FEATURE

Whose Revenue Is it Anyway?

BY FRED BARSTEIN

Should participants pay equally for the services they receive from their plan's service providers — record keepers, money managers and advisors — rather than through Sub-TA or 12(b)(1) fees?

ow that the entire market — not just advisors and providers — is focused on fees, a fundamental question is being asked: Who owns the revenue generated from the investments?

More plans are looking to push more of their plan costs off to participants. The funds to pay those costs come either from participants' accounts or from revenue sharing generated from the funds they purchase. The question addresses how cost sharing should be allocated, including whether participants should pay based on the revenue sharing that their funds generate rather than the size of their account balances.

Currently the question of fee equalization for participants is centered on fairness, not fiduciary responsibility, and there are signs that it could become a market differentiator for record keepers and advisors. As Stig Nybo, President of Transamerica Retirement Services — a leader in the fee equalization market — puts it, "Fee levelization for participants is intuitive."

Troy Hammond, an advisor with LPL and President of Pensionmark, believes that fee equalization is important, but the market is not demanding it. Jim O'Shaunessy, another LPL advisor and founder of Sheridan Road, agrees that it's a huge topic and plan sponsors may respond when it's brought up, but they are not driving the market.

Using an extreme example, in a plan where the plan sponsor does not write a check for any of the services provided by the record keeper or the plan advisor, a participant with a $100,000 balance using Vanguard funds may pay nothing to subsidize costs. However, another participant with the same account balance could be paying $500 annually if the funds in her account pay an average of 50 BPs, which is not uncommon. Yet both participants are receiving the same services and have the same account balances.

The situation is worse for larger account balances — especially for owners, fiduciaries and people making plan-level decisions who might be investing in low-cost passive funds or even ETFs while participants with lower account balances are paying relatively high revenue share fees to subsidize all plan costs.

Few would recommend that all participants pay a flat fee. Making a low-balance participant pay the same as a high-balance account hardly seems fair. Maybe, though, there's a hybrid model where participants pay a percentage of assets up to a certain amount, and then pay a flat fee.

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This raises the question of whether these high-balance, low-revenue-sharing decision makers will be reluctant to move to a more equitable arrangement. According to O'Shaunessy, these senior managers do not hesitate when making the decision. In fact, the situation may motivate them to move to fee equalization. The potential liability and "bad press" with rank-and-file participants is greater than the relatively small dollar amounts they may have to pay.

Who Owns Revenue Sharing?

So who really owns this revenue sharing from mutual funds, usually in the form of Sub-TA fees?

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According to Steve Saxon, a principal with the Groom Law Group, revenue sharing is not a plan asset, at least when it is first paid into the plan, without a specific arrangement between the plan sponsor and record keeper.

Saxon was pleased to have the Department of Labor agree in a recent Advisory Opinion (Adv. Op. 2013-03A) involving his client, an insurance provider. The Advisory Opinion was important because if revenue sharing is a *de facto* plan asset under Schedule H of the Form 5500, it would have to be held in trust and give rise to all sorts of prohibited transactions. There might also be issues with the mutual fund companies.

But once that revenue sharing is received, it can become a plan asset if there is a written arrangement between the parties to that effect. Saxon is quick to point out that the issue is about disclosure, not fairness, and that currently equalization is not required and may not make sense for really small plans where the administrative costs might outweigh the benefits.

Technology Holds the Key

To really accomplish participant fee levelization, there needs to be a sophisticated technology solution. In the past, record keepers took a monthly snapshot of a participant's account to calculate how much revenue sharing each participant paid and how much should be charged or credited to that account. While that's cumbersome, it's still easier than calculating and crediting accounts daily.

But monthly snapshots do not accurately reflect how much revenue sharing each participant paid due to market fluctuations, contributions and transactions that may have occurred during the month. A savvy participant could game the system by moving all investments to low-revenue sharing funds monthly when revenue sharing is calculated. Though prohibitions against excessive trading due to the market timing scandals limit transactions (and most participants would not even know what to do), having this kind of loophole is a potential problem.

The three major providers who are making fee equalization available — Transamerica, John Hancock and OneAmerica — have limited the service to mid-market plans or those generally with more than $10 million in assets, although Transamerica is just starting to offer the service to smaller plans.

Transamerica calculates the revenue sharing paid by each participant daily and then credits or charges their accounts based on the overall charge needed to run the plan monthly. If the plan requires 25 BPs by agreement with the plan sponsor, and the investments in a participant's account generated 35 BPs, that participant's account would be credited with 10 BPs. Similarly, a participant whose investments paid 15 BPs of revenue sharing fees would be charged 10 BPs. According to George Revoir, VP at John Hancock Retirement Services, "It's a technology solution." That may be why very few providers are offering it — though everyone claims to be "six to nine months away from making a solution available."

Share Classes

Some may ask, "Why not offer all institutional shares like R6, which pay no revenue sharing, and just create an ERISA account where all participants pay an equal percentage to offset costs?" The problem is that some popular funds do not offer R6 funds.

According to Transamerica's Nybo, using share classes that include revenue sharing may be more efficient. Nybo claims that R4 or R5 funds, for example, may be cheaper than the same R6 fund when revenue sharing is stripped out because these nascent funds include fees to pay for their formation. Nybo says that the ability to levelize participant fees makes share classes irrelevant — which assumes that the plan has negotiated a reasonable fee for the services provided and adequately negotiated a fair deal based on share classes available for plans of their size and situation.

Legal Requirements

While we are far from the DOL requiring participant fee equalization, according to David Levine, a principal with Groom, he emphasizes that the process a plan sponsor goes through in making a decision may be reviewed.

Fiduciaries may not be paid out of plan assets unless the fees are reasonable and levelized, which is why advisors acting as a fiduciary may not be paid depending on which fund the plan or its participants selects. This seems logical and fair. So why not levelize revenue sharing?

Record keepers would argue that they do not act as fiduciaries and therefore should not be required to levelize their compensation. They would also argue that their fees are equalized at the plan level under arrangement with their plan sponsor clients, whether it's based on the services rendered or a percentage of assets.

But courts are beginning to realize that some record keepers can swap out funds without prior permission under annuity contracts, which puts them in a position to select funds that pay them more rather than what's best for their clients.

And why are some funds willing to pay greater revenue sharing, not just to get on the platform but to get "premier positioning"? These are savvy people, so it's doubtful they are willing to just give money away. (It would be interesting to study whether similar funds with greater revenue sharing have a larger market share on a particular platform.) In addition, advisors and record keepers may be tempted to offer these higher revenue sharing funds to make the plan expenses appear cheaper.

Market Demand

Most agree that fee equalization will happen or not based on market demand.

Almost everyone agrees that the conversations are not being driven by plan sponsors. Of course, some cynics ask when plan sponsors ever drive change — although auto-enrollment was started by big plans like McDonalds before there was rapid adoption following the enactment of the 2006 Pension Protection Act. Most innovation, however, is spearheaded by providers, who spend a lot of money and hire high-priced talent to focus on the markets' problems — trying to find a solution that will at least give them a head start, if not an edge.

Massive change happens when academics validate the innovation through independent research, and then the government requires it (or at least creates a safe harbor like it did with auto plan features). OneAmerica created their fee levelization on the NAV platform they inherited from the McCready and Keene acquisition because a few of their clients were ready to bolt if they did not. Peter Welsh, OneAmerica's VP, claimed that the cost of creating the service was less than the loss of revenue from these plans.

Currently, 50% of proposals for that market are interested in fee levelization, which matches other providers' experience. Marc Kahn, Transamerica's legal counsel, believes that Transamerica (through its former Diversified division) is being invited to RFPs because of its ability to equalize fees that it would not otherwise be participating in. And Hancock's Revoir says that the firm is making participant fee levelization "a hallmark of our new mid-market NAV service" and is getting into advisors' offices that it would have been shut out of otherwise.

In fact, one of Transamerica's long-standing clients, Donald Fager, a medical malpractice insurance firm with 460 employees, moved to fee equalization two years ago because, after being presented with the option, they thought that it made sense. James Rhatigan, Fager's plan administrator, believes that the service is more equitable and provides greater benefit to their participants. "Reaction from participants was very good, with no negatives, while there was minimal work on our part," Rhatigan relates. But Rhatigan and his committee did not ask for the service — it was presented to them and they felt that it was more equitable, without concern that higher account balance holders would be paying more.

According to Troy Hammond, a big proponent of fee equalization, "Plan sponsors and participants are just getting their arms around fees and don't see a reason to change if fees are reasonable or low." And even though most providers claim to be working on it, will it just be another service or business model that sounds sexy but never really takes off, like gross-to-net pricing? And will it be a commodity if everyone offers it, like brokerage accounts?

In any case, fee levelization is an issue that appeals to most plan sponsors' sense of fairness. If there's no cost, work or increased liability — the three-part gauntlet that any new service must pass through — many of them will be interested.

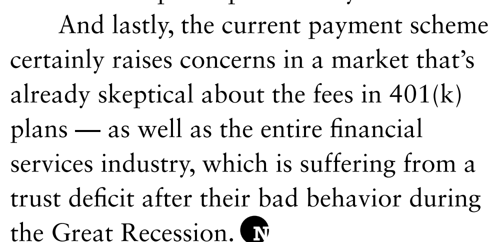
The issue has more practical impact on participants but, based on their reaction to last year's participant fee disclosure regs, it might be a while before they even understand what fee equalization means. When they do, or if the media picks up on it, there might be more demand. Sheridan Road's O'Shaughnessy notes that at a minimum these discussions with clients raise awareness, and can even lead to them paying more of the costs, including advisor fees.

Regardless of the eventual impact, the discussion of participant fee equalization is just beginning, and it should have "legs" for at least the next two to three years. But two questions remain:

- Will it lead to more business for those providers that offer it or advisors who advocate for it?
- Will it make plan sponsors change record keepers or advisors?

It certainly raises the obvious question of whether participants should pay equally for the services they receive from their plan's service providers — record keepers, money managers and advisors — rather than through Sub-TA or 12(b)(1) fees within funds that participants rarely understand.

And lastly, the current payment scheme certainly raises concerns in a market that's already skeptical about the fees in 401(k) plans — as well as the entire financial services industry, which is suffering from a trust deficit after their bad behavior during the Great Recession.



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SEC REGISTRATION MAY BE NEXT FOR RECORD KEEPERS

Will record keepers need to register with the Securities and Exchange Commission if they are receiving payments from mutual fund companies? Last summer the SEC indicated that it would "ask for information on third party administrators, and may use this information to consider whether entities that provide these services are appropriately registered or exempt from registration." The question that seems to be piquing the agency's interest is whether record keepers are receiving payments from mutual funds held in clients' accounts to pay for services that the funds would have otherwise had to provide — and whether those payments are being made in compliance with the rules. Stay tuned.