Moving out of the shadows on revenue-sharing

MAR 22, 2015 | BY JOHN BRINKLEY

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The Labor Department has made it clear that revenue-sharing allocation has to be done on a prudent and reasonable basis. Problem is, it left it at that.

And that leaves a lot of plan sponsors scratching their heads and wondering what is prudent and reasonable and what isn't. Charge a flat, per-head fee? Use a pro rata formula? Charge all participants the same expense ratio?

Revenue-sharing in defined contribution plans has "been fairly common for about 20 years, but the awareness of it has only been in the last five to 10 years or less," said Fred Reish, an attorney with Drinker, Biddle & Reath in Los Angeles. "The law hasn't really caught up with that yet. So, there's no guidance for plan sponsors on how revenue-sharing should be allocated."

According to a 2013 survey by Boston-based investment consultancy NEPC, revenue-sharing deals – used to help offset, or in some cases, to pay for all plan-related expenses – began to fall in 2010. It found that 13 percent of plans had no form of revenue-sharing whatsoever, a figure that most expect will only grow.

Still, revenue-sharing remains part of the retirement-plan picture, as do concerns about fees and transparency.
The good news is that sponsors who use an objective, well-defined and transparent process for deciding how to handle revenue-sharing probably will not run afoul of ERISA, said George Revoir, a senior vice president at John Hancock Financial Services in Boston.

When the Labor Department issued ERISA Rule 408(b)(2) in 2012, it addressed disclosure of plan sponsors' revenue-sharing allocation methods, but not the methods themselves.
"You need to have a process to understand what you're paying and who you're paying, and then the results of that process will tell you what (revenue) you have, and then you would make an informed decision on how you're going to allocate expenses and fees," Revoir said. "Having a sponsor make an informed decision on how they want to do it is the most important thing."

In the early years of 401(k) plans, record-keepers usually kept all the revenue-sharing proceeds and thus were able to charge very low fees.

Plan sponsors "didn't really understand what was going on," Reish said. "It made 401(k) plans seem very inexpensive and as a result it helped them become popular. So, even though it wasn't transparent, there actually was a benefit."
Then, a few years ago, "because of the government's constant drumbeat on fees and expenses, some plan sponsors began questioning the amount of revenue-sharing that the providers were receiving. And they began negotiating reductions," Reish said.

More recently, providers have developed the ability to actually take the revenue-sharing received because of each participant's (gains) and credit that back to that particular participant's account," he said. "That's called levelizing revenue-sharing or equalizing revenue-sharing profits."

Reish, Revoir and Philip Chao, principal at Chao & Co. in Vienna, Va., addressed the issue at a workshop Sunday at the NAPA 401(k) Summit in San Diego.
Some common revenue-sharing allocation practices are unfair or create conflicts. Most agree that these problems arise primarily from confusion, not from venality, and can be easily fixed.
For example, in some plans, participants invested in index funds, ETFs and other low-cost investments get a free ride, courtesy of participants in expensive, actively-managed funds, Reish said.

"In many cases, some participants are in expensive investments that pay a lot of revenue sharing, while other participants are in inexpensive index funds that pay no revenue sharing," he said. "That means the participants in the expensive funds are paying the whole cost of the plan, and the participants in the index funds are in there for free. They are paying nothing toward the cost of the plan."

If one participant is in an S&P 500 Index fund and another is in an emerging market fund that charges 12b-1 fees, "their account balance shouldn't pay for the other guy's account balance," Revoir said. "When you look at it from a standpoint of the subsidies, I don't think most people know it's taking place. And I think that if most people knew it was taking place, they'd want to correct it."

Another common problem is that some plan sponsors unwittingly create a conflict of interest when they act as fiduciary to the participants at the same time they represent the interests of the company and its shareholders, said Chao.
What often happens is that the plan sponsor offers to pay any costs not covered by revenue-sharing. The employees appreciate his generosity.

"It sounds good, right? But in reality, it's a conflict. It's a terrible conflict," said Chao, who is a plan advisor.
That's because the employer is also responsible for deciding what share classes to offer in the 401(k) plan, and he has to choose between those that give participants the most bang for the buck and those that cost the company the least, he said.

ERISA "requires plan fiduciaries, when selecting and monitoring service providers and plan investments, to act prudently and solely in the interest of the plan's participants and beneficiaries," according to a Labor Department fact sheet on Rule 408(b)(2).

Employers who are guilty of this conflict usually don't know it, and because they run small companies, they're often too busy to learn the law and they can't afford to hire consultants to explain it to them, Chao said.

Luckily, he said, they're not likely to be punished for it, "because DOL has (better things) to do than knock on doors of a 10-person company and say, 'I'm going to check all your fiduciary prudence records.' It never happens."

The original article can be found at: http://www.benefitspro.com/2015/03/22/moving-out-of-the-shadows-on-revenue-sharing?page_all=1