



## Strategies to Control Defined Contribution Plan Fees

### Executive Summary

---

In 1974, the Employee Retirement Income Security Act (“ERISA”) was passed in order to establish a set of governing laws and regulations to protect the interests of participants in employee benefit plans. Since then, the responsibilities of defined contribution (DC) plan fiduciaries have continually evolved, and plan expenses in particular have become heavily scrutinized. In addition to increasing accountability to meet ERISA’s fiduciary demands to act “prudently” and ensure that plan fees are “reasonable,” several legal cases have introduced the risk of financial losses for failure to control costs. For example, two high-profile court cases, “Tibble vs. Edison” and “Tussey vs. ABB,” resulted in substantial financial penalties for companies that failed to apply prudent cost oversight.<sup>1,2</sup>

**Written By:**

**RVK, Inc.**

The objective of this paper is to provide plan sponsors with greater insight in to how they can better control fees and the risks associated with excessive costs. The paper provides a concise summary of the key drivers of plan fees and useful practices to assist plan sponsors with prudent fee management. Our hope is that plan sponsors will find this paper to be a helpful resource to improve the quality of plan oversight, minimize plan fees, and ultimately increase retirement balances for participants.

### Defined Contribution Plan Fee Components

---

In order to develop an effective strategy for monitoring fees, it is important to first understand the types of fees necessary to administer a traditional DC plan. These fees are commonly categorized as investment management, plan administration, and individual participant services. The following are brief overviews for each fee type.

#### ***Investment Management***

Investment management fees include the fees charged by specific fund providers to manage investment strategies. Important sources of variance for investment management fees include the nature of the underlying asset class, investment strategy, and degree of active management. Investment management fees are paid by the participant based on the fund(s) in which the participant chooses to invest.

## ***Plan Administration***

Plan administration includes the day-to-day services required to operate a DC plan. Administrative components of a DC plan include recordkeeping, employee communication and education, call centers, website development and maintenance, trustee services, and several other operational requirements. Plan administration costs may be paid by participants, plan sponsors, or a combination of both. The method of payment for these costs is generally less transparent than investment management fees. This lack of transparency was a driving force behind the 2012 fee disclosure regulations, which effectively forced plan sponsors to take a closer review of the fees they are paying. Typical structures or models to cover administrative costs include revenue sharing, asset-based wrap fees, a fixed per-participant fee, or a hybrid approach. Several of these practices are discussed throughout this paper. In summary, plan administration fees are generally more complex and less transparent than other fees. Understanding these costs and applying proper scrutiny often requires more intense education and monitoring.

## ***Individual Participant Services***

Individual participant service fees cover services that are typically used by a subset of plan participants and on an episodic basis. Examples include services such as personal loans, hardship withdrawals, qualified domestic relations orders (QDROs), self-directed brokerage, and managed account services. While these fees are generally less substantial in aggregate, plan fiduciaries must ensure that fee levels are fair and appropriate for those participants who take advantage of these individual services.

## **Plan Administration Fee Models**

---

Plan fiduciaries contract with service providers to administer DC plans. These service providers require a fee for their services based on a variety of plan attributes, most of which correlate closely to the number of plan participants. Plan sponsors typically find that controlling administrative fees (or even measuring them) is a complex endeavor. One particularly noteworthy source of confusion stems from the degree to which services are bundled under a single provider. A second source of confusion stems from the way in which administrative fees are often paid, namely through the use of revenue share arrangements.\* There may be very good reasons to select one fee model over the other, but the way in which oversight is applied differs from model to model. The following pages explain in more detail the types and considerations associated with plan administration service fee models available to plan sponsors.

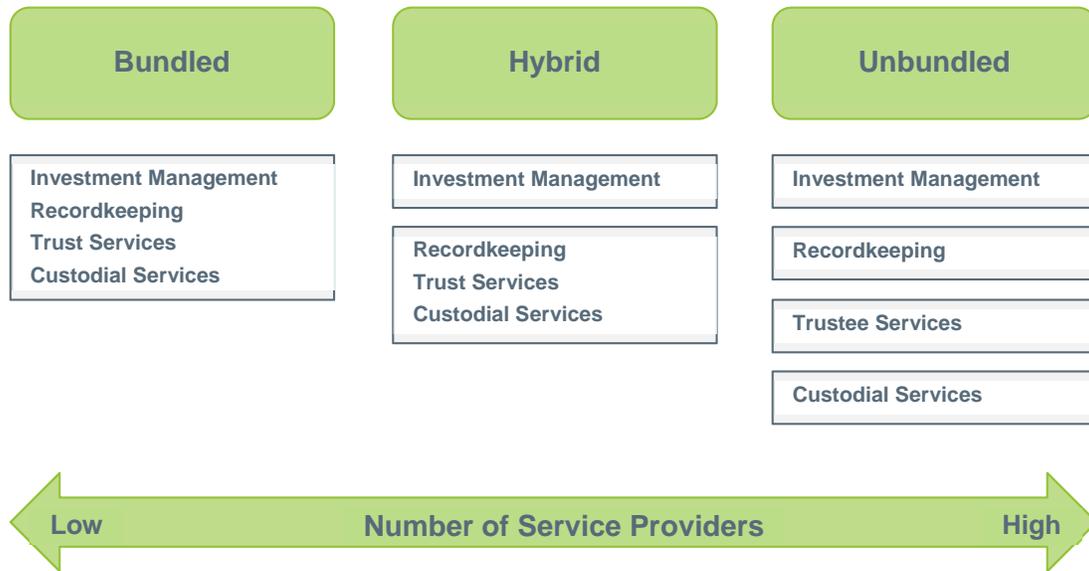
### ***Bundled vs. Unbundled Service Models***

A DC plan can be offered through a “bundled” or “unbundled” service model. A bundled service structure typically incorporates all or most plan services into one service agreement with a single plan provider. An unbundled service model separates the services, and each service provider contracts individually with the plan. A hybrid model combines elements of both. **Figure 1**, shown on the following page, provides a basic overview of the three delivery models.

---

\* We use the term “revenue share” throughout this document, as it is typically the term most familiar to plan sponsors. However, it should be noted that third party recordkeepers may describe such charges as “administrative fee reimbursement,” “administrative credits,” and other terms.

Figure 1: DC Plan Service Models



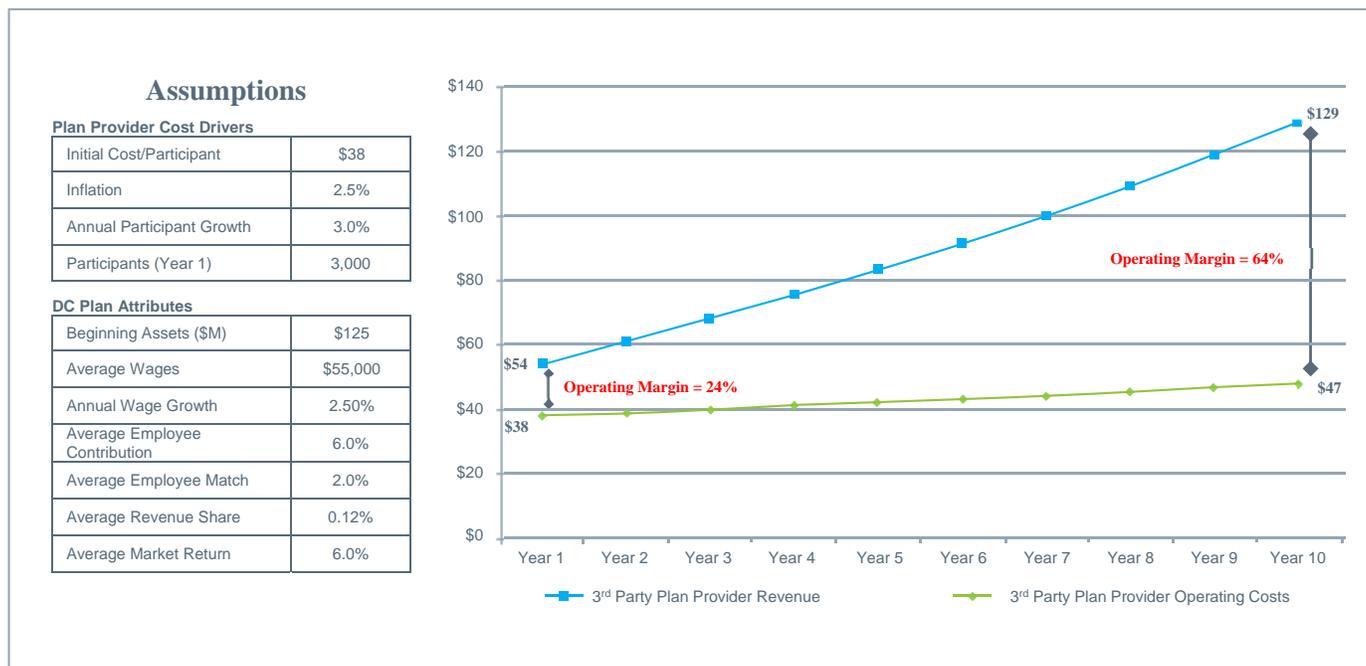
Regardless of the service model employed, understanding the fees charged for each service can be challenging. It can be particularly difficult to understand a bundled provider structure, as it is often unclear how different services contribute to the total fee. In general, the greater degree of *bundling* services results in the greater difficulty of conducting fee evaluations.

In addition to determining the degree of bundling, plan fiduciaries must also select an administrative services fee model. Generally, fee models fall into one of four possible categories as described below and on the following page.

**Fee Model #1: Revenue Share**

Revenue share refers to the contractual payments made by investment fund providers to third party plan providers to offer funds on the third party’s platform. Many bundled plan providers use revenue share to offset administrative expenses. While this approach sounds reasonable in theory, it can be problematic. In addition to being less transparent than a direct, per participant fee or wrap fee (both described below), revenue sharing payments can easily become disconnected from the costs of operating the plan if not properly and regularly monitored. The costs of administering a plan should be closely linked to the number of participants in the plan, while the total revenue share generated by the funds in the plan is linked primarily to the amount of assets in the plan. Therefore, as plan assets increase (which typically occurs at a higher rate than the growth in the number of participants), revenue generated from a revenue sharing structure can quickly dwarf the costs to administer the plan. In addition, individuals invested in higher revenue share funds effectively pay more than those invested in funds with lower revenue share. **Figure 2** illustrates how an unconstrained revenue sharing arrangement can increase more rapidly than plan costs. In the process, plan provider profit margins rapidly expand at the expense of plan participants.

**Figure 2: Sample Revenue Sharing/Administrative Fee Growth Model**



Source: RVK, Inc. (2015).

### Fee Model #2: Wrap Fees

A wrap fee is a separate asset-based fee that can be applied to the funds within a plan. Wrap fees are an “add-on” basis point fee, rather than built-in expense ratio like a revenue sharing arrangement. For example, a plan can use all collective trusts or zero revenue share mutual funds, neither of which generate revenue share. In order to meet the required administrative costs (also referred to as a “revenue” or “revenue requirement”), a consistent wrap fee would be applied across each fund. The primary advantage of wrap fees is that each participant pays the same percentage of their assets to cover administrative expenses regardless of the specific funds they choose. However, a disadvantage is that participants with higher account balances contribute a larger absolute dollar amount to cover administrative costs relative to participants with a low balance. A second disadvantage is that wrap fees increase proportionately with overall assets in the plan. For plans with increasing participants and average account balances (even if the result of strong performance), there is risk that these fees will increase disproportionately to the cost of administering the plan.

### Fee Model #3: Fixed, Per Participant Fees

Assessing fixed fees to plan participants is the simplest and most transparent model. Under this approach, each participant is charged a specified rate to cover recordkeeping services. The fixed cost structure allows fiduciaries and participants to know the exact costs required for administrative services. Another attractive attribute of this structure, is that these costs do not vary based on the amount of assets in the plan. As a simple example, if the required administrative expense is fixed at \$200,000 per year and the plan has 2,000 participants, a \$100 annual fee is deducted from participant accounts, typically on a quarterly basis. The advantage of this approach is the higher level of administrative cost transparency, as well as the fact that costs are equally spread across all participants in the plan. The combination of simplicity, transparency, and consistent functionality has led many plan fiduciaries to implement this approach.

Despite the benefit of transparency, per-participant fees do have some disadvantages. For example, the sudden introduction of a direct fee may be viewed negatively by participants if they have not seen an explicit charge for administration costs in the past.<sup>†</sup> In order to address this issue, plan fiduciaries should organize participant communications in advance of a switch to a fixed per participant fee in order to explain the rationale. A second potential disadvantage is that perceptions of inequality can still exist due to the fact that the percentage charge for administrative services that each participant pays varies based on the value of their account balance. For example, a \$100 fee applied to a participant with a \$5,000 balance translates into a 2% fee. Yet, the same fee applied to a participant with a \$50,000 account balance translates into a fee of 0.20%. The fact is that it costs the same to administer a large account as it does to administer a small account. Fiduciaries can mitigate any perceived inequity to some extent by excluding participants with account balances below a certain threshold (for example \$5,000 or \$10,000), from paying the per-participant charge and assess a wrap fee to collect fees from these accounts.

### ***Fee Model #4: Hybrid Model***

Hybrid models typically come into play when a plan has revenue sharing, but the funds do not generate enough revenue to fully cover the plan's administrative costs. The three ways to structure a hybrid model are (1) revenue sharing with a wrap fee, (2) revenue sharing with a fixed per participant fee, and (3) a fixed per participant fee with a wrap fee. In a revenue sharing with a wrap fee model, an additional wrap charge is applied to the funds in the plan by dividing the revenue shortfall by the total plan assets. For example, if a plan with \$50 million in assets has a \$100,000 revenue shortfall, a 2 basis point (0.02%) wrap charge could be applied to each fund in order to meet the revenue requirement. Next, under revenue sharing with a fixed per participant fee model, a per participant fee would be assessed based on the revenue shortfall and the number of plan participants. Using the same example above, if the plan has a \$100,000 shortfall with 2,000 participants; each participant would pay a fixed annual fee of \$50. Lastly, some plans may use a fixed per participant with a wrap fee model. Under this model, plan sponsors can select (and change as necessary) the portion of administration costs paid through a fixed per participant fee and a wrap fee. This hybrid model is most useful with plans that have dense distributions of participants at opposite ends of the compensation scale.

The primary advantage of the hybrid model is that it leverages revenue share only to the extent that it is needed to cover a capped administrative fee. However, the disadvantage is that some of the inequities of revenue sharing arrangements remain (i.e., investors in certain, high revenue share funds pay a disproportionately large percentage fee).

## **Strategies for Managing DC Plan Fees**

---

In order to demonstrate prudent fee management there are several practices that plan sponsors can employ to properly scrutinize fees, demonstrate prudent due diligence, and ultimately minimize fees on behalf of plan participants. Outlined below and on the following pages are several general practices that we recommend to plan fiduciaries in order to exercise control over fees. Beginning on **page 6**, we also outline several tactics that can be used to control administrative fees specifically, which are often the source of the greatest uncertainty.

---

<sup>†</sup> This is a perception issue, as the participants always paid this fee under a revenue sharing and/or wrap fee methodology; however, the fees were less transparent.

## General Best Practices

We recommend that plan fiduciaries follow a few standard practices to demonstrate appropriate management and monitoring of fees. While the specific implementation strategy will, of course, vary by plan, we believe plan fiduciaries can implement each of these practices in some form.

1. **Document and Adhere to a Set Process**—In the case of *Tibble vs. Edison* and *Tussey vs. ABB*, the courts focused on the existence and documentation of fee evaluation processes, which in these cases were deemed to be inadequate.<sup>3</sup> In order to demonstrate prudent fee monitoring, it is important for plan fiduciaries to establish and follow policies. As fee litigation has increased in recent years and new regulations have passed, it has become best practice for plan fiduciaries to document the process and rationale for decisions made. Although certain decisions may not always yield the optimal outcome, having a process in place can at least demonstrate that the fiduciaries were thoughtful and attentive in arriving at their decision. A few considerations when establishing a fee review process include:
  - a. Document frequency with which fee reviews will be conducted
  - b. Document commitment to perform periodic, formal bid solicitations (e.g., RFIs and RFPs) to third party service providers
  - c. Create a robust and comprehensive annual plan fee budget that will help provide guidance in determining an appropriate cap on fees. This should include all qualified plan expenses (auditor, legal, consulting, communications, etc.)
  - d. Document requirements for meeting minutes and all decisions made by the plan fiduciaries
  - e. Consult plan counsel for other potential decision making and documentation requirements
  
2. **Periodically Benchmark Plan Fees**—Plan fiduciaries should regularly and systematically gauge whether plan fees are reasonable. A common approach is to evaluate plan costs against peers. Unfortunately, as explained previously, it is often difficult to benchmark certain types of fees, such as administrative fees. That said, listed below are several steps that plan fiduciaries can take to roughly benchmark plan fees.
  - a. **Conduct Periodic Investment Management Fee Benchmarking Studies**—Benchmarking investment management fees is relatively easy. The data is readily available for each asset class or sub asset class, which can yield a credible comparison. Plan sponsors should evaluate fees relative to peer groups on a regular basis.
  - b. **Regularly Investigate the Availability of Less Expensive Share Classes and Investment Vehicles**—Over time, DC plans may gain access to lower-cost share classes or investment vehicles, such as separate accounts, collective trusts or institutional mutual funds that offer more attractive pricing. Availability may occur because plan assets reach levels that establish eligibility or investment managers may simply launch new share classes, commingled funds and/or separate account options. When these opportunities arise, plan sponsors should consider the cost/benefit of making the switch.

- c. **Periodically Benchmark Administrative Fees with Peers**—Benchmarking administrative fees can be challenging due to a lack of public benchmarks and limited disclosure in benchmarking studies explaining the different services embedded in plan costs. Nevertheless, we encourage plan fiduciaries to periodically benchmark fees against similar-sized peers. We also encourage plan sponsors to have their vendors review fees annually with them and track the level of fees over time. Benchmarking helps provide additional perspective on the plan relative to peers.
3. **Regularly Re-Negotiate Service Agreements**—As illustrated in **Figure 2**, the relative competitiveness of service agreements can change over time. In addition to expected changes in plan demographics and account balances, corporate events, such as merger and acquisition activity, and pension reform, can have a material impact on the characteristics of a retirement plan. In order to ensure continued competitiveness, service agreements must be periodically reevaluated and renegotiated to ensure that fees and services are reasonable and appropriate based on the characteristics of the plan.

### ***Tactics for Managing Administrative Fees***

Administrative fees are a significant portion of overall participant fees and are generally less transparent. Listed below are several tactics that plan fiduciaries should consider to gain greater control over administrative fees.

1. **Evaluate Current and Alternative Fee Structures**—Given the different fee models for administrative fees, we encourage plan fiduciaries to periodically evaluate their current fee structure and consider the potential advantages and disadvantages of alternative models. When conducting this analysis, plan fiduciaries should consider the following:
  - a. **Alignment of Plan Provider Costs and Revenue**—As illustrated in **Figure 2**, the costs that plan providers incur to provide services to DC plans increase at a different rate than the assets in the plan. Assets usually increase at a faster rate, which can lead to a situation in which participant fees become excessive over time. By setting fixed, per participant fees, plan fiduciaries provide greater assurance that costs of servicing the plan and fees generated from participants remain aligned over time.
  - b. **Fee Transparency**—A per participant fee is highly transparent to plan fiduciaries and individual participants. Asset-based fees (which are often covered through revenue sharing arrangements) are generally less visible.
  - c. **Equitable Distribution of Administrative Costs**—The costs of administering a DC plan is largely driven by the number of participants. For plans using asset-based fees covered by revenue sharing or wrap fees, the burden of payment for administrative services falls disproportionately on participants who have high balances and/or investments in high revenue share funds. This is often perceived to be less fair than a flat participant fee, in which all participants pay equally for administration of the plan.<sup>‡</sup> In contrast, a fixed, per participant fee can be perceived as disadvantageous to participants with small account balances.

---

<sup>‡</sup> It is important to note that perceptions of inequality can still exist based on the proportion of that fee relative to the participant's account balance. For example, a \$125 fee applied to a participant with a \$5,000 balance translates into a 2.5% fee. Yet, the same fee applied to a participant with a \$50,000 account balance translates into a fee of 0.25% or a quarter-of-a-percent. Some fiduciaries choose to waive the fee for participants with account balances below a certain threshold in order to address this perception of inequity.

2. **Establish Caps on Plan Administration Fees**—Regardless of how a plan decides to pay for administration expenses, fiduciaries should work with recordkeepers and other service providers to place firm caps on plan costs. Plans with asset-based fee models, based on revenue sharing or wrap fees, should cap total costs to ensure that increases in contributions and market returns do not cause run-away fee growth.
3. **Monitor ERISA Accounts**—Depending on how the plan chooses to pay administrative costs, there may be times when the plan generates revenue in excess of what is required by the third party plan provider. In these cases, plan providers typically hold excess revenue in an account commonly known as an “ERISA account” or “Plan Expense Reimbursement Account” (PERA). The excess funds can be used to pay for qualified plan expenses such as legal, auditing, participant education or consulting fees. While this is a legitimate method of covering plan expenses, it also has risks. One issue that plan fiduciaries should monitor, specifically, is the accumulation of excess funds to ensure they are used appropriately and in a timely manner.
4. **Participant Reimbursement of Excess Fees**—After qualified plan expenses are paid, there may be excess funds available in ERISA or PERA accounts that can be credited back to participants to lessen the overall costs they pay for the administrative services. There are two methods for crediting excess revenue back to participants; pro-rata or per-capita. The per-capita method takes the total excess revenue and divides it by the number of total participants in the plan to produce the same credit for all participants. The pro-rata method allocates a percentage of the excess revenue back to participants based on his or her account balance relative to total plan assets. Both methods have pros and cons that should be considered prior to making a decision on the reimbursement methodology. Regardless of which method is selected, we strongly encourage plan fiduciaries to reimburse excess fees to participants on an annual basis if excess revenue exists.

## Conclusion

---

The amount of scrutiny placed on DC plan fees has increased in recent years, and is only anticipated to grow in the future. We hope this paper enables plan fiduciaries to gain a deeper understanding of the key drivers of plan fees, as well as several practices that can be employed to effectively control fees. In order to identify potential areas to target for improvement, we have constructed a quick self-assessment on the following page. Please note that the assessment is intended to simply serve as a tool to identify potential improvement areas; answers of “no” are not intended to indicate failure in any area.

## DC Plan Fee Self-Assessment

**Instructions:** The goal of this self-assessment is to help plan fiduciaries identify areas that may benefit from improvement efforts. While we encourage fiduciaries to investigate each area marked “no” to look for improvement opportunities, an answer of “no” is not intended to indicate failure in any area.

Questions	Yes	No
1. Does your plan have a process for periodically reviewing plan fees?	<input type="checkbox"/>	<input type="checkbox"/>
2. Does your plan periodically benchmark plan fees?	<input type="checkbox"/>	<input type="checkbox"/>
3. Does your plan periodically re-evaluate service provider arrangements	<input type="checkbox"/>	<input type="checkbox"/>
4. Have assets in the plan changed significantly over the last few years?	<input type="checkbox"/>	<input type="checkbox"/>
5. Have alternative administrative service pricing models been evaluated?	<input type="checkbox"/>	<input type="checkbox"/>
6. Does your plan have a process to periodically evaluate different administrative pricing models?	<input type="checkbox"/>	<input type="checkbox"/>
7. Does your plan have a cap on total administrative plan fees?	<input type="checkbox"/>	<input type="checkbox"/>
8. Does your plan create a robust and comprehensive annual plan fee budget?	<input type="checkbox"/>	<input type="checkbox"/>
9. Does your plan have a process for reimbursing excess fees back to participants??	<input type="checkbox"/>	<input type="checkbox"/>

Source: RVK, Inc. (2014)

## Endnotes

- <sup>1</sup> In the case of *Tibble vs Edison* (2010), the plan offered investment options with retail share classes despite the fact that lower-cost, institutional share classes were available. The court ruled Edison had imprudently selected the retail funds and failed to utilize a prudent selection process. **Source:** United States Department of Labor. (2011). *Tibble Amicus Brief*. Department of Labor Publication Nos. 10-56406 and 10-56415. Washington, DC.
- <sup>2</sup> In the case of *Tussey vs. ABB* (2012), ABB used revenue sharing to cover administration and recordkeeping costs. While the court did not find the revenue sharing structure to be in violation of any fiduciary duties, it did conclude that the fiduciaries breached their responsibilities by failing to ensure that fees were reasonable. The court ruled ABB, Inc. breached its fiduciary responsibilities by failing to monitor and evaluate plan costs while employing an improper process for fund selection and termination. **Source:** United States Department of Labor. (2013). *Tussey Amicus Brief*. Department of Labor Publication No. 12-2056. Washington, DC.
- <sup>3</sup> United States Department of Labor. (2013). *Tussey Amicus Brief*. Department of Labor Publication No. 12-2056. Washington, DC.

*The views expressed in this commentary reflect those of RVK, Inc. as of the date of this commentary. These views are subject to change at any time based on market, industry, regulations, or other conditions, and RVK disclaims any responsibility to update such views. Nothing in this commentary is intended as legal advice. In preparing this commentary we have used sources that we believe reliable but cannot guaranty their accuracy.*

## About RVK

---

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Chicago and New York City. RVK is one of the ten largest consulting firms in the U.S. (as defined by Pensions & Investments) and has a diversified client base of over 190 clients covering 28 states. This includes endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.