

# Choosing the best fee allocation model for your 401(k) plans



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We all know that paying for the administration of a retirement plan adds an expense to the bottom line. The U.S. Department of Labor (DOL) requires plan fiduciaries to closely monitor fees to ensure they are competitive and reasonable, it has not yet stipulated a model by which fees must be allocated among plan participants. This leaves plan sponsors struggling with deciding whether to base fees on a percentage of assets (i.e., pro rata) or whether to access a flat dollar fee (i.e., per capita).

Generally, there are three types of defined contribution plan fees and expenses:

- Plan administration fees which are paid directly to the plan (i.e., recordkeeping, compliance testing and trustee fees);
- Investment management fees which include operating expense ratios such as investment management fees and various operating and administrative expenses;
- Individual service fees such as distribution and loan fees, typically paid by the participant.

The easiest approach for many plan sponsors is to simply have the organization pay all of the plan fees directly. However, this adds to plan costs so many plan sponsors choose to pass the expense onto their participants. With retirement plan fees the centerpiece of fiduciary lawsuits, it's easy to understand why this is a leading topic of interest with plan fiduciaries.

While both methods have merit it important that retirement plan committees understand their options and how their decisions may impact participants:

**1.** Expense reimbursement account (ERA). This model is also known as a revenue credit account. Typically, the recordkeeper charges a flat fee for services and then revenue sharing amounts in the plan investments are used to offset applied to these fees. If the revenue

sharing is not enough to cover the recordkeeping fees, the recordkeeper charges an additional fee to cover the shortfall which is either absorbed by the organization or passed along to participants. Conversely, if the revenue sharing exceeds the cost to administer the plan, the excess amount is allocated to the plan ERA and either used to pay plan expenses such as auditors, legal counsel and advisors or refunded back to participants.

Although the ERA model is used by most plan sponsors and fees are disclosed to participants on an annual basis, many participants may not be aware of the cost to administer their plans simply because they do not fully review their statements. Plan sponsors must also consider the fact that not all investments contribute the same revenue sharing amount, which could leave the plan with a shortfall if participants begin transferring assets into investments with little revenue sharing. This is why it's imperative that plan sponsors work closely with their advisors to fully understand the necessary share classes of each investment before making their decisions.

**2.** Fee levelization. Using this model, the recordkeeper applies the required revenue to each individual investment option. The fees match when the investment has exactly the required revenue sharing built into its expense ratio. However, if revenue sharing in the fund exceeds required revenue, the recordkeeper credits the excess revenue to each participant who has assets in that fund. If the investment returns less than the required revenue, a "wrap" fee is added in the amount of the shortfall to each participant using the investment.

Although this model generally solves the plan expense issue because each investment option pays exactly the needed revenue amount, it can confuse

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participants due to the associated fee credits and/or wrap fees seen on their quarterly statements. For this reason, it's very important that plan sponsors educate participants so they understand the fees.

3. Flat-dollar payment. In this model, the recordkeeper charges a flat-dollar amount which is deducted from each account either quarterly or annually. The participant sees this amount on their statement.

Although constructing a lineup of entirely zero revenue sharing funds may not be achievable and depends on the investments available on the recordkeeping platform, this model simplifies fees charged by selecting investment options that have no built-in revenue sharing. This not only enables the recordkeeper to charge the full revenue amount for each investment, it's also easier for participants to grasp as they see the full amount of their fees (rather than a series of credits and debits) with each statement.

### Key takeaways

- Plan fiduciaries have a responsibility to ensure that plan service expenses are necessary and reasonable;
- Plan fiduciaries have three methods to consider for determining if the fees they pay for plan expenses are reasonable;
- Plan fiduciaries will need to fully understand and recognize any inequities in participant payment of fees.

There is no right or wrong answer when determining which fee allocation model to select. However, the potential consequences for a breach of fiduciary responsibility can range from personal liability for participant losses and a 20% civil penalty under ERISA Section 502(i), making this decision a very important one for every plan sponsor. By understanding the three methods of evaluating fees, in addition to following best practices and adhering to DOL guidelines, plan sponsors can determine if the fees paid to retirement plan services providers are reasonable.

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