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More 401(k) plans moving from revenue-sharing model

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Jamie McAllister said some sponsors want to drop or revise their revenue-sharing arrangements.

Many 401(k) plans are moving away from revenue sharing as executives cite the need for greater transparency, simplicity and democracy in how fees are assessed to participants.

Defined contribution plan consultants say federal fee regulations enacted in 2012 prompted executives to review plan practices for greater transparency.

"The revenue sharing is embedded in the expense ratio, but participants may not know this," said Jamie McAllister, Chicago-based senior vice president at Callan LLC. "There's also a question of the fairness of the fees," she added. "Some (investment) funds may have revenue sharing and some don't within the same plan."

Among her clients, sponsors want to drop or revise their revenue-sharing arrangements — the practice by which revenue from plan assets is the primary source of paying record-keeping fees. "They don't want to add to them," Ms. McAllister said.

Annual surveys by Callan show a steady decline in the use of revenue sharing — to 27.4% of plans last year from 66.6% in 2012. These figures cover plans solely using revenue sharing as well as plans using a combination of revenue sharing and "out-of-pocket" expenses — defined by Callan as an explicit fee, either per person or based on assets, paid by the participant. The percentage of revenue sharing-only plans was 14.2% last year vs. 36.2% in 2012.

Democracy and simplicity go hand in hand with transparency, experts say, as more plans decide that a per-head fee is fairer than the revenue-sharing practices in which fees are based on assets.

The Callan survey showed that 54.7% of plans used a per-participant fee last year to pay for plan administration vs. 41.6% in 2016. The survey contained responses from 152 sponsors — 64.5% of which were 401(k) plans; 21.7% were 457 plans; and the rest were profit-sharing, 403(b) or 401(a) plans. A survey published Feb. 26 by Willis Towers Watson PLC found 41% of plans used a fixed-dollar amount per participant for record-keeping fees vs. 32% in 2014 when the previous survey was conducted. Of the 349 plans surveyed, 91% were 401(k) plans and 9% were 403(b) plans.

Room still exists

Despite more fixed-fee arrangements and plaintiffs' lawyers' attacks against revenue sharing, DC industry members said there's room for revenue sharing depending on plans' unique circumstances. And in the case of 403(b) plans with lineups heavily weighted toward annuities, sponsors cannot easily drop revenue sharing.

Consultants point out that revenue sharing isn't automatically more expensive than other forms of record-keeping fees. Plans' size, participants' account balances and demographics plus, of course, the investment manager's requirements all play a role in calculating whether revenue sharing is a good idea.

"Some feel that an asset-based fee is better," said Ross Bremen, a partner at the Boston-based investment consulting firm NEPC LLC. For example, a fixed-fee system at a law firm with highly paid partners and not-so-highly paid support personnel might be less equitable than asset-based revenue sharing, he said.

A fixed-fee system could "wallop" a young employee with a small retirement balance who is auto enrolled in a 401(k) plan, added Marina Edwards, a Chicago-based consultant with Willis Towers Watson.

Some sponsors that continue to offer revenue sharing have taken steps to make sure money in excess of the contracted fees goes back to participants or is used for additional plan services, she said.

Some plans have expense reimbursement accounts — also known as ERISA budget accounts — in which excess money is held to be distributed to participants or qualified plan expenses. NEPC's annual survey of DC fee practices found 59% of plans with revenue sharing had such accounts last year, the highest in the survey's history.

"Education is paramount, because the sponsor must understand all of the moving parts" of revenue sharing, Mr. Bremen said. "Given all of the litigation, sponsors want to know if revenue sharing is fair and appropriate. It's not always a one-size-fits-all situation."

Litigation is certainly a motivation for DC plan executives to review their revenue-sharing arrangements. ERISA lawsuits assailing plan fees often include revenue sharing as a component of multiple allegations against DC plans by plaintiffs' attorneys.

Sponsors have a better chance of guarding against or defending an ERISA suit if they have the "proper governance processes in place and if they document it to show they made a prudent decision," Mr. Bremen said. If sponsors don't follow their own policies, he added, they are inviting trouble.

"Despite the representations of the plaintiffs' bar, there is no prohibition to revenue sharing," said David Levine, a partner at Groom Law Group, Washington.

"The greatest challenge to plan sponsors is understanding revenue sharing," he said. "Do you know how it works? It's all about process."

Confusion remains

Unfortunately, surveys show some plan executives aren't clear about revenue sharing.

The Callan survey found 16% of DC executives didn't know what percentage of funds in their plans offer revenue sharing. For each of the previous three years, the don't-know answers ranged from 8.3% to 16.3%.

Ms. McAllister said the latest don't-know results were aided by the unusually high percentage (21.7%) of 457 plans in last year's survey vs. 7.9% in the 2016 survey. Ms. McAllister said half of the don't-know responses came from the government plan sponsors last year.

A December survey of 403(b) plans found 30.9% of respondents weren't sure if their plans used revenue sharing to pay plan expenses, said the Plan Sponsor Council of America, Chicago, and Principal Financial Group, Des Moines, Iowa, which conducted the survey. Among the largest sponsors — those with 1,000 or more employees — 8.9% of respondents said they were unsure.

When asked if their plans reallocate revenue-sharing money among all participants, 24.2% of respondents said they were unsure. Among the largest plans, 21.7% said they didn't know.

The large don't-know response "is likely due" to these plans' structures, in which they "generally have limited HR staff," Aaron Friedman, Principal's national practice leader-tax-exempt, wrote in an email. "Financial matters surrounding the plan are often handled separately by the CFO. Therefore, the HR people who would be responding to a survey, are likely not as familiar with the financial aspects of how the plan works."

Mr. Friedman pointed out the survey also found that 72.1% of respondents had annuities in their plans either exclusively or in addition to mutual funds. "Since the vast majority of annuities contain some form of revenue sharing ... the reality is that most of the 70% — plus some portion of the rest — have some sort of revenue sharing," he wrote.

The latest survey results were "about as expected," he said. The presence of annuity-filled investment lineups means 403(b) sponsors "will not have the flexibility to be able to reallocate fees."

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