A Framework for Key Recordkeeping Fee Decisions

How plan sponsors allocate plan fees to participants is a key fiduciary responsibility.

By Julie Yusko

Americans held nearly $9 trillion in defined contribution plan assets as of the end of 2019[1] — a figure that has doubled in the last ten years. According to the U.S. Department of Labor (DOL), there are 662,829 defined contribution retirement plans in the U.S., covering more than 100 million total participants[2].

With figures like these, it should come as no surprise that these plans receive a lot of attention and scrutiny, or that plan fiduciaries are on alert to the potential target that is on their backs. Plan sponsor surveys consistently rank plan fees as a primary area of focus for plan fiduciaries.

In 2019, settlement dollars totaled approximately $193 million from ERISA lawsuits that challenged the fees associated with defined contribution plans[3]. To put this into perspective, ERISA is expansive, and this represents about half of the ERISA settlements that were reached last year.

One of the most notable settlements of 2019 was *Tussey v. ABB*, a case whose history goes all the way back to 2006. The settlement provided for an award of $55 million to the plaintiffs, with $18.3 million going to the plaintiffs' attorneys. Among the allegations made by Tussey, was that ABB failed to monitor revenue sharing and negotiate rebates from their recordkeeper and failed to utilize lower-cost share classes; all things they should have done considering the size of their plan. However, smaller plans should not feel immune — Gucci was also among the employers that settled their class action suit last year and its plan held fewer than $100 million in assets.

With the eruption of excessive fee litigation since the mid-2000s and then the enactment of DOL fee disclosure regulations, plan fiduciaries have spent considerable time and energy focusing on monitoring and benchmarking plan fees and trying to negotiate fee reductions. Plan sponsors have been successful in these benchmarking efforts as recordkeeping fees have steadily declined through scaling efficiencies and competition. Plan sponsors that have made benchmarking their plan's fees a regular practice have not seen fees move significantly in more recent efforts. However, as recordkeeping fees may be reaching their floor, the discussions have not ended there. The lessons taken from the settlement terms in *Tussey v. ABB* illustrate the importance of understanding not only how fees are charged to the plan and determining whether they are reasonable for the services received, but also how fees are allocated across plan participants.

There are several key recordkeeping fee decisions that are important for prudent plan fiduciaries to analyze carefully. More often than in the past, when plan sponsors benchmark their plan fees, they often use the opportunity to evaluate the way fees are allocated to participants and to make changes to the way fees are paid.

Three key recordkeeping fee decisions that go directly to the heart of the question of how fees should be allocated across participants are discussed below. First is the decision as to the type of recordkeeping fee structure. Second is the decision around using a lowest-cost share class strategy for the investment menu versus a revenue

[1] Investment Company Institute. 2019. "The US Retirement Market, Fourth Quarter 2019" (March 2020).

[2] DOL Employee Benefits Security Administration, "Private Pension Plan Bulletin: Abstract of 2017 Form 5500 Annual Reports", September 2019.

[3] Bloomberg Law, Jacklyn Wille, "ERISA Class Settlements Rebounded to $449 Million in 2019", Dec. 26, 2019. https://www.bloomberglaw.com/document/X2OP8RK8000000?bna_news_filter=employee-benefits&jcsearch=BNA%25200000016ef65bdc41adfefffb378d0001#jcite

sharing model. Last is the decision of how to apply revenue sharing when there is an active decision to use that model or when it is unavoidable.

Recordkeeping Fee Structure

There are various cost structures that are common. Most notably are the per capita, or per participant, fee structure and the pro rata, or asset-based, fee structure. The per-participant method is a fixed annual charge, typically charged quarterly, that spreads the cost of recordkeeping equally across all participants regardless of the size of their account balance. The asset-based method is typically quoted in basis points or as a percentage of plan assets. In this method, fluctuations in the size of a participant's account balance will determine that participant's share of recordkeeping fees. However, also true is that as the amount of assets in the plan fluctuates, so does the compensation received by the plan recordkeeper. Given the growth in defined contribution assets over the last decade and beyond, in the aggregate, this method has benefited recordkeepers immensely.

In recent years, more plan sponsors have considered implementing, or have implemented, a shift of all or a portion of the recordkeeping fees to a per-participant allocation method. Although this shift has been most pronounced in the large end of the market, it has quickly moved down market. Yet still, overwhelmingly among small plans, fees based on assets, whether it is a level asset-based fee or revenue sharing, remains the norm. Often, plan sponsors that have implemented the per-participant method recount that decisions are made to achieve greater transparency around the plan fees and to eliminate the fee fluctuations that may be attributable to market volatility and account growth. Furthermore, by decoupling the recordkeeping fees from the investment fees, plan sponsors can institute a policy of utilizing the lowest-cost share classes for the investments offered within their plan.

Lowest-Cost Strategy vs. Revenue Sharing Model

Revenue sharing has been a common practice historically. In this model, a recordkeeper receives a portion of basis points charged on the investments as compensation for the administration, marketing, distribution, and/or accounting costs related to having that fund available on their recordkeeping platform. However, it was not until DOL regulations required recordkeepers, and other plan service providers, to supply plan sponsors with full disclosure of all the compensation they receive related to the plan that this practice was brought to the forefront. It became abundantly clear that recordkeeping was not a "free" service.

The fee disclosure requirements increased transparency. As plan sponsors began analyzing plan fees from various angles, the debates around the impact of the revenue-sharing model on different participant groups also began. In a typical investment menu, revenue-sharing amounts may vary greatly across funds. When participants make fund allocation decisions in their plan, their choices will likely vary, leading them to pay different amounts of fees for investments and recordkeeping.

In light of fee litigation trends, and the likely enduring trend of plan sponsors moving to per-participant fee structures, the use of the revenue-sharing model has sharply declined. More and more plan sponsors have moved towards adopting investment menus that exclusively include the lowest-cost share classes of the funds they select. Mutual fund companies have responded to the demand by launching more share classes that eliminate revenue sharing. However, revenue sharing, even in the lowest-cost share classes, may be inevitable in some cases.

Application of Revenue Sharing

When revenue sharing cannot be eliminated, either by an active decision by the plan fiduciaries or because an alternative share class without revenue sharing is unavailable, the plan sponsor needs to reconcile how they will handle the revenue-sharing amounts that are generated.

Fee leveling, or neutralization, is an approach that seeks to reverse the effect of revenue sharing within the plan. Participants in funds with revenue sharing receive a direct credit based on their specific allocation to the given fund. Most recordkeepers can handle fee leveling, but their approaches may vary considerably. Plan fiduciaries that pursue this option should do their due diligence and understand how the process will be managed.

What is the Right Answer?

The DOL has provided limited guidance, and beyond the general fiduciary requirements proscribed by ERISA, there is also limited legal guidance that specifically addresses how fees should be allocated across plan participants. There are no guarantees that one method will provide greater fiduciary protection. The DOL acknowledges that plan sponsors have considerable discretion provided that a prudent process is followed that considers various allocation methods, the implications of these methods on different groups of participants, and that there is a rational basis for the method that is chosen.

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