



Revenue Sharing: The Pros and Cons of Using This Popular Cost-Shifting Approach

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Given all the press and litigation directed at 401(k) fees, it is hard to believe, but on occasion we still hear plan sponsors tell us that their plan does not cost them anything. Needless to say, this notion of free record keeping - which was likely born from the marketing efforts of mutual fund companies promoting their retirement plan services - is dangerous when held by plan fiduciaries. What the plan sponsor really meant to say is that their plan is paid for by participants out of fees collected from revenue sharing.

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For anyone not familiar with the term “revenue sharing,” it refers to a process that allows for plan expenses, i.e. record-keeping, administration, communications and consulting services to be paid entirely or in part from a percentage of mutual fund fees that are rebated to a retirement plan’s record-keeper. For example, if a plan is using ABC Equity Fund and the total annual expense of the fund is 0.75 percent, it’s likely that a portion of this fee, say 0.10 percent to 0.25 percent, will be rebated or “shared” from the mutual fund company to the record-keeping entity. The record-keeper then uses the fees generated from revenue sharing to pay plan expenses.

Revenue sharing has become a popular means for paying the plan expenses for defined contribution plan sponsors for good reason. From a plan sponsor’s perspective the advent of revenue sharing provides a seamless process to pay for plan services, freeing the sponsor from writing checks or directing the record-keeper to charge per participant fees. Consequently, the financial and administrative burdens of running a defined contribution plan can be greatly reduced for the sponsor. Yet, unbeknownst to many plan sponsors there are several potential pitfalls to this practice. Below are a few of the more common trouble spots:

1. Failing to evaluate the reasonable cost of services paid for by the plan.
2. Failing to determine the amount of revenue sharing that is collected from plan investments.
3. Failing to ensure that any revenue sharing collected in excess of legitimate plan expenses is reclaimed for plan participants by the end of the year.
4. Failing to understand the potential conflicts of interest and inequities that are inherent in revenue-sharing arrangements.

What is reasonable?

Evaluating the reasonableness of plan fees is difficult at best even for those experienced in the process. Service provider pricing is affected by a multitude of factors including the size of the plan, participant demographics,



plan design features, plan sponsor characteristics, plan investments and how participant balances are allocated. Simply comparing a plan to that of a similar sized plan in terms of participants and assets is inadequate. In our experience, the most reliable method to determine if plan fees are reasonable is through the request for proposal (RFP) process. The information collected from a carefully constructed RFP makes side-by-side fee comparisons between different providers possible, which in turn, answers and documents the reasonableness of plan fees through an independent investigation.

How much revenue sharing is being collected and what is the total cost to participants?

Normally this is a fairly easy question to answer, but it is important to pay attention to the details. Consider the following fee quotes from providers A and B. Both providers largely offer the same funds, but some share classes for the funds are different. This means the amount of revenue sharing generated from participant assets will be different as well. To add to the confusion, not all funds pay revenue sharing. (Note that revenue sharing is a component of the fund's total expense ratio, not in addition to it).

Plan Assets	Provider A	Fund Expense Ratio	Revenue Sharing	Total Expense	Revenue Sharing \$
\$6,000,000	Small Cap Blend	0.92%	0.20%	\$55,200	\$12,000
\$11,000,000	Foreign Large Blend Class 2	0.76%	0.20%	\$83,600	\$22,000
\$15,000,000	U.S. Large Growth	0.72%	0.15%	\$108,000	\$22,500
\$9,000,000	500 Index Fund	0.10%	0.00%	\$9,000	\$0
\$4,000,000	U.S. Large Value	0.72%	0.15%	\$28,800	\$6,000
\$14,000,000	Intermediate Bond Institutional Class	0.46%	0.00%	\$64,400	\$0
\$20,000,000	Stable Value A	0.55%	0.20%	\$110,000	\$40,000
\$79,000,000				\$459,000	\$102,500
Cost as a percentage of total assets				0.58%	0.13%

Plan Assets	Provider B	Fund Expense Ratio	Revenue Sharing	Total Expense	Revenue Sharing \$
\$6,000,000	Small Cap Blend	0.92%	0.20%	\$55,200	\$12,000
\$11,000,000	Foreign Large Blend Class 3	0.95%	0.25%	\$104,500	\$22,000
\$15,000,000	U.S. Large Growth	0.72%	0.15%	\$108,000	\$22,500
\$9,000,000	500 Index Fund	0.10%	0.00%	\$9,000	\$0
\$4,000,000	U.S. Large Value	0.72%	0.15%	\$28,800	\$6,000
\$14,000,000	Intermediate Bond Investor Class	0.60%	0.15%	\$84,000	\$0
\$20,000,000	Stable Value B	0.40%	0.15%	\$80,000	\$40,000
\$79,000,000				\$469,500	\$119,000
Cost as a percentage of total assets				0.59%	0.15%



The better quote is not as obvious as it may seem. It appears the total cost to participants for provider A is \$459,000 or 0.58 percent of plan assets, while provider B's total cost is \$469,500 or 0.59 percent – a difference of \$10,500 in favor of Provider A, right? Initially, it seems that way. But it's important to consider the amounts collected from revenue sharing and the asset based fee for plan services required by both providers.

Assume Provider A requires 0.13 percent of plan assets, which happens to be the same amount collected from revenue sharing. Meanwhile, Provider B requires an amount slightly less to run the plan, say 0.12 percent or \$94,800. When we net this cost against the revenue sharing generated by Provider B we end up with excess revenue sharing of \$20,600 ($\$119,000 - \$98,400 = \$20,600$). This excess, if not used for other legitimate plan expenses (such as your consultant), must be credited back to participant accounts by year-end. To answer the question of which provider has the better quote, we'll assume all the excess is credited back to participant accounts, resulting in a total cost to participants of \$448,900 ($\$469,500 - \$20,600 = \$448,900$), which is \$10,100 less than Provider A.

Conflicts of interest and inequities inherent with revenue-sharing arrangements

Consider the example quotes provided above and ask yourself: "Are all plan participants sharing equally in the cost of the plan?" The short answer is no. Below are some general observations.

- Participants largely invested in index funds and (although not shown here), self-directed brokerage accounts, generally pay little or nothing toward the plan's administration through revenue sharing.
- Taking up where we left off with the prior example of crediting back excess revenue sharing to participant accounts, record-keepers typically will prorate the excess amount across all participants. In essence, if Provider B were

your record-keeper and you personally were diversified across all plan funds, not only would you be subsidizing the cost of the plan for participants invested largely in the index fund, it's likely part of the excess revenue sharing collected from your account would be credited back to the guy paying little or nothing.

- Since fees are based on a percentage of assets, participants with larger account balances generally pay more of the plan's costs through revenue sharing.

Participants with larger balances generally pay more costs through revenue sharing.

- As plan assets grow, so will the revenue (and profits) collected by the plan's service provider. Asset based pricing creates a conflict of interest for retirement plan service providers. Most plan sponsors discover this fact and learn they are overpaying only after they take their plan out to bid through the RFP process.

In conclusion, retirement plan fiduciaries maintaining the illusion that their record-keeping services are free or those that ignore the pitfalls of revenue sharing do so at their own peril. At a minimum, an independent investigation through the RFP process and documentation surrounding the reasonableness of plan fees should be conducted every few years. Additionally, an awareness of possible inequities and conflicts of interest that are inherent with revenue sharing arrangements should help plan sponsors avoid potential trouble spots down the road.



This Informed Sponsor Report gives you an idea of how fees can be euphemistically cloaked in friendly terms like term revenue sharing, which can give plan sponsors a false sense of fiduciary confidence. It's by far not the only way funds can siphon money from participants. For more on this complex topic, please contact a principal at Bidart and Ross.

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