



Fee Disclosure Forensics

BY AL OTTO

Plan expenses eat up rates of return. Fiduciaries, in their role of prudently selecting plan investments, should be examining these expenses. The purpose of this article is to evaluate and uncover where excessive fees typically lurk in 401(k) plans and to give the reader tools for identifying and evaluating them.

“What’s the big deal? Who cares if all the fees are disclosed as long as the overall expense ratio is lower than the averages?”

These are typical questions asked by many plan fiduciaries and practitioners in the 401(k) industry. They are excellent questions. The problem is that ERISA Section 401(a)(1)(B) requires a different question to be asked: “Are the fees being paid to the service providers reasonable?”

These two questions are quite different in scope. The first looks at the issue from the perspective of the seller (*i.e.*, the 401(k) plan providers); the second question correctly looks at the issue from the buyer’s (*i.e.*, the plan’s) perspective. In the 401(k) plan environment the buyer usually has a representative called a fiduciary, who has a duty to make sure the plan is run solely for the benefit of the participants and their beneficiaries. [ERISA §§ 404(a)(1), 403(c)(1)]

Fee disclosure in 401(k) plans has become a hot topic at many levels over the last 18 months. This is evidenced by a November 2006 GAO Report titled, “Changes Needed to Provide 401(k) Plan Participants and the Department Of Labor Better Information on Fees.” Public hearings held by Representative Miller of California in March 2007, as well as numerous lawsuits filed by participants against large plan sponsors, addressed the issues of fees and fee disclosure. Countless articles about fees and disclosure, some good and some poor, now proliferate the mainstream media. The Department of Labor (DOL) is so concerned about 401(k) fees that it posts bulletins for employers and employees alike on its website (www.dol.gov/dol/pwba), explaining its rules. It also offers a form that sponsors can use to determine if the fees charged their participants are reasonable.

Plan expenses eat up rates of return. Fiduciaries, in their role of prudently selecting plan investments, should be examining these expenses. Plan fiduciaries have three basic duties regarding the determination of fees according to Don Trone, president of the Center for Fiduciary Studies. They are to:

1. Control and account for all investment-related fees and expenses;
2. Identify every party that has been compensated from portfolio assets; and
3. Demonstrate that a determination was made that the fees and expenses paid to each party were appropriate and reasonable, given the level of services rendered. [Investment News, March 26, 2007, “Fees and Expenses: It’s About Fiduciary Duty”]

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The purpose of this article is to evaluate and uncover where excessive fees typically lurk and to give the reader tools for identifying and evaluating them.

To understand and discover the location of possible excessive fees, one needs to look at the services provided by the service providers. Five basic services are provided in a typical 401(k) plan:

1. Custodianship of the funds;
2. Money management;
3. Administration and recordkeeping;
4. Communication and education; and
5. Advisory services including investment, legal, financial, and human resources.

The challenge for plan fiduciaries in determining the reasonableness of fees for these five services results from the fact that the services are normally bundled together from a pricing standpoint. The industry pricing model, as shown in Exhibit 1, includes only two sources of revenue to pay for the five types of services:

1. A hard dollar billable expense paid by the plan sponsor; and
2. The overall expense ratio charged on the assets.

This is why revenue sharing exists. Money must flow from one of these two sources of revenue for the plan to pay for the five services being rendered. Therefore, to determine if costs are reasonable,

a fiduciary must look at all five services being provided, benchmark the cost of each, and then compare that to the price actually being paid. Simply benchmarking overall cost can lead to misinformation and poor decisions, and cause the plan to pay excessive fees to one or more of the service providers.

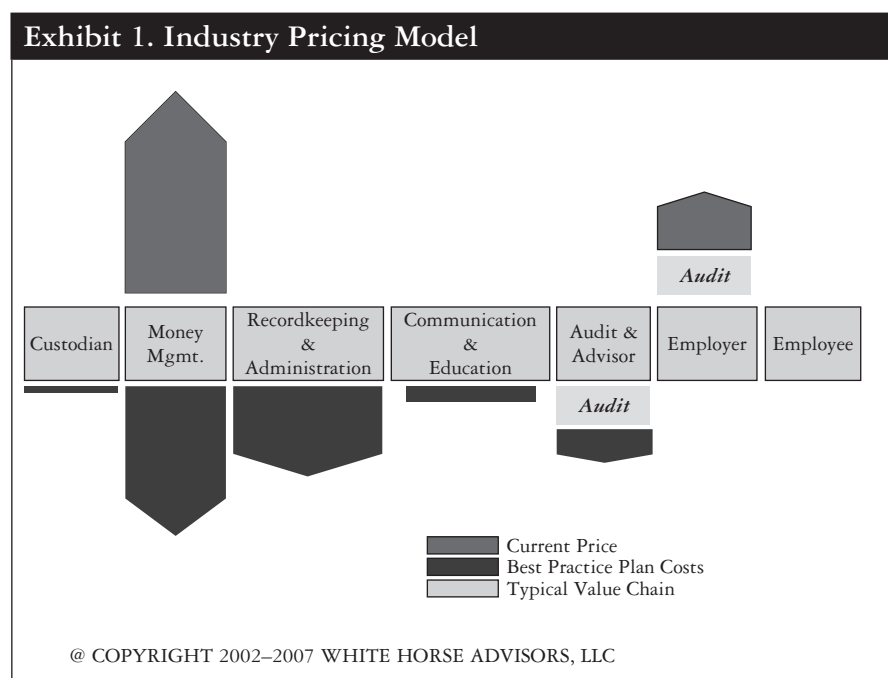
The reality of the situation is even more complex. Up to 15 different entities potentially could be receiving money from 401(k) plan fees. It is beyond the scope of this article to go into detail on each of them, but it does underscore the complexity of the situation and the daunting task in front of most fiduciaries when it comes to understanding the reasonableness of fees.

Nonfiduciary service providers are not required to disclose what they are receiving for the services being rendered; however, plan fiduciaries *are required* to know that the service costs are reasonable. [ERISA § 401(a)(1)(B)] Most 401(k) plans have these services delivered in a bundled or integrated package, which makes it difficult for a plan sponsor to determine who is being paid for what.

A Simplified Example

In a bundled 401(k) arrangement, several entities are usually being paid through the fund expense ratio. These may include:

1. The actual money management company;
2. A fund distribution company;
3. A custodian;



4. A research organization;
5. A recordkeeping and administration company; and
6. An advisor, potentially.

The plan sponsor and the participant only see the fund expense ratio. So, the general argument goes like this: “The fund expense ratios are well below the Morningstar or Lipper averages, so you are getting a great deal!”

This may be true or it may be completely false. Look at two examples. Assume Company A and Company B both use the same bundled provider with whom they deal directly. The companies have exactly the same fund line-up. Further assume that the percentage allocation of assets is into the 15 fund choices for both plans, and the weighted average expense ratio is .86 percent. Both plans are receiving exactly the same services from the bundled provider. Both plans have \$50 million in plan assets, so most people would assume that .86 percent is a great deal. Lastly, assume that neither plan sponsor pays any hard dollar charges. According to the *401(k) Averages Book* (7th Edition), the average percentage plan expense for a \$50 million plan is around 1.17 percent. [Actual data documents 1.17 percent for a \$40 million plan and 1.17 percent for an \$80 million plan.]

Based on the typical price comparison analysis, these plans are both way below the average cost and most plan sponsors and many industry professionals will believe they have a great deal. This article is, however,

about fee forensics, so there must be more under the surface.

Taking the analysis one step further, look at Exhibit 2. Company A has 700 participants and Company B has 2,000 participants, which means that the average participant balance is \$71,428 for Company A and \$25,000 for Company B. So, the only difference between these two plans is in the participant count.

On the surface, from the plan sponsor’s perspective, services that both of these plans receive are “free.” Yet, most of the “prudent experts” running the 401(k) plans across the United States know that someone is getting paid for the recordkeeping and administration of the plan. The question is how much?

After asking the plan provider to disclose the internal revenue sharing arrangement we discover .35 percent (35 basis points) is allocated to the recordkeeping and administration company owned by the bundled provider. That means that both companies are paying \$175,000 for these services. Here is the challenge: Recordkeeping costs are largely a function of the number of participants for which records are being kept. So Company A is paying \$250 per participant and Company B is paying \$87.50.

Company A is overpaying significantly. The \$250 per participant cost for recordkeeping and administration of a \$50 million plan with 700 participants is excessive and definitely not reasonable. To be more specific, the authorization by the trustee to pay this

Exhibit 2.*		
	Company A	Company B
Bundled Plan Provider	Company ABC	Company ABC
Plan Assets	\$50,000,000	\$50,000,000
Overall Expense Ratio	0.86%	0.86%
Industry Average Cost**	1.16%	1.16%
Number of Fund Choices	15	15
Revenue Sharing %	0.35%	0.35%
Revenue Sharing \$	\$175,000	\$175,000
Number of Participants	700	2,000
Average Account Balance	\$71,428	\$25,000
Cost of Recordkeeping per Participant	\$250.00	\$87.50
* Assumes all revenue sharing is captured at the plan provider and is not shared.		
** <i>401(k) Averages Book</i> , 7th Edition (401(k) source.com).		

fee could be considered a fiduciary breach under ERISA Section 404(a)(1)(A)(ii). The participants in Company A's plan should not have to pay more for administrative services than Company B's participants are just because their average balance is higher. Administrative services are not highly correlated with the asset balance.

If this situation were to continue for a period of 30 years, assuming an 8 percent growth in plan assets, the impact would be significant on the accounts of Company A's participants. The average current participant would have an account balance \$56,000 lower because of the excess cost embedded in the plan.

Just to be fair, this is not a problem with recordkeepers only. The same type of situation can occur with investment advisors, custodial services, education services, and sometimes even money management. The key to the analysis is to unbundle the services being received and then benchmark the pricing of each individual service to make sure each is reasonable. Then, compare the sum of the benchmarks to the price being paid.

Herein lies the problem. 401(k) plans are complex programs that are made even harder to understand by the structure of the organizations providing services. Plan sponsors and other fiduciaries are just not given the tools they need to perform this analysis and there is no requirement that plan service providers fully disclose their true pricing. As a result, plan fiduciaries are left holding the liability bag.

Often providers argue that they should not be required to disclose their profit margin. Nonetheless, they should be required to disclose their actual price for services being offered.

Department of Labor

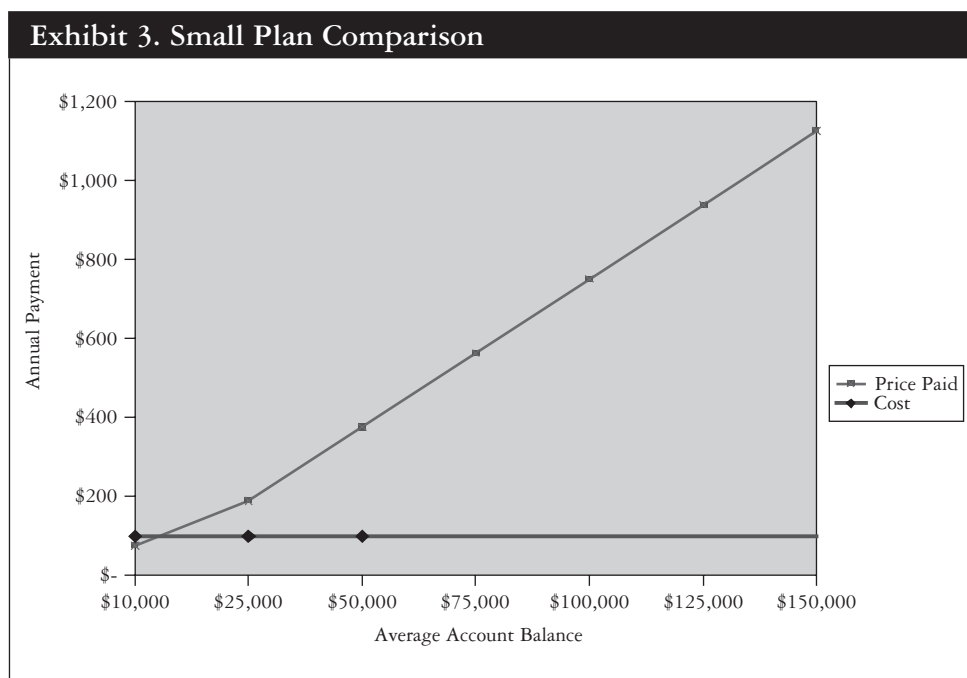
Hopefully the current work on Form 5500 disclosures by the DOL will help to eliminate the situation described here. The DOL is currently undertaking three projects, which include:

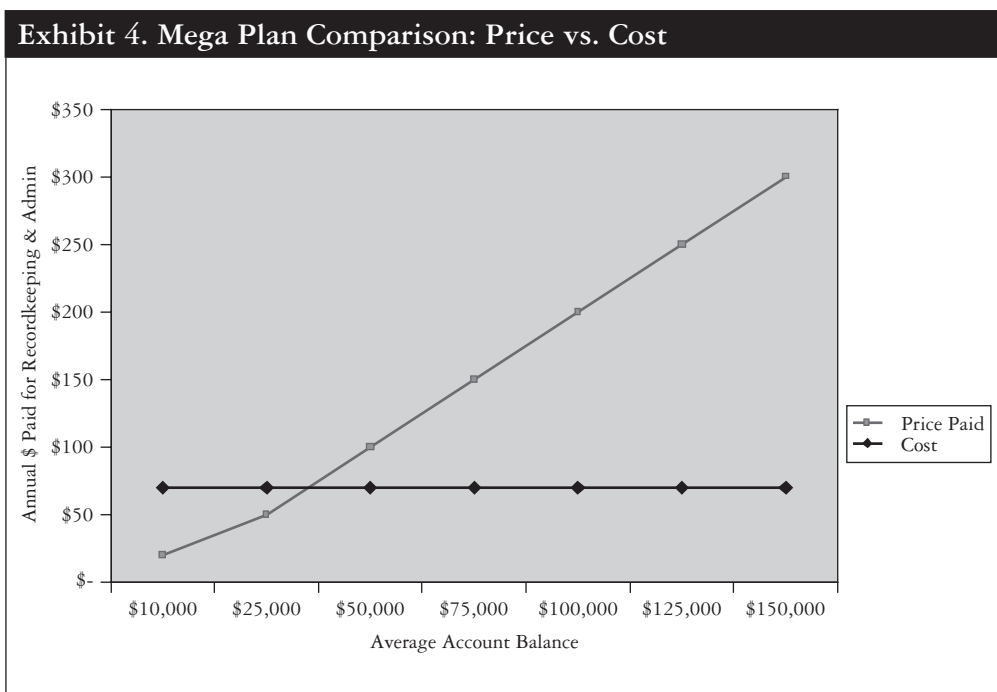
1. The reporting of fees, expenses, and revenue sharing on Schedule C of Form 5500 in 2008;
2. Issuance of a model notice under the fiduciary advisor provisions in the Pension Protection Act of 2006; and
3. The ERISA Section 408(b)(2) point-of-sale disclosure regulation.

Of these three projects, numbers 1 and 3 have the greatest current promise of helping to remedy fee disclosure challenges for plan sponsors.

Where Can Excess Fees Be Found?

The following paragraphs identify some of the key areas in which fee excesses occur. It is not a thorough discussion of every type of fee that can be incurred, but simply of the areas that are most common.





Percentage-Based Recordkeeping and Administration Fees

The previous example discusses percentage-based recordkeeping fees. It is an absolute mistake for any plan fiduciary to allow this type of fee charge. To determine reasonableness, the fiduciary should always look at recordkeeping and administration fees on a cost-per-participant-account basis. There is virtually no correlation between the amount of assets in a plan and administration costs.

In addition, recordkeeping and administration is never free. A plan sponsor and the plan fiduciaries are required to make sure that costs are reasonable. The fiduciary needs to demand that each service provider disclose its price for the services rendered.

The cost of recordkeeping and administration services will vary based on the number of participants and the scope of services provided. However, a reasonable cost for the service could vary from \$50 per participant per year for mega plans to \$200 per participant per year for very small plans.

Pricing Creep

Pricing creep occurs naturally as a 401(k) plan grows. Regardless of whether a plan is small or a mega plan, pricing creep can affect the reasonableness of fees simply because growth in 401(k) plans naturally occurs. Ongoing contributions and the growth of investments increase the average account balance of each participant on a continuous basis. A plan fiduciary must therefore understand the impact of this

growth on the asset-based charges. Exhibits 3 and 4 illustrate the impact that pricing creep can have on a small plan and a mega plan.

The small plan example (Exhibit 3) *assumes* the use of R2 shares, which often carry a 100 basis point revenue sharing component. As seen in the diagram, the revenue sharing component exceeds the recordkeeping and administration costs as long as the average account balance is greater than \$10,000. Plan fiduciaries running small plans should consider more effective share classes such as A, R3, R4, or R5 shares. These would result in a more equitable arrangement as plan assets per participant grow.

The mega plan example (Exhibit 4) assumes the use of R4 shares. Once the average account balance reaches \$35,000, recordkeeping and administration costs are paid for completely by revenue-sharing. Plan fiduciaries running mega plans should consider more effective funds such as separately managed accounts or collective trust arrangements. The use of lower cost fund shares eliminates much of the pricing creep.

Both of these examples will eventually result in excessive recordkeeping and administration fees because these fees are based on a percentage of assets rather than a flat dollar or per-head amount.

Small plans have a real disadvantage here because of the lack of staff and exposure to qualified advisors. Ideally, small plans are better served by an open architecture, fully disclosed 401(k) platform. The challenge is that these platforms are hard to find, harder to implement than their bundled counterparts are, and

Exhibit 5. Stable Value Fund Comparison		
Stable Value Fund Comparison Pricing for New 401(k) Provider	Plan Provider A	Plan Provider B
Fund Name	ABC Company Stable Value Fund Class 2	ABC Company Stable Value Fund Class 2
Assets in Fund	\$2,500,000	\$2,500,000
Net Yield	4.25%	3.15%
Gross Yield	5.15% (Disclosed)	5.15% (Undisclosed)
Available Revenue Sharing	0.50% (Disclosed)	1.60% (Undisclosed)
Actual Fund Expense Ratio	0.40% (Disclosed)	0.40% (Undisclosed)
Expense Ratio per Proposal	0.90%	0.00%

generally provide fewer services. As a result, there is a need for an outside advisor to supplement services. In a perfect world, full service bundled providers would simply price and disclose on an appropriate basis so plan sponsors could determine if costs are reasonable.

For plans with assets in excess of \$1 billion, the collective trust route can be far less expensive than mutual funds. At this level, it becomes unnecessary to pay the extra costs embedded in a mutual fund, such as legal fees, securities fees, postage costs, and distribution expenses. Many fund families will provide clone funds that mirror their mutual fund counterparts with as little as \$25 million. The use of cloned collective trusts can easily cut up to 30 basis points from the fund's expense ratio. This leads to increased plan performance, and is a better choice from a fiduciary's perspective. Funds managed exclusively for a retirement plan can also avoid the expenses associated with tax planning inside mutual funds.

Embedded Fees: Stable Value Funds

Stable value funds maintain the value of the principal and all accumulated interest regardless of interest rate moves because of the investments held by the fund. A stable value fund generally holds a mix of high-quality, intermediate-term bonds and guaranteed-interest contracts (GICs) from insurance companies. A stable value fund's portfolio is protected against both principal and interest rate risk by a bank or an insurance company through a wrap contract that guarantees the principal and the return for a period of time.

Although stable value funds are excellent tools for providing safety of principal investments to retirement plans, they are also a great place for plan providers to hide revenue sharing. On the surface, stable value funds are wonderfully simple. The participant receives

a stated fixed interest rate for a set period of time (generally one year), as one would when owning a certificate of deposit from a bank.

Underlying that simple front-end structure is a complex financial instrument. The investments inside many stable value funds include corporate securities, asset-backed securities, guaranteed insurance contracts, and structured notes. There is a fee for managing the funds, there is a fee for the insurance wrapper, and there is a fee for recordkeeping the account. There may be an additional wrap fee to accommodate payments to distribution partners and administration partners.

Many plan providers and investment platforms do not disclose the revenue sharing that comes from the stable value fund or the additional wrap fee that may be added to the stable value fund's fees by the plan provider. These revenue sharing agreements can vary greatly, even from the same fund provider.

The first sign that there is a problem is when the stable value fund's expense ratio is stated to be zero percent. No money manager in the world receives no fee for the work he or she does. According to a recent IOMA/RogersCasey study on fees, stable value fees average 41 basis points (excluding recordkeeping costs). These fees will grade down as fund assets become larger. They average 21.8 basis points for funds up to \$100 million and 14.47 basis points for funds from \$200 to \$499 million. ["Focusing on 401(k) Fees Can Help Build Retirement Savings," *Stable Times* (First Quarter 2005), vol. 9 no. 1.] Note, however, that an average price may not imply reasonableness. Each plan's situation must be evaluated based on its own facts and circumstances.

Just to prove the point, Exhibit 5 illustrates a real-life example of two vendors using the same stable value fund in their line-up during a vendor search. The actual names have been withheld to avoid the obvious

legal challenge that would occur if names were disclosed. One provider disclosed all costs and the other did not.

Both plan providers were receiving revenue sharing, but the undisclosed scenario provided significantly more revenue sharing to Plan Provider B, which was not disclosed in the proposal. It made Provider B's fees look much less expensive than they really were. The difference was discovered only by chance because two providers in the vendor search offered the same fund.

Not disclosing stable value fund or GIC fund fees is a dirty little secret used by plan providers who will likely never be a strategic partner with a plan sponsor. Better providers will disclose all fees and revenue sharing. Fiduciaries who have stable value funds in their line-up should demand complete pricing information and avoid partnering with those that will not disclose. Complete pricing information includes gross yield, net yield, expense ratio, and the costs of services embedded in the stable value fund.

The Stable Value Investment Association has an excellent fee disclosure worksheet on its Website (<http://www.stablevalue.org/library/feetempl.asp>).

Sub TA Arrangements

Sub transfer agent arrangements (Sub TA fees) are hidden fees that plan providers use to pay for outsourcing recordkeeping and administration to third parties. Sub TA fees may be paid as a flat dollar amount per participant, per fund (generally ranging from \$5 to \$20 per account), or as a percentage of assets in a given fund (generally ranging from 5 basis points to 25 basis points).

Most plan fiduciaries are unaware of these Sub TA arrangements. They are not specifically disclosed in any prospectus, annual report, or summary of additional information associated with mutual funds. In addition, agreements between fund companies and plan providers will vary based on the individual contract between those two entities. There are only two ways to discover the amount of these Sub TA fees:

1. Get full disclosure from the plan provider; and
2. Collect data during vendor searches with full disclosure providers.

These full disclosure providers typically show a search consultant revenue sharing available from all the funds on their platform. This is a strong indicator of what revenue sharing fees are available from other undisclosed sources.

It is vitally important for a plan fiduciary to know the Sub TA revenue being paid by the funds inside a plan. Without this information it is virtually impossible to determine the reasonableness of the fees for services being provided. Plan fiduciaries should demand disclosure from their plan providers—better providers are happy to disclose these arrangements.

Finder's Fees

For many years, finder's fees have been used in the small to midsize plan market to attract brokers and agents to sell the services of a particular plan provider. A recent sales flyer from a new 401(k) product touted up-front commissions ranging from 1.25 percent to 2.75 percent on "all deposits." This would produce a \$27,500 commission on a tiny \$1 million plan and include a back-end surrender charge. The problem with products like this is that they approach a plan from the perspective of a salesperson, not a fiduciary. In addition, these upfront commissions result in excessive costs for participants in the plan. One has to question the value received when a salesperson receives tens of thousands of dollars for making a sale to a relatively small 401(k) plan.

Fortunately, most providers are moving away from this type of compensation. It is still common in products manufactured by insurance companies, and less common for those manufactured by mutual fund companies. Finder's fees become less common and lower in percentage as the plan size increases.

Plan fiduciaries should always ask if any finder's fees are being paid and in what amounts. In addition, Form 5500 now requires that these fees be disclosed publicly. The only unfortunate part of this is that the disclosure occurs after the fact. This is simply a function of the reporting timeline. Many plan fiduciaries feel that there is little that they can do seven months after a finder's fee was paid. A good step to take is to ask the provider to return the finder's fee if it was not clearly disclosed up front.

Trading Costs

Trading costs are completely hidden from plan participants and plan fiduciaries regardless of the type of platform used. This includes mutual funds, collective trusts, and group variable annuities. They are included in the net performance of a fund; however, because they can be so large, it is important that plan fiduciaries understand the trading costs associated with each fund in their plan's line-up.

Determining total trading costs for any mutual fund requires a rigorous, complex, and time-consuming

exercise. Trading costs can be estimated for a specific fund through a mathematical calculation combining information from a mutual fund's prospectus, annual report, and summary of additional information.

Studies like the one completed by O'Neal, et al., in 2004, titled "Portfolio Transaction Costs at US Equity Mutual Funds," show that mutual fund trading costs can be as much as the actual expense ratio. The net effect is a doubling of the cost. Plan fiduciaries should understand how trading costs affect their plans.

Proprietary Funds

Proprietary funds may be described as funds that are manufactured and distributed by the same organization that provides 401(k) plan services. These organizations include many of the brand-name 401(k) plan service providers in the country.

Revenue sharing on proprietary funds is often not disclosed, and is often higher than the revenue sharing on externally managed funds. As a result, it is important for the plan fiduciary to gather the information. It is also important to note that internal revenue sharing in proprietary funds does not require a 12b-1 arrangement. The payments must, however, be allowed by prospectus, but there is no mandatory disclosure rule.

Fund companies often argue that they should not have to disclose their profit margins and therefore should not have to disclose the internal revenue sharing numbers. This is a lousy argument. Fund managers do not do recordkeeping or administration of 401(k) plans. The recordkeeper is typically a separate wholly owned subsidiary of the fund family. The lack of disclosure withholds both the payment and the profit. That all entities in a bundled arrangement have the same parent name should not matter: They are still separate entities and each one should disclose its pricing.

The issue is not about profit margin. It is about disclosing the price for each key service being rendered. The plan fiduciary must understand the true cost of services, so the internal revenue sharing payments should be disclosed.

Broker Dealer Compensation

Certain compensation to broker dealers is completely hidden and difficult to obtain. It is extremely important to have commissioned brokers, advisors, and their respective broker dealer (BD) disclose *all* compensation received.

The selling agreements between broker dealers and 401(k) providers are not disclosed. On the surface, there is no real problem here. A plan sponsor need not know the intricacies of a selling agreement. The problem is that the lack of disclosure hides compensation inside a distribution system. Broker dealers can receive significant extra compensation when distribution targets are hit. In addition, BDs with large distribution networks can receive far more compensation on the same funds when compared to smaller distribution networks. These extra monies are kept by these BDs and little service is derived by the plan in these situations. The result is that money is paid to the sales people and there is no additional benefit to the plan or its participants.

Plan fiduciaries whose plans were sold through BDs should demand to have all the BDs disclose compensation in writing. At times, compensation to the BD can be more than double what is disclosed to the plan sponsor.

Sub-Advised Arrangements

Many funds do not employ money managers. Instead they outsource the money management to a third party. This is common with mutual funds, wrap programs, variable annuities, and collective trusts.

Some fund families charge a significant fee to oversee the outsourced money managers they have chosen. These sub-advisory fees should be identified and understood by plan fiduciaries. In effect, two management companies are being paid. Sub-advised funds generally have layered fees, so these funds should be examined closely before deciding to invest.

Sub-advisory fees may range from 5 basis points to 100 basis points depending on the fund family and its structure. Certainly, a fund family should be compensated for the oversight of its money managers; however, one has to question the value of sub-advisory fees that exceed the actual money management fee. If the money management fee is 20 basis points and the sub-advisory fee is 60 basis points, a prudent fiduciary might question if the sub-advisory fee is in the best interest of the plan participants—or is it simply a mechanism to pay for distribution services? Distribution services are not necessary in an ongoing relationship with a 401(k) plan.

Sub-advisory fees are fully disclosed in the prospectus, so they are easy to identify, but the prospectus must actually be read.



Fund of Funds

Many of the highly popular new target date funds and asset allocation funds are mutual funds whose holdings are simply a basket of other mutual funds (*i.e.*, a fund of fund). This situation is similar to the sub-advised arrangements discussed previously: Fees are layered between more than one manager.

Funds of funds that reside inside a group annuity or a wrap arrangement often have a triple layering of fees. These fees compound and can be a detriment to the plan participants' account balance growth.

Filtering the Noise

Not all 401(k) plans have excessive fees. Many are reasonably priced. The key lies in understanding pricing and cost realities. One easy way to get real information is to force every service provider to disclose its fees fully—to get naked financially. Although this is still uncomfortable for some, it is a growing practice among the higher quality providers.

Comparing the use of fee-based advisors versus commission-based advisors is a good beginning. Choosing service providers that acknowledge their fiduciary responsibility in writing is an even stronger step. Fiduciary duty is a serious thing. Financial organizations generally do not treat it lightly, so the service providers that do acknowledge their fiduciary status have thought it through and generally embrace the responsibility.

Putting It All Together

Nonfiduciary providers do not have to disclose profits; they simply need to demonstrate value. Here

are seven steps to drive better solutions for plan fiduciaries:

1. Ask all service providers to disclose their fees on both a percentage and a dollar basis.
2. Benchmark all plan costs on an unbundled basis and then compare the total to the price being paid.
3. Evaluate recordkeeping and administration fees on a cost per plan participant basis.
4. Avoid commission-based arrangements for any service being rendered to a plan.
5. Choose service providers that will demonstrate in writing that they are a fiduciary when appropriate.
6. Have an ERISA attorney review all contracts.

Include a section on monitoring plan fees in the plan's investment policy statement to keep the issue in the forefront of the fiduciaries' minds.

The US retirement system is at a serious point in its history. Defined benefit plans are on the wane and 401(k) plans are significantly underfunded. There is an extreme need to face reality. Without changing, the current retirement system will not support the retirement needs of the US population. The private retirement system has the ability to deliver a dignified retirement to all its participants, but we must enter a new era of full disclosure.

Now is the time for all retirement plan professionals to get it right. Now is the time to move to a full fee disclosure environment for all 401(k) plan service providers. Now is the time truly to help sponsors and participants understand their plan costs. Fee disclosure will not undermine the industry. It will simply require the players to demonstrate value. Yes, it may eliminate those who choose to deceive, but that is not such a bad thing. ■

