Arnerich Massena
Building Better Portfolios

Fee Equality: leveling the playing field for participants

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Contributors:
Scott Dunbar; Jake O'Shaughnessy, CFA; Jillian Perkins

For most plan sponsors, managing their plan with the participants' best interests in mind is not just a fiduciary duty; it is a driving principle. Sponsors know that recordkeeping fees and other costs associated with managing the plan can have a significant impact on retirement outcomes. This is why we encourage plan sponsors to examine the idea of fee equalization. Employers don't usually intend to charge fees unfairly, but may be surprised to know that fees are often inadvertently structured inequitably. Fee equalization can eliminate fee imbalances across the participant base to help plan sponsors embed fundamental fairness into the plan.

In this paper, we'll examine the ways in which traditional fee structures create imbalances among participants and consider ways to equalize fees. We'll also discuss how communicating fee equalization to your participants can enhance their perception of the plan and their trust in the plan's committee.

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Fee Equality: Leveling the playing field for participants

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Recent fee disclosure regulation, while imposing some inconvenience on employers, was largely welcomed by plan sponsors as a step in the right direction toward transparency. Participants seemed to respond to fee disclosures with maturity, understanding the reasons for fees and not overreacting, as some in the industry may have worried. Fee equalization is the next step on this path. In this paper, we'll examine the ways in which traditional fee structures create imbalances among participants and consider ways to equalize fees. We'll also discuss how communicating fee equalization to your participants can enhance their perception of the plan and their trust in the plan's committee.

How can fees be unfair?

Retirement plans commonly include funds that engage in revenue sharing, returning a portion of the management fees paid by participants back to the plan. Sponsors often use this shared revenue to help pay plan administrative expenses. On the surface, this practice doesn't seem unfair, but unfortunately, using revenue sharing to pay plan expenses can fall far short of fair. Let's take a look at why.

Imagine a plan that offers a set of target-date funds and a line-up of passively managed funds. In this hypothetical plan, the target-date funds have a higher expense ratio, commensurate with the increased active management of the funds. They return a significant portion of the investment management fees back to the sponsor via a revenue sharing arrangement, which monies are then used to pay the plan's administrative costs. The passive funds, on the other hand, do not have any revenue sharing associated with them. The result is that the participants who invest in the target-date funds pay all the plan's administrative expenses, while participants who build a portfolio from the line-up of passive funds pay no administrative expenses at all.

This is, unfortunately, a fairly typical scenario; those participants who choose to invest in funds that have revenue sharing end up paying a greater share (or the entire share) of the plan's administrative expenses than participants who choose non-revenue sharing funds. Participants often have no way of knowing which funds pay revenue sharing and which funds do not, nor do they necessarily understand the difference, since revenue sharing agreements are not usually explained to plan participants. At best, revenue sharing is just a footnote in the wilderness of their fee disclosure materials. Because the administration of the plan benefits all participants, this unequal weighting of the fees is bound to end up being unfair.

The scale of unfairness can range from slight inequity to glaring differences in how much individual participants pay. For instance, in a plan where some participants hold a large share of index funds (with no revenue sharing), other employees are subsidizing the plan's administration through their mutual fund fees.

> "'There are situations that could be potentially dangerous for plan sponsors and there could be litigation in the future if the plan is doing things that seem fundamentally unfair.' [Fred] Reish [of Drinker Biddle & Reath LLP] says."
>
> ~ *Shidler, 2012*

Fee disclosure regulations don't directly address revenue sharing issues, leaving it up to plan sponsors to navigate fund revenue sharing. Revenue sharing has a long history in defined contribution plans and is extremely common in the industry. For all practical purposes, the potential unfairness or inequality is hidden and out of sight, requiring a close look to uncover and action to correct.

> **We consider fee equalization to be a fiduciary best practice.**

Why equalize fees?

Despite a lack of regulatory pressure in this area (yet), we consider fee equalization to be a fiduciary best practice. Assuring the fairness of your plan's fees is part and parcel of your fiduciary responsibility to serve the best interests of participants. And our experience has been that once plan sponsors realize the potential inequality this issue poses, most are eager to do the right thing for participants.

Additionally, fee equalization can be a source of employee goodwill, demonstrating that the committee is taking the best interests of participants into consideration. When participants understand that the plan has made a priority of incorporating fairness at every level of fees, there is a deep appreciation for the integrity of the committee and their ability to act as caretaker for their employees' retirement funds.

Fee equalization has not yet taken hold broadly across the industry as a whole, in part due to some of the technological hurdles for recordkeepers. However, as fee equalization becomes more prevalent among plan sponsors, regulators may catch up and begin to scrutinize this issue. By addressing it now, plan sponsors can be well ahead of any regulatory changes.

Furthermore, using varying levels of revenue sharing among plan investment options to pay plan expenses can make things difficult for plan sponsors, since invested assets fluctuate constantly, and the total amount of revenue to be shared can fall short of or exceed needed monies for expenses depending on the fluctuations. Applying a fee equalization solution and paying for plan administrative expenses by applying specific fees to participant accounts can actually make it easier to budget and manage plan costs.

How do you create fee equality?

The solution to fee inequality is not necessarily a straightforward one; there are many factors to consider. The first issue is how to eliminate the inherent inequality caused by using varying rates of revenue sharing among plan options. For some plans, it is possible to choose fund share classes that don't include any revenue sharing arrangement at all. Depending on the fund company, these are sometimes referred to as "institutional" share classes. This may be the best-case scenario, allowing the plan sponsor to eliminate revenue sharing altogether and apply a level charge to participant accounts to cover plan-related expenses.

Not all funds or fund families, however, offer share classes that do not include revenue sharing in the expense ratio. Should you choose funds predicated strictly on whether or not a zero-revenue share class is an option? We would recommend that it not be the sole basis upon which to make a decision, but that revenue sharing fit should always be included among the many factors that you evaluate when selecting investments for your plan line-up.

The second issue is how to cover the costs of administering the plan. This is accomplished by layering an administrative fee back in as a separate line item for participants.

Recordkeeper capabilities vary widely. Some recordkeeping platforms have the capability to track revenue sharing fees and equalize the fees by crediting and charging accounts proportionately to evenly distribute administrative costs across participants. They may also be able to simply rebate revenue sharing fees, allowing the plan sponsor to then pull out and charge administrative fees as a separate line item.

How do you structure administrative fees?

The next issue is how to allocate the explicit administrative expenses to participants. Some plan sponsors elect to charge a flat, per-head dollar amount annual administrative fee. Charging the same fee across all participants ensures a level of fairness and is a simple, straightforward solution. However, consider the difference between a participant who has an $800,000 account balance versus a participant who has a $2,000 account balance. If the plan charges a $100 annual fee for administrative expenses, Participant A will be paying .01% of their assets in administrative fees, whereas Participant B will be paying 5%. Though technically fair, this may not be an optimal structure, since the cost burden falls more heavily on newer participants or participants with lower account balances.

An alternative solution is to assess the administrative fee as an asset-based fee, charging a certain number of basis points based on each participant's account balance. Consider the same scenario of Participant A with $800,000 and Participant B with $2,000, this time paying a fee of 10 bps, or .01% of their account in annual fees. Participant A would pay $800, and Participant B would pay $2. As with a flat fee, an asset-based fee seems fair initially, but can result in large disparities.

To remedy this situation, plan sponsors may choose to combine a flat fee and asset-based fee, perhaps charging a flat fee up to a certain account size and adding an asset-based fee for larger accounts, often also setting a cap on the fee. You can see a comparison in Table 1 of a few different options and how they affect participants with different account sizes.

Table 1 Comparing Fee Structures

Account balance	Flat $100 per-head fee	10 bps fee	$50 per-head fee plus 10 bps on assets up to $75,000
$2,000	$100	$2	$52
$20,000	$100	$20	$70
$200,000	$100	$200	$125
$800,000	$100	$800	$125

Important for plan sponsors to remember when structuring how administrative fees will be charged is to embed consistency into the method and to establish clear reasoning behind the decision. With those in place, when you communicate the fee to participants, you will be able to clearly explain the "why" behind it.

How do you communicate to participants?

The communication of fee equalization to participants seems daunting. It's true: in all likelihood, communicating administrative fees will bring to participants' attention something that they may not have even been aware of previously. Many participants do not realize that they are paying an administrative fee, as those fees are often buried or bundled in participant statements and disclosures — particularly when paid via shared revenue. However, most participants, especially following the flurry of fee disclosure communications over the last few years, understand that their plan is not free. They also understand that the value generated by their retirement plan costs money and is worth paying for.

> "…plan sponsors do need to consider that plan adminstration fees, which had not been explicitly disclosed in the past, would be a distinct line item on the quarterly statements.… Plan sponsors will want to think about how this 'new fee' will be received by participants and how to thoughtfully communicate the change in fee structure."
>
> ~*Paulson*

When you roll out new administrative charges on participant statements, it is essential to communicate *before* the statements are issued so that you can preempt questions and concerns. You want to be able to set up and frame the discussion. How you present it will determine in large part how participants react to and feel about it. In your communication campaign, you will want to emphasize several main points:

Fee equalization *is* a step toward transparency and equality, which makes it easy to communicate it as such.

- The fee is not new; it is simply structured differently than before: Be clear that participants are not being charged a new fee, even though it may look new. Explain that the fee was previously included in the expenses they paid as part of their investment management fees, and that this new structure is designed to make the fees clearer to see and easier to understand, as well as more equitable.
- That you are committed to making fees transparent in order to help participants better plan for retirement: Here you can contrast the industry practice of maintaining hidden fees with your diligent efforts to make fees transparent and understandable. Your employees will appreciate your integrity and may feel more confident about how their plan is managed and maintained.
- Oversight of plan fees: Make sure participants are aware that the committee regularly reviews and evaluates overall plan fees to ensure that they are reasonable and in line with the plan's objectives. Knowing that there is oversight responsibility will help employees trust that their fees are indeed reasonable. Showing fee benchmarking information, if available, can help to underscore this point.
- That you have carefully considered how best to structure the fee so that participants each pay a fair share: Focus on communicating the value that participants receive from their plan and how the administrative costs are distributed according to the benefits participants receive from the plan. It is essential for participants to recognize that this is not just a fee; it's the cost they are paying for the value they are receiving. Outlining the administrative expenses that are covered by this fee — specifically what the money pays for — can also be helpful in letting participants know what they are getting for their dollars and even encourage them to take better advantage of the resources available to them.

With effective communication, fee equalization will be perceived by your participants as a significant benefit. Fee equalization *is* a step toward transparency and equality, which makes it easy to communicate it as such. The message that it sends to participants reassures them that you are looking out for their best interests, going above and beyond to ensure that they are paying a fair fee for their plan.

Conclusion

We believe that as more plan sponsors recognize the inherent unfairness of using revenue sharing to pay plan expenses, fee equalization will become increasingly common across the industry. We recommend that plan sponsors act now, both to preempt changing regulations and industry standards, but also to do the right thing

for participants. Fee equalization, we believe, is a fiduciary best practice. Undergoing the process of examining and equalizing fees is part of sponsors' responsibility to prudently manage a retirement plan.

Following are steps you can take to begin the process of equalizing your plan's fees:

- Evaluate how the administrative expenses are currently covered in your plan. Does the plan engage in revenue sharing? Examine whether there are any disparities caused by the way the fees are structured.
- If you find inequality, consider how to restore balance to participant fees. Select a method of charging for administrative expenses that fairly distributes the cost across the participant base.
- Ask your recordkeeper if they have the necessary capabilities to support fee equalization. Discuss your fee equalization objectives with your recordkeeper and find out whether they have the necessary tools to help the plan achieve those goals.
- Include in your Investment Policy Statement any new criteria for selecting funds and how that criteria will impact the fund selection process. If there is a preference toward funds that have a share class without revenue sharing, how much will that preference weigh in the overall decision-making process?
- Develop a communication strategy to help your participants understand their plan fees and any changes you make to the fee structure.
- Review *all* plan expenses annually. Make sure expenses are in line and reasonable; compare them against peers or a benchmark if possible.
- Speak with your Arnerich Massena advisor to learn more about fee equalization and how we have helped our clients implement some of the best practices described in this paper.

Endnotes:

Paulson, Karen, CIMA, PRP, "Fee Equalization: Is it Right for Your Organization's Defined Contribution Plan?" Fiduciary Investment Advisors, LLC

Shidler, Lisa, "RIAs join move to right a 401(k) wrong: Lopsided plan expenses — a non-DOL issue," RIABiz LLC; September 9, 2012

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