



Understanding and Evaluating Retirement Plan Fees, Part Three: Fee Allocation

NOTE: Information on this page has been updated as of August 2024.

Today's 401(k) industry has grown to more than 60 million participants, \$3 trillion in participant assets, and a whopping \$30 billion in annual fees, according to the Plan Sponsor Council of America. With numbers like this, it should come as no surprise that the way plan sponsors assess their service provider fees is receiving a lot of attention.

In this article, we'll explore three key options for retirement plan sponsors that are considering how service provider expenses will be paid by participants. Each option has its own potential benefits and considerations. The three most common approaches include:

- A built-in method whereby provider costs are covered through revenue sharing;
- An institutional method in which participants are assessed a flat fee and revenue sharing is removed from the investment lineup; and
- A fee-leveling method whereby revenue sharing is credited to each participant and a flat fee is assessed.

Let's take a deeper dive into each.

Built-In Method

The built-in fee allocation model uses fund revenue—known as *revenue sharing*—to pay for recordkeeping fees. Revenue sharing consists of 12(b)-1 and sub-transfer agency fees built into the expense ratios of a plan's investments. These fees are collected by the investment managers, paid to

the recordkeeper, and used to offset plan expenses, typically for recordkeeping fees. In this fee allocation method, the total fund revenue is collected by the service provider and aggregated at the plan level.

The total amount of revenue sharing in a plan is often enough to cover the entire recordkeeping fee. If not, the recordkeeper charges an additional fee to cover the gap. When revenue sharing exceeds the amount owed to a recordkeeper, the surplus can be used to cover other qualified plan expenses or rebated to participant accounts.

The benefit of this method is it's easy to implement and reduces, or even eliminates the need for explicit participant fee charges. Additionally, the net investment cost of the funds may be overall lower than when non-revenue sharing share classes are utilized. However, it may be harder to hit a specific revenue target since each investment option's revenue sharing amount will vary from fund to fund.

Institutional Method

Another method for covering recordkeeping fees is to offer a menu of institutional share class funds that do not pay revenue sharing and charge each participant a dollar or basis-point amount. The recordkeeper deducts the amount from each participant's account either annually or quarterly. The fee is stated clearly on participant statements and in fee disclosures. This approach is straightforward to implement, transparent, and easy to explain to participants.

While simple in execution, the institutional method can be met with some challenges. The most common issue occurs when a fund company does not offer a share class without revenue sharing, resulting in a fund lineup with some funds that pay revenue sharing and others that do not. In this scenario, plan sponsors must decide where the received revenue will go and how it will be used to offset service provider fees.

Fee-Leveling Method

Fee leveling is an allocation approach that rebates any revenue sharing back to the participants who paid the fees. Typically, this revenue is distributed on a monthly or a quarterly basis. Then, each participant is assessed a dollar or basis-point amount for the services provided.

In another version of the fee-leveling method, the recordkeeper assesses a fee or rebates revenue at the individual fund level for each participant. If the investment has exactly the required revenue amount in revenue sharing built into its expense ratio—let's say 0.20 percent or 20 basis points as an example—no additional fees or rebates are needed.

If revenue sharing in the fund exceeds required revenue—for instance, 0.25 percent or 25 basis points—the recordkeeper credits each participant who has assets in the fund with the amount of the excess. In our example, the revenue sharing would exceed required revenue by 0.05 percent, resulting in a 5 basis-point credit returned to participants. Meanwhile, if the fund provides less than



the required revenue amount, the recordkeeper would add a billed fee in the amount of the shortfall to the accounts of each participant using the investment.

The benefit of either of these fee-leveling approaches is that the plan sponsor can combine the use of both revenue sharing funds and institutional classes to arrive at the best net cost lineup. The drawback is that each service provider offers its own accounting methodologies based on its system's capabilities for fee-leveling, which can make a difference in how fees get allocated back and how often. Additionally, lots of debits and credits on each fund within participant accounts can create investor confusion.

Plan Sponsor Considerations

Each methodology has its own potential advantages and considerations. There is no single correct approach to fee allocation. In most cases, philosophical perspectives will drive an organization's fee allocation decision. Plan sponsors should speak with their advisors about which fee allocation model might make the most sense for their organization. Contemplating a consistent approach to pay for fees can assist fiduciaries in fulfilling their plan oversight responsibilities while providing continuity in future decision-making.

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