way retirement plan fees are calculated, they fall into four main categories or types of plan expenses.

These are:
- Plan administration fees
- Investment product fees
- Individual service fees
- Start up and termination fees

Plan administration fees include recordkeeping fees, costs of providing plan and participant statements, and costs associated with distributions, among others.

Investment product fees include sales charges, management fees and fees unique to particular investment products. Sales charges (loads or commissions) are transaction costs for buying and selling shares. Sales loads are one-time fees paid either at the time of purchase (front-end loads) or when shares held for less than a specified number of years are redeemed (back-end loads or contingent deferred sales loads). Management fees (investment advisory fees or account maintenance fees) are ongoing charges for managing the assets of the investment fund. They are generally stated as a percentage of the amount of assets invested in the fund.

Individual service fees include fees associated with services such as QDROs or loan administration and are generally born by the participant requesting the service.

Start up and termination fees relate to the employer's cost of setting up or terminating a plan. This might include the cost of an attorney to draft the plan document or the cost of a consultant to help the plan sponsor with plan design decisions.

Of these fee categories, the first two are generally born by all plan participants, the third by the affected participant, and the last <u>must</u> be borne by the plan sponsor.

Revenue sharing
"Revenue sharing" refers to compensation paid by mutual funds to various service providers because the service providers are doing work that would otherwise have to be done by the mutual funds themselves. Revenue sharing payments typically include 12b-1 fees and subtransfer agency or sub-TA fees. The 12b-1 fees are ongoing fees that are used to pay commissions to brokers and other salespersons for advertising and other costs of promoting the fund to investors and to pay service providers under a bundled service arrangement.

Sub TA fees are paid by a mutual fund to an intermediary, like a record keeper, who maintains the mutual fund's shareholders records on behalf of the mutual fund. Sub-TA fees are typically fixed fees on a per-participant basis or asset-based fees, or a combination of both.

Methods for reimbursing revenue sharing payments
While service providers may retain revenue sharing payments as part of their overall compensation, many pass the payments back to the plan. In such cases, the plan sponsor should determine whether to use the payments to cover plan expenses or whether to credit the payments to participants' accounts. Amounts may be credited on a pro rata or per capita basis or through revenue equalization.

Per capita means that all participants share in reimbursements on an equal basis. Pro rata distributions would base reimbursements on each participant's balance as a percentage of the whole. Both methods can be seen to have a greater impact on one group of participants over another. Revenue equalization either credits to each participant his or her own fund revenue sharing payments based on the participant's investment selections or reduces the asset fee based on payments from funds for participants who have invested in those funds.

Institutional vs. retail funds
Plan sponsors should also be aware of the difference between institutional funds and retail funds. Large investors, such as large money managers and large retirements plans, may be eligible for lower fund fees by using specific funds or share classes designated for larger group investors — institutional funds. Retail funds, which are also marketed to

individual and small groups of investors, typically charge higher fees. The Supreme Court held in Tibble v. Edison[3] that retail class funds are not categorically imprudent, but a plan fiduciary may violate its fiduciary duty by not investigating whether the plan is eligible to offer institutional class shares.

A special class of institutional shares that is being introduced is R shares. This class is designated for retirement accounts and generally may only be purchased through 401(k) and other employer sponsored plans. While there are various forms of R-shares, R-6 shares, which strip out revenue sharing payments, have been "growing like wildfire," according to Chris Brown, founder and principal of Sway Research, an asset management distribution research shop. For example, in 2015, 72% of assets held in the various "R" share classes were in those share classes that strip out a 12b-1 fee. By comparison, it was 56% in 2012.[4]

Fee disclosure

The DOL has been concerned about plan sponsors' and participants' lack of knowledge and understanding about the fees charged to retirement plans and its perception (whether accurate or not) that plan service providers have not done enough to disclose the fees they charge to plans. To attempt to remedy this perceived problem, the DOL has taken a three-pronged approach to improving plan fee disclosure. The first involves requirements for reporting service provider fees and other compensation on Schedule C of the Form 5500 annual information return. The second involves required fee disclosure by plan service providers to the responsible plan fiduciary of direct and indirect compensation received for those services. These rules are found in the ERISA section 408(b)(2) regulations. And the last involves new rules around fee disclosure to participants. These rules are found in DOL regulation 404a-5. While the responsibility for this participant fee disclosure resides with the plan fiduciary, service providers must cooperate and assist the plan fiduciary in obtaining the necessary information to make the disclosures.

While it is important to understand how fees are calculated and the categories of fees that may be imposed on a plan, the DOL's focus on fee disclosure should now make it somewhat easier for employers and plan participants to find the fees being charged to the plan. Plan sponsors should carefully review the information provided by service providers about investment expenses and plan level charges such as expense ratios, mutual fund service fee payments, redemption fees and recordkeeping fees so that they can ensure that the plan is only paying reasonable fees. In addition, plan participants should also review the information they receive about administrative fees and individual service fees as well as investment-related information such as expense ratios and shareholder fees or restrictions.

Fee litigation impact

In the last decade or so, numerous class action lawsuits have been filed against plan sponsors and service providers claiming they have breached their fiduciary duties with respect to retirement plan fees. It appears that this fee litigation and focus on fee disclosure is impacting plan fees. According to a 2016 NEPC survey,[5] 82% of defined contribution executives reported that they have renegotiated their recordkeeping fees during the prior three years. The report also reflected the growing use of fixed-dollar formula — calculated as a fixed dollar amount per participant — for record-keeping fees. Fifty one percent of survey respondents use fixed dollar fees.[6] This compares to 47% in 2015 and 29% in 2014.[7] The 2017 NEPC survey found that defined contribution plans have a median record keeper, trust and custody fee of $59 per participant, a slight increase from $57 in 2016. The asset-weighted average expense ratio for defined contribution plans is currently 0.41%, consistent with the ratio reported in NEPC's 2016 survey (0.42%). However, both the median fee and average expense ratio have dropped substantially since NEPC first conducted this study in 2006, when fees were $118 and the expense ratio was 0.57%.

Tips for reviewing fees

- Make informed investment decisions
- Consider fees as one of several factors in your decision making
- Consider any revenue sharing payments when evaluating whether-or-not service provider compensation is reasonable
- Compare all services received with the total cost
- Realize that cheaper is not necessarily better

Remember

Retirement plan fees have a direct and potentially significant negative impact on a participant's account balance over time. Plan sponsors should understand how fees are calculated and be able to recognize the various categorizes of fees involved in the administration of their retirement plan. They should be aware of revenue sharing and carefully review all fee information provided by service and product providers.

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[1] "A Look At 401(k) Plan Fees", the Department of Labor, available at http://www.dol.gov/ebsa/publications/401k_employee.html.

[2] ERISA section 404(a)(1).

[3] 135 S. Ct. 1823 (2015)

[4] www.investmentnews.com/article/20160628/FREE/160629904/dol-fiduciary-rule-will-nudge-401-k-advisers-to-zero-revenue-share

[5] NEPC 2016 Defined Contribution Plan & Fee Survey

[6] *Id.*

[7] *Id.*